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Sick Pay Reporting

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Introduction

This publication is written primarily for employers and third-party payers of sick pay. It discusses the federal employment tax rules that apply to sick pay, including special rules that split employment tax responsibilities between the employer and a third-party payer. The publication explains:

- What payments are sick pay subject to social security tax, Medicare tax, federal unemployment (FUTA) tax, and federal income tax withholding,
- Who is liable for the employment taxes on sick pay (the employer or the third-party payer), and
- How employers and third-party payers report sick pay on Forms W-2, W-3, 940, and 941.

What is not discussed. This publication covers only federal taxes. It does not cover any state or local taxes on sick pay. It also does not cover the special procedures for filing Forms W-2 on magnetic media.

The publication does not discuss disability retirement payments. These payments are subject to the rules for income tax withholding from pensions and annuities. See Circular E for information.

Also, the publication does not discuss the income tax rules that apply to the recipient of sick pay or other payments received for injury or disability. See Publication 907 for information on these rules.

Useful Items

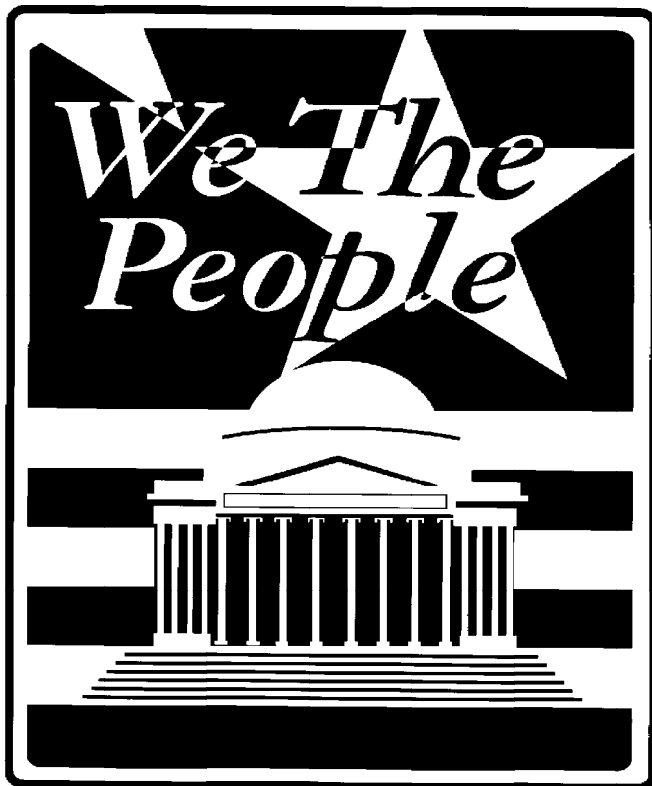
You may want to see:

Publication

- 15** Circular E, Employer's Tax Guide
- 907** Information for Persons With Handicaps or Disabilities
- 937** Employment Taxes and Information Returns

Form (and Instructions)

- W-2** Wage and Tax Statement



- ❑ **W-3** Transmittal of Income and Tax Statements
- ❑ **W-4** Employee's Withholding Allowance Certificate
- ❑ **W-4S** Request for Federal Income Tax Withholding From Sick Pay
- ❑ **940** Employer's Annual Federal Unemployment (FUTA) Tax Return
- ❑ **941** Employer's Quarterly Federal Tax Return

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Definitions

Certain key terms are given special definitions in this publication that may differ from your understanding of these terms. It is important to keep these definitions in mind when reading the publication.

- **Sick pay** generally means any amount paid under a plan because of an employee's temporary absence from work due to injury, sickness, or disability. Sick pay may also be called payments on account of sickness or accident disability. It may be paid by either the employer or a third party, such as an insurance company. Sick pay includes both short-term and long-term benefits. It is often expressed as a percentage of the employee's regular wages.
- An **agent of the employer** is a third party that bears no insurance risk and is reimbursed on a cost-plus-fee basis for payment of sick pay and similar amounts. A third party may be an agent of the employer even if the third party is responsible for determining which employees are eligible to receive payments. For example, if a third party provides administrative services only, the third party is an agent of the employer. If the third party is paid an insurance premium and is not reimbursed on a cost-plus-fee basis, the third party is not an agent of the employer. Whether an insurance company or other third party is an agent of the employer depends on the terms of the agreement with the employer.
- A **definite plan or system** means a plan or system established by an employer under which sick pay is available to employees generally or to a class or classes of employees. A definite plan or system is not present if the benefits are provided on a discretionary or occasional basis with merely a good intention to aid particular employees in time of need. The existence of a plan or system is shown if the plan or system is in writing or otherwise made known to employees, such as by a bulletin board notice or the long and established practice of the employer. Other

indications of the existence of a plan or system include, but are not limited to, references to the plan or system in the contract of employment, employer contributions to a plan, or segregated accounts for the payment of benefits.

- The **employer for whom the employee normally works** is either the employer for whom the employee was working at the time the employee became sick or disabled or the last employer for whom the employee worked before becoming sick or disabled, if that employer made contributions to the sick-pay plan on behalf of the sick or disabled employee.

Social Security, Medicare, and FUTA Taxes on Sick Pay

Employer. If the employer pays sick pay, the employer must generally withhold employee social security and Medicare taxes on the sick pay. The employer must timely deposit employee and employer social security and Medicare taxes and federal unemployment (FUTA) tax. There are no special deposit rules for sick pay. See Circular E for more information on the deposit rules.

Employer's agent. A third party that makes payments of sick pay as an **agent of the employer** (defined earlier) is not considered the employer and generally has no responsibility for employment taxes. This responsibility remains with the employer. However, under an exception to this rule, the parties may enter into an agreement that makes the third-party agent responsible for employment taxes. In this situation, the third-party agent should use its own name and EIN (rather than the employer's name and EIN) for the responsibilities it has assumed.

Third party not employer's agent. A third party that makes payments of sick pay **other than as an agent of the employer** is liable for the employee part of the social security and Medicare taxes. The third party is also liable for the employer part of the social security and Medicare taxes and the FUTA tax, unless the third party transfers this liability to the **employer for whom the employee normally works** (defined earlier). This liability is transferred to the employer for whom the employee normally works if the third party:

- 1) Withholds the **employee** social security and Medicare taxes from the sick pay payments,
- 2) Makes timely deposits of the **employee** social security and Medicare taxes, and
- 3) Notifies the employer for whom the employee normally works of the payments on which employee taxes were withheld and deposited. The third party must notify the employer within the time required for the

third party's deposit of the employee part of the social security and Medicare taxes. For instance, if the third party is a monthly depositor, it must notify the employer by the 15th day of the month following the month in which the sick pay payment is made, because that is the day by which the deposit is required to be made. For multi-employer plans, see the special rule discussed next.

Multi-employer plan timing rule. A special rule applies to sick pay payments made to employees by a third-party insurer under an insurance contract with a multi-employer plan established under a collectively bargained agreement. If the third-party insurer making the payments complies with (1) and (2) above and gives the plan (rather than the employer) the required timely notice described in (3) above, then the plan (not the third-party insurer) must pay the employer part of the social security and Medicare taxes and the FUTA tax. Similarly, if, within 6 business days of the plan's receipt of notification, the plan gives notice to the employer for whom the employee normally works, the employer (not the plan) must pay the employer part of the social security and Medicare taxes and the FUTA tax.

Amounts not subject to social security, Medicare, or FUTA tax. The following payments, whether paid by the employer or a third party, are not subject to social security, Medicare, or FUTA tax (different rules apply to income tax withholding):

- 1) Amounts paid under a definite plan or system, as defined earlier, on or after the termination of the employment relationship because of death or disability retirement.

However, even if there is a definite plan or system, amounts paid to a former employee are subject to social security, Medicare, and FUTA taxes if they would have been paid even if the employment relationship had not terminated because of death or disability retirement. For example, a payment to a disabled former employee for unused vacation time would have been made whether or not the employee retired on disability. The payment is therefore wages for social security, Medicare, and FUTA tax purposes.
- 2) Payments to the employee's estate or survivor after the calendar year of the employee's death.
- 3) Payments to an employee when the employee is entitled to disability insurance benefits under section 223(a) of the Social Security Act. This rule applies only if the employee became entitled to the Social Security Act benefits before the calendar year in which the payments are made, and the employee performs no service for the employer during the period for which the payments are made. **Note:** These payments **are** subject to FUTA tax.
- 4) Payments that exceed the applicable wage base. The social security tax wage base for 1994 is \$60,600. There is no wage base for Medicare tax. The FUTA

tax wage base is \$7,000. For example, if an employee receives \$58,000 in wages from an employer in 1994, and then receives \$3,000 of sick pay, only the first \$2,600 of the sick pay is subject to social security tax. All of the sick pay is subject to Medicare tax. None of the sick pay is subject to FUTA tax. See *Example of Figuring and Reporting Sick Pay*, later.

- 5) Payments made, on account of sickness or accident disability, more than 6 calendar months after the last calendar month in which the employee worked. For example, if the employee's last day of work was December 11, 1993, payments of sick pay made after June 30, 1994, are not subject to social security, Medicare, or FUTA tax. If the employee returns to work for one day on February 19, 1994, the 6-month period would begin again, and only those payments made after August 31, 1994, would not be subject to these taxes.
- 6) Payments received under a workers' compensation law. However, this exception does not apply to payments to state and local government employees under a statute **in the nature** of a workers' compensation act, even though these payments are exempt from income tax and income tax withholding. See *Workers' compensation paid to state and local government employees*, later.
- 7) Payments of medical and hospitalization expenses of employees, spouses, and dependents, and insurance premiums for this coverage, if paid under a definite plan or system (defined earlier).
- 8) Payments, or parts of payments, attributable to **employee contributions** to a sick-pay plan made with **after-tax** dollars. (Contributions to a sick-pay plan made on behalf of employees with employees' **pre-tax** dollars under a cafeteria plan are **employer contributions**.)

Group policies rule. Special rules apply to situations in which both the employer and the employees contribute to a group insurance policy. If, at the beginning of the calendar year in which sick pay is paid, the net cost for group insurance coverage for 3 or more policy years is known, the part of the sick pay attributable to employer contributions is determined by multiplying the sick pay by a fraction. The numerator of the fraction is the net premiums contributed by the employer for the last 3 policy years. The denominator is the net premiums contributed by the employer and all employees for those years.

If the net premiums for group coverage for 3 or more policy years are not known at the beginning of the calendar year, but are known for at least 1 policy year, the determination is made by using the net premiums for the coverage that are known at the beginning of the calendar year. If the net premiums for the coverage are not known at the beginning of the calendar year for even 1 policy year, the determination is made by using either (1) a reasonable estimate of the net premiums for the

first policy year, or (2) the net premiums for a policy year, if the net premiums are ascertained during the calendar year. Also, see *Example of Figuring and Reporting Sick Pay*, later.

- 9) Accident or health insurance payments unrelated to absence from work. These include payments for:
 - a) Permanent loss of a member or function of the body,
 - b) Permanent loss of the use of a member or function of the body, or
 - c) Permanent disfigurement of the body, but only if the payments are based on the nature of the injury and not the period the employee is absent from work. See *Example of Figuring and Reporting Sick Pay*, later.

Reliance on information supplied by the employer. To determine the amounts not subject to employment taxes, the third party may need to request information from the employer relating to some of the exceptions listed earlier. Unless the third party has reason not to believe the information, the third party may rely on it as to the following items:

- 1) The total wages paid by the employer to the employee during the calendar year,
- 2) The last month in which the employee worked for the employer, and
- 3) The employee contributions to the sick-pay plan made with after-tax dollars.

The third party should not rely on statements regarding these items made by the employee.

Workers' compensation paid to state and local government employees. State and local government employees, such as police officers and firefighters, sometimes receive payments due to injury in the line of duty under a statute that is **not** the general workers' compensation law of a state. If the statute limits benefits to work-related injuries or sickness and does not base payments on the employee's age, length of service, or prior contributions, the statute is "in the nature of" a worker's compensation act. Payments under the statute are not subject to FUTA tax or federal income tax withholding, but they are subject to social security and Medicare taxes to the same extent that the employee's regular wages are subject to social security and Medicare taxes. State and local government employers should not rely on any prior guidance indicating that payments under a statute "in the nature of" a workers' compensation act are exempt from social security and Medicare taxes.

Example. State S entered into an agreement under section 218 of the Social Security Act, under which social security coverage is provided for many employees of State S, including all employees of Cash County. Wages paid to employees covered under the section 218 agreement are subject to social security and Medicare taxes.

Bob, an employee of Cash County, was injured in a job-related accident on January 26,

1994. Bob received sick pay for 8 months (February 1994 through September 1994) under a Cash County ordinance that provides benefits for county employees injured in work-related accidents. Cash County's ordinance is entirely separate and distinct from the general workers' compensation law of State S.

Under Cash County's ordinance, an employee temporarily injured in the line of duty is entitled to sick pay for a period of up to 12 months. The payments are equal to 75% of the employee's regular salary payments during the last full month of employment before the job-related injury. The payments are not based on the employee's age or years of service or employee contributions. The payments are made by a third-party insurance company that is not an agent of Cash County. During the policy year of Bob's injury, Cash County paid 100% of the insurance premiums. Thus, the plan is not a "contributory plan."

The payments under Cash County's ordinance are paid under a statute "in the nature of a workers' compensation act." Therefore, the payments are excludable from gross income and are not subject to income tax withholding. However, because the payments are not paid under the general workers' compensation law of State S, the February through July payments are subject to social security tax, if the applicable wage base has not been exceeded, and Medicare tax. The insurance company may transfer to Cash County the liability for the employer part of these taxes under the same rules that would apply if Cash County were a private employer.

Income Tax Withholding on Sick Pay

The requirements for income tax withholding on sick pay and the methods for figuring it differ depending on whether the sick pay is paid by:

- 1) The employer,
- 2) An agent of the employer (defined earlier), or
- 3) A third party that is not an agent.

Liability for the withheld income tax is determined under the same rules that apply to withheld employee social security and Medicare taxes. See *Social Security, Medicare and FUTA Taxes on Sick Pay*, earlier.

Employer or employer's agent. Sick pay paid by the employer or the employer's agent is subject to mandatory income tax withholding. An employer or agent paying sick pay generally determines the income tax to be withheld based on the employee's Form W-4. The employee cannot choose how much will be withheld by giving the employer or agent a Form W-4S. Sick pay paid by an agent is treated as supplemental wages. If the agent does not pay regular wages to the employee, the agent may choose to withhold income tax at a flat 28% rate, rather than at the wage withholding rate.

Third party not an agent. Sick pay paid by a third party *not an agent* of the employer is not subject to mandatory income tax withholding, but an employee may elect to have income tax withheld by filing Form W-4S with the third party.

If Form W-4S has been filed, the third party should withhold income tax on all payments of sick pay made 8 or more days after receiving the form. The third party may, at its option, withhold income tax before 8 days have passed.

The third party may allow the employee to choose to have either a specific percentage (with a minimum of 10%) or a specific whole dollar amount withheld from sick pay. However, if the requested withholding would reduce any net payment below \$10, the third party should not withhold any income tax from that payment. The minimum whole-dollar amount that the employee can specify is \$20 a week.

If a particular payment is less than or greater than a regular payment, the amount withheld must be in the same proportion to the particular payment as the regular withholding is to a regular payment. For example, if \$25 is withheld from a regular full payment of \$100, then \$20 should be withheld from a partial payment of \$80.

Amounts not subject to income tax withholding. The following amounts, whether paid by the employer or a third party, are not wages subject to income tax withholding.

- 1) Payments received under a workers' compensation law or a statute in the nature of a workers' compensation act.
- 2) Payments, or parts of payments, attributable to employee contributions made to a sick-pay plan with after-tax dollars under the rules discussed earlier under *Amounts not subject to social security, Medicare, or FUTA tax.*
- 3) Accident or health insurance payments unrelated to absence from work explained earlier under *Amounts not subject to social security, Medicare, or FUTA tax.*
- 4) Amounts received by an employee, spouse, or dependent under an accident or health plan as a reimbursement of medical expenses. (**Note:** A reimbursement of medical expenses may be subject to federal income tax if the expenses were deducted on the employee's income tax return for a prior year. See Publication 502, *Medical Expenses.*)
- 5) Payments made to the employee's estate or survivor at any time after the employee's death.

Depositing and Reporting

This section discusses who is liable for depositing social security, Medicare, FUTA, and withheld income taxes on sick pay. These

taxes must be deposited under the same rules that apply to deposits of taxes on regular wage payments. See Circular E for information on the deposit rules.

This section also explains how sick pay should be reported on Forms W-2, W-3, 940, and 941. For additional information covering specific line numbers and box numbers on these forms, see *Completing Forms 941, W-2, and W-3*, later.

Employer or agent of employer. If the employer or agent of the employer (defined earlier) makes sick pay payments, the employer deposits taxes and files Forms W-2, W-3, 940, and 941 under the same rules that apply to regular wage payments.

However, the agreement between the parties may require the third-party agent to carry out responsibilities that would otherwise have been borne by the employer. In this situation, the third-party agent should use its own name and EIN (rather than the employer's name and EIN) for the responsibilities it has assumed.

Third party. The rules for a third party that is not an agent of the employer depend on whether liability has been transferred as discussed under *Social Security, Medicare, and FUTA Taxes on Sick Pay*, earlier.

To figure the due dates and amounts of its deposits of employment taxes, a third party should combine:

- 1) The liability for the wages paid to its own employees, and
- 2) The liability for payments it made to all employees of all its clients. This does not include liability that has been transferred to the employer.

Liability Not Transferred

If the third party does not satisfy the requirements for transferring liability for FUTA tax and the employer's part of the social security and Medicare taxes, the third party reports the sick pay on its own Forms 940 and 941.

The third party must deposit social security, Medicare, FUTA, and withheld income taxes using its own name and EIN. The third party must give each employee to whom it paid sick pay a Form W-2 by January 31 of the following year. The Form W-2 must include the third party's name, address, and EIN; the employee's name, address, and social security number; and the following information:

- 1) The sick pay the employee must include in income (box 1),
- 2) Any federal income tax withheld from the sick pay (box 2),
- 3) The sick pay subject to employee social security tax (box 3),
- 4) The employee social security tax withheld from the sick pay (box 4),
- 5) The sick pay subject to employee Medicare tax (box 5),
- 6) The employee Medicare tax withheld (box 6),

- 7) Any amount not subject to federal income tax because the employee contributed to the sick-pay plan (box 13).

In this situation, the employer has no tax responsibilities for sick pay.

Liability Transferred

Generally, if a third party satisfies the requirements for transferring liability for the employer part of the social security and Medicare taxes and for the FUTA tax, the following rules apply:

Deposits. The third party must make deposits of withheld employee social security and Medicare taxes and withheld income tax using its own name and EIN. The employer must make deposits of the employer part of the social security and Medicare taxes and the FUTA tax using its own name and EIN. In applying the deposit rules, the employer's liability for these taxes begins upon receiving the third party's notice of sick pay payments.

Form 941. The third party and employer must each file Form 941. Line 9 of each Form 941 must contain a special adjusting entry for social security and Medicare taxes. These entries are required because the total tax liability for social security and Medicare taxes (employee and employer parts) is split between the employer and the third party.

Employer. The employer must include third-party sick pay on lines 2, 6a, and 7 of Form 941. After completing line 8, the employer subtracts on line 9 the employee social security and Medicare taxes withheld and deposited by the third party. The employer enters the sick pay amount on line 9 and in the space provided on the left. If line 9 includes adjustments unrelated to sick pay, the employer shows those amounts in the spaces provided, and the total is shown in the line 9 box on the right. (See *Figure 1*, later.)

Third party. The third party must include on Form 941 the employee part of the social security and Medicare taxes (and income tax, if any) withheld by the third party. The third party does not include on line 2 any sick pay paid as a third party, but does include on line 3 any income tax withheld. On line 6a, the third party enters the total amount the third party paid subject to social security taxes. This amount includes both wages paid to its own employees and sick pay paid as a third party. The third party completes line 7 in a similar manner. On line 9, the third party subtracts the part of the social security and Medicare taxes the employer must pay. The third party enters the sick pay amount on line 9 and in the space provided to the left for sick pay. If line 9 includes adjustments unrelated to sick pay, the third party shows those amounts in the spaces provided and enters the total of all adjustments in the line 9 box. (See *Figure 4*, later.)

Dummy Forms W-2 and W-3. The third party must prepare "dummy" Forms W-2 and a "dummy" Form W-3. These forms do not reflect sick pay paid to individual employees, but instead show the combined amount of sick pay

paid to all employees of all clients of the third party. The dummy forms provide a means of reconciling the wages shown on the third party's Form 941. However, see *Optional Rule for Form W-2*, later.

The third party fills out the dummy Form W-2 as follows (See *Figure 5*, later).

Box b – the third party's EIN.

Box c – the third party's name and address.

Box e – "Third-party sick pay" in place of the employee's name.

Box 1 – total sick pay paid.

Box 2 – any federal income tax withheld from the sick pay.

Box 3 – the sick pay subject to employee social security tax.

Box 4 – employee social security tax withheld from sick pay.

Box 5 – the sick pay subject to employee Medicare tax.

Box 6 – the employee Medicare tax withheld from the sick pay.

The third party attaches the dummy Form W-2 to a separate Form W-3, of which only boxes b, e, f, g, 1, 2, 3, 4, 5, 6, 13, and 14 are completed. The third party makes no entry in box 15 of Form W-3. (See *Figure 7*, later.) The employer provides information in box 15 of its Form W-3.

Sick-pay statement. The third party must furnish the employer with a sick-pay statement by January 15 of the year following the year in which the sick pay was paid. The statement must show the following information about each employee who was paid sick pay:

- 1) The employee's name,
- 2) The social security number of the employee (if social security, Medicare, or income tax was withheld),
- 3) The sick pay paid to the employee,
- 4) Any federal income tax withheld,
- 5) Any employee social security tax withheld, and
- 6) Any employee Medicare tax withheld.

Form W-2. The employer must generally prepare Forms W-2 for the sick pay, but see *Optional Rule for Form W-2*, later. The employer may either combine the sick pay with other wages and prepare a single Form W-2 for each employee or may prepare separate Forms W-2 for each employee, one reporting sick pay and the other reporting regular wages. A Form W-2 must be prepared even if all the sick pay is nontaxable. All Forms W-2 must be given to the employees by January 31.

The Form W-2 filed for the sick pay must include the following information:

- 1) The employer's name, address, and EIN,
- 2) The employee's name, address, and SSN,

- 3) The sick pay the employee must include in income (box 1),
- 4) Any federal income tax withheld from the sick pay (box 2),
- 5) The sick pay subject to employee social security tax (box 3),
- 6) The employee social security tax withheld from the sick pay (box 4),
- 7) The amount of sick pay subject to employee Medicare tax (box 5),
- 8) The employee Medicare tax withheld (box 6),
- 9) Any amount not subject to federal income tax because the employee contributed to the sick-pay plan (box 13, enter Code "J").

Form 940. The employer, not the third party, must prepare Form 940 for sick pay.

Optional Rule for Form W-2

The third party and the employer may choose to enter into a legally binding agreement designating the third party to be the employer's agent for purposes of preparing Forms W-2 reporting sick pay. The agreement must specify what part, if any, of the payments under the sick-pay plan is excludable from the employees' gross incomes because it is attributable to their contributions to the plan. If the parties enter into an agreement, the third party prepares the actual Forms W-2, not dummy Forms W-2 as discussed earlier, for each employee who receives sick pay from the third party. If the optional rule is used:

- 1) The third party does not provide the employer with the sick-pay statement described earlier, and
- 2) The employer (not the third party) prepares dummy Forms W-2 and W-3. These dummy forms are needed to reconcile the sick-pay shown on the employer's Form 941.

Example of Figuring and Reporting Sick Pay

Alan, an employee, was seriously injured and lost an eye in a car accident on January 1, 1994. Alan's last day of work was December 30, 1993. The accident was not job-related.

Key, an insurance company that was not an agent of the employer, paid Alan \$2,000 each month for 10 months, beginning in January 1994, and ending in October 1994. In March 1994, Alan received a lump-sum of \$5,000 from Key as compensation for the loss of the eye. This payment was determined according to the type of injury and qualifies as a payment unrelated to absence from work, as discussed earlier. Alan filed a Form W-4S with Key, requesting 15% federal income tax withholding. Alan received no payments from Edgewood, his employer, from January 1994 through October 1994. Alan returned to work in November 1994.

For the policy year in which the car accident occurred, Alan paid a part of the premiums for his coverage, and Edgewood paid the remaining part. The plan was, therefore, a "contributory plan." During the 3 policy years before the calendar year of the accident, Edgewood paid 70% of the total of the net premiums for its employees' insurance coverage, and Edgewood's employees paid 30%. No part of the premiums was paid with pre-tax dollars under a cafeteria plan.

Social security and Medicare taxes. No part of the \$5,000 lump-sum payment for loss of the eye is included in wages for social security and Medicare tax purposes, because the payment was determined according to the type of injury and qualifies as a payment unrelated to absence from work. For social security and Medicare tax purposes, wages are \$8,400 (\$2,000 per month \times 70% = \$1,400 wages per payment; \$1,400 \times 6 months = \$8,400 total wages). Only the six \$2,000 checks received by Alan from January through June are included in the calculation. The check received by Alan in July (the seventh check) was received more than 6 months after the month in which Alan last worked (December 1993).

Of each \$2,000 payment Alan received, 30% (\$600) is not subject to social security and Medicare taxes because the plan is contributory and Alan's after-tax contribution is considered to be 30% of the premiums during the 3 policy years before the calendar year of the accident.

FUTA tax. No part of the \$5,000 lump-sum payment is included in wages for FUTA tax purposes. FUTA wages are \$7,000. (The total wages of \$8,400, calculated in the same manner as for social security and Medicare taxes, exceed the FUTA contribution base of \$7,000).

Income tax withholding. No part of the \$5,000 lump-sum payment is subject to income tax withholding. Of each \$2,000 payment, \$1,400 (\$2,000 \times 70%) is subject to voluntary income tax withholding at the 15% rate requested on Form W-4S. Therefore, \$210 was withheld from each payment.

Liability transferred. For the first 6 months following the last month in which Alan worked, Key is liable for social security, Medicare, and FUTA taxes on any payments that constitute taxable wages. However, Key may shift the liability for the employer part of the social security and Medicare taxes (and for the FUTA tax) during the first 6 months by withholding Alan's part of the social security and Medicare taxes, timely depositing the taxes, and notifying Edgewood of the payments.

If Key shifts liability for the employer part of the social security and Medicare taxes to Edgewood and provides Edgewood with a sick-pay statement, then Key does not prepare a Form W-2 for Alan. However, Key must prepare dummy Forms W-2 and W-3. Key and Edgewood must each prepare Form 941. Edgewood must also prepare Forms W-2, W-3, and 940. See *Completing Forms 941, W-2, and W-3*, later.

As an alternative, the parties may use the optional rule described under *Optional Rule for Form W-2*, earlier. Under this rule, Key

prepares Form W-2 even though liability for the employer part of the social security and Medicare taxes has been shifted to Edgewood. Also, Key does not prepare a sick-pay statement, and Edgewood, not Key, prepares the dummy Forms W-2 and W-3 reflecting the sick pay shown on Edgewood's Form 941.

Liability not transferred. If Key does not shift liability for the employer part of the social security and Medicare taxes to Edgewood, Key must prepare Forms W-2 and W-3 as well as Forms 941 and 940. In this situation, Edgewood does not report the sick pay.

Payments received after 6 months. The payments received by Alan in July through October are not subject to social security, Medicare, or FUTA taxes, because they were received more than 6 months after the last month in which Alan worked (December 1993). However, Key must continue to withhold income tax from each payment because Alan furnished Key a Form W-4S. Also, Key must prepare Forms W-2 and W-3, unless it has furnished Edgewood with a sick-pay statement. If the sick-pay statement was furnished, then Edgewood must prepare Forms W-2 and W-3.

Completing Forms 941, W-2, and W-3

This section illustrates the completion of forms when the third party transfers the social security and Medicare tax liability to the employer. It also explains how the forms are completed if the liability is not transferred.

Third party transfers liability to employer.

During 1994, Cedar Company, the employer (Cedar), paid its employees \$250,000 in social security and Medicare wages. Included in this figure is \$20,000 paid to Tracy Terry during the

second, third, and fourth quarters. In the first quarter of 1994, Cedar paid \$50,000 in social security and Medicare wages.

Ajax Company, the third party (Ajax), paid Tracy \$5,000 of sick pay during the first quarter. Ajax withheld income taxes and the employee part of social security and Medicare taxes from the \$5,000. Ajax deposited these taxes and gave timely notice of the wages paid on which the taxes were withheld and deposited. By taking these steps, Ajax transferred the employer tax liability to Cedar.

During 1994, Ajax paid its employees \$120,000 in social security and Medicare wages. Ajax paid \$200,000 of sick pay to employees of its clients. In the first quarter of 1994, Ajax paid \$30,000 in social security and Medicare wages to its employees and \$50,000 of sick pay to employees of its clients (including the \$5,000 to Tracy).

During the first quarter of 1994, Ajax ascertained that it had overpaid social security taxes by \$2,000 for the third quarter of 1993.

The optional rule for Form W-2 (discussed earlier) is not used. Ajax and Cedar complete Forms 941, W-2, and W-3 as follows:

Employer (Cedar). On Form 941 (Figure 1) for the first quarter, Cedar reports \$55,000 in total wages subject to withholding on line 2. This figure includes the \$5,000 in sick pay Ajax paid to Tracy. However, because Ajax withheld and deposited Tracy's part of social security and Medicare taxes (\$382.50) on the \$5,000, Cedar reports an adjustment to these taxes by entering \$382.50 on line 9 and in the space marked "Sick Pay" at the left.

By January 31, 1995, Cedar issues a Form W-2 (Figure 2) to Tracy. The form combines the \$20,000 of wages Cedar paid her and the \$5,000 of sick pay Ajax paid her. It also combines the taxes withheld by both companies. On its Form W-3 (Figure 3), Cedar shows the income tax withheld by Ajax on Tracy's sick pay (box 15).

Third party (Ajax). On Form 941 (Figure 4) for the first quarter, Ajax reports on line 2 the \$30,000 total wages subject to withholding it paid its employees. Because Ajax paid \$50,000 in sick pay to employees of its clients, Ajax reports \$80,000 of taxable social security wages on line 6a and \$80,000 of taxable Medicare wages on line 7. Because Ajax transferred the employer tax liability to its clients, Ajax adjusts social security and Medicare taxes by \$3,825 on line 9. Ajax also adjusts the \$2,000 overpayment for the third quarter of 1993 on line 9. Ajax details this adjustment on Form 941c (not shown), which Ajax attaches to Form 941. The adjustment for the prior quarter is shown in the space for "Other" and total adjustments are shown in the box for line 9.

After the end of the year, Ajax prepares a dummy Form W-2 (Figure 5) to report all sick pay it paid employees of its clients in 1994. It prepares two Forms W-3, one for its own employees (Figure 6) and one for the dummy Form W-2 (Figure 7).

Third party does not transfer liability to employer (not illustrated).

The employer reports on Form 941 only the wages it paid to its employees. The employer does not include on lines 2, 6a, and 7 the sick pay the third party paid to the employees.

The third party includes on lines 2, 6a, and 7 of Form 941 the sick pay paid to the insured employees.

The employer and the third party must each issue a Form W-2 to each employee who received wages from the employer and sick pay from the third party. The employee's Form W-2 from the employer reflects only the wages paid and taxes withheld by the employer. The Form W-2 from the third party reflects only the sick pay paid and the taxes withheld by the third party.

Figure 1

Employer's Quarterly Federal Tax Return

4141

▶ See separate instructions for information on completing this return.

Please type or print.

Enter state code for state in which deposits made (see page 2 of instructions).

DD 10-7654321 APR94 S28 C
CEDAR CO. (Employer)
1111 NORTH STREET
HOME CITY MN 55000

Number
R
S

OMB No. 1545-0029

T
FF
FD
FP
I
T

If address is different from prior return, check here ▶ <input type="checkbox"/>	1	1	1	1	1	1	1	1	1	2	3	3	3	3	3	4	4	4							
	5	5	5	6	7	8	8	8	8	8	9	9	9	9	9	10	10	10	10	10	10	10	10	10	10

If you do not have to file returns in the future, check here ▶ and enter date final wages paid ▶

If you are a seasonal employer, see **Seasonal employers** on page 2 and check here (see instructions) ▶

1	Number of employees (except household) employed in the pay period that includes March 12th ▶	10
2	Total wages and tips subject to withholding, plus other compensation	2 55000 00
3	Total income tax withheld from wages, tips, and sick pay	3 7000 00
4	Adjustment of withheld income tax for preceding quarters of calendar year	4
5	Adjusted total of income tax withheld (line 3 as adjusted by line 4—see instructions)	5 7000 00
6a	Taxable social security wages \$ 5500000 × 12.4% (.124) =	6a 6820 00
6b	Taxable social security tips \$ × 12.4% (.124) =	6b
7	Taxable Medicare wages and tips \$ 5500000 × 2.9% (.029) =	7 1595 00
8	Total social security and Medicare taxes (add lines 6a, 6b, and 7). Check here if wages are not subject to social security and/or Medicare tax. ▶ <input type="checkbox"/>	8 8415 00
9	Adjustment of social security and Medicare taxes (see instructions for required explanation) Sick Pay \$ 382.50 ± Fractions of Cents \$ ± Other \$ =	9 (382 50)
10	Adjusted total of social security and Medicare taxes (line 8 as adjusted by line 9—see instructions)	10 8032 50
11	Total taxes (add lines 5 and 10)	11 15032 50
12	Advance earned income credit (EIC) payments made to employees, if any	12
13	Net taxes (subtract line 12 from line 11). This should equal line 17, column (d) below (or line D of Schedule B (Form 941))	13 15032 50
14	Total deposits for quarter, including overpayment applied from a prior quarter	14 15032 50
15	Balance due (subtract line 14 from line 13). Pay to Internal Revenue Service	15
16	Overpayment , if line 14 is more than line 13, enter excess here ▶ \$ and check if to be: <input type="checkbox"/> Applied to next return OR <input type="checkbox"/> Refunded. <ul style="list-style-type: none"> • All filers: If line 13 is less than \$500, you need not complete line 17 or Schedule B. • Semiweekly depositors: Complete Schedule B and check here ▶ <input type="checkbox"/> • Monthly depositors: Complete line 17, columns (a) through (d) and check here ▶ <input checked="" type="checkbox"/> 	

17 Monthly Summary of Federal Tax Liability.			
(a) First month liability	(b) Second month liability	(c) Third month liability	(d) Total liability for quarter
5,006.00	5,007.50	5,019.00	15,032.50

Sign Here Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature ▶ *John Pine* Print Your Name and Title ▶ John Pine Owner Date ▶ 4/30/94

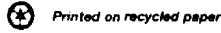


Figure 2

a Control number		OMB No. 1545-0008					
b Employer's identification number 10-7654321			1 Wages, tips, other compensation 25000.00	2 Federal income tax withheld 2500.00			
c Employer's name, address, and ZIP code CEDAR CO. (Employer) 1111 NORTH STREET HOME CITY, MN 55000			3 Social security wages 25000.00	4 Social security tax withheld 1550.00			
			5 Medicare wages and tips 25000.00	6 Medicare tax withheld 362.50			
			7 Social security tips	8 Allocated tips			
d Employee's social security number 472-00-1955			9 Advance EIC payment		10 Dependent care benefits		
e Employee's name, address, and ZIP code TRACY TERRY 102 STATE ROAD HOMETOWN, IA 52761			11 Nonqualified plans		12 Benefits included in box 1		
			13 See Instrs. for box 13		14 Other		
			15 Statutory employee <input type="checkbox"/>		Deceased <input type="checkbox"/>		Pension plan <input type="checkbox"/>
				Legal rep. <input type="checkbox"/>		942 emp. <input type="checkbox"/>	
				Subtotal <input type="checkbox"/>		Deferred compensation <input type="checkbox"/>	
16 State	Employer's state I.D. No.	17 State wages, tips, etc.	18 State income tax	19 Locality name	20 Local wages, tips, etc.	21 Local income tax	

Department of the Treasury—Internal Revenue Service

Form W-2 Wage and Tax Statement 1994

Copy B To Be Filed With Employee's FEDERAL Tax Return

This information is being furnished to the Internal Revenue Service.

Figure 3

DO NOT STAPLE

a Control number 33333		For Official Use Only ▶ OMB No. 1545-0008			
b Kind of Payer ▶	941 <input checked="" type="checkbox"/>	Military <input type="checkbox"/>	943 <input type="checkbox"/>	1 Wages, tips, other compensation 250000.00	2 Federal income tax withheld 27000.00
	CT-1 <input type="checkbox"/>	942 <input type="checkbox"/>	Medicare gov't. emp. <input type="checkbox"/>	3 Social security wages 250000.00	4 Social security tax withheld 15500.00
c Total number of statements 10	d Establishment number			5 Medicare wages and tips 250000.00	6 Medicare tax withheld 3625.00
e Employer's identification number 10-7654321			7 Social security tips	8 Allocated tips	
f Employer's name CEDAR CO. (Employer)			9 Advance EIC payments	10 Dependent care benefits	
1111 NORTH STREET HOME CITY, MN 55000			11 Nonqualified plans	12 Deferred compensation	
			13 Adjusted total social security wages and tips 250000.00		
g Employer's address and ZIP code			14 Adjusted total Medicare wages and tips 250000.00		
h Other EIN used this year			15 Income tax withheld by third-party payer 500.00		
i Employer's state I.D. No.					

Under penalties of perjury, I declare that I have examined this return and accompanying documents, and, to the best of my knowledge and belief, they are true, correct, and complete.

Signature ▶ John Pine Title ▶ Owner Date ▶ 1/31/95
 Telephone number (612) 111-1001

Form **W-3** Transmittal of Wage and Tax Statements 1994

Department of the Treasury
Internal Revenue Service

Figure 4

Form **941**
(Rev. January 1994)
Department of the Treasury
Internal Revenue Service

Employer's Quarterly Federal Tax Return

4141

▶ See separate instructions for information on completing this return.

Please type or print.

Enter state code for state in which deposits made (see page 2 of instructions).

DD 10-3456789 APR94 S28
AJAX CO. (Third Party)
111 SOUTH STREET
HOMETOWN FALLS MN 55001

OMB No. 1545-0029

T
FF
FD
FP
I
T

If address is different from prior return, check here ▶

1	1	1	1	1	1	1	1	1	1	2	3	3	3	3	3	3	4	4	4																					
5	5	5	6	7	8	8	8	8	8	9	9	9	9	9	9	9	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10

If you do not have to file returns in the future, check here ▶ and enter date final wages paid ▶
 If you are a seasonal employer, see **Seasonal employers** on page 2 and check here (see instructions) ▶

1	Number of employees (except household) employed in the pay period that includes March 12th			4
2	Total wages and tips subject to withholding, plus other compensation		30000	00
3	Total income tax withheld from wages, tips, and sick pay		8000	00
4	Adjustment of withheld income tax for preceding quarters of calendar year			
5	Adjusted total of income tax withheld (line 3 as adjusted by line 4—see instructions)		8000	00
6a	Taxable social security wages	\$ 80000 00	x 12.4% (.124) =	6a 9920 00
6b	Taxable social security tips	\$	x 12.4% (.124) =	6b
7	Taxable Medicare wages and tips	\$ 80000 00	x 2.9% (.029) =	7 2320 00
8	Total social security and Medicare taxes (add lines 6a, 6b, and 7). Check here if wages are not subject to social security and/or Medicare tax.			8 12240 00
9	Adjustment of social security and Medicare taxes (see instructions for required explanation) Sick Pay \$ 3825.00 ± Fractions of Cents \$ ± Other \$ 2000 =			9 5825 00
10	Adjusted total of social security and Medicare taxes (line 8 as adjusted by line 9—see instructions)			10 6415 00
11	Total taxes (add lines 5 and 10)			11 14415 00
12	Advance earned income credit (EIC) payments made to employees, if any			12
13	Net taxes (subtract line 12 from line 11). This should equal line 17, column (d) below (or line D of Schedule B (Form 941))			13 14415 00
14	Total deposits for quarter, including overpayment applied from a prior quarter			14 14415 00
15	Balance due (subtract line 14 from line 13). Pay to Internal Revenue Service			15
16	Overpayment, if line 14 is more than line 13, enter excess here ▶ \$ and check if to be: <input type="checkbox"/> Applied to next return OR <input type="checkbox"/> Refunded.			
	• All filers: If line 13 is less than \$500, you need not complete line 17 or Schedule B.			
	• Semiweekly depositors: Complete Schedule B and check here			▶ <input type="checkbox"/>
	• Monthly depositors: Complete line 17, columns (a) through (d) and check here			▶ <input checked="" type="checkbox"/>

17 Monthly Summary of Federal Tax Liability.			
(a) First month liability	(b) Second month liability	(c) Third month liability	(d) Total liability for quarter
4805.00	4805.00	4805.00	14415.00

Sign Here Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature ▶ *Dave Cougar* Print Your Name and Title ▶ Dave Cougar Comptroller Date ▶ 4/30/94



Figure 5

a Control number		OMB No. 1545-0008					
b Employer's identification number 10-3456789		1 Wages, tips, other compensation 200000.00		2 Federal income tax withheld 20000.00			
c Employer's name, address, and ZIP code AJAX CO. (Third Party) 111 SOUTH STREET HOMETOWN FALLS, MN 55001		3 Social security wages 200000.00		4 Social security tax withheld 12400.00			
		5 Medicare wages and tips 200000.00		6 Medicare tax withheld 2900.00			
		7 Social security tips		8 Allocated tips			
d Employee's social security number		9 Advance EIC payment		10 Dependent care benefits			
e Employee's name, address, and ZIP code Third-Party Sick Pay		11 Nonqualified plans		12 Benefits included in box 1			
		13 See Instrs. for box 13		14 Other			
		15 Statutory employee <input type="checkbox"/>		Deceased <input type="checkbox"/>		Pension plan <input type="checkbox"/>	
		Legal rep. <input type="checkbox"/>		942 emp. <input type="checkbox"/>		Subtotal <input type="checkbox"/>	
		Deferred compensation <input type="checkbox"/>					
16 State	Employer's state I.D. No.	17 State wages, tips, etc.	18 State income tax	19 Locality name	20 Local wages, tips, etc.	21 Local income tax	

Department of the Treasury—Internal Revenue Service

FORM W-2 Wage and Tax Statement 1994

This information is being furnished to the Internal Revenue Service.

Copy B To Be Filed With Employee's FEDERAL Tax Return

Figure 6

DO NOT STAPLE

a Control number		33333		For Official Use Only ▶ OMB No. 1545-0008	
b Kind of Payer ▶	941	Military	943	1 Wages, tips, other compensation	2 Federal income tax withheld
	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	120000.00	12000.00
	CT-1	942	Medicare gov't emp.	3 Social security wages	4 Social security tax withheld
	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	120000.00	7440.00
c Total number of statements	d Establishment number		5 Medicare wages and tips	6 Medicare tax withheld	
4			120000.00	1740.00	
e Employer's identification number			7 Social security tips	8 Allocated tips	
10-3456789					
f Employer's name			9 Advance EIC payments	10 Dependent care benefits	
AJAX CO. (Third Party)			11 Nonqualified plans	12 Deferred compensation	
g Employer's address and ZIP code			13 Adjusted total social security wages and tips		
			120000.00		
h Other EIN used this year			14 Adjusted total Medicare wages and tips		
			120000.00		
i Employer's state I.D. No.			15 Income tax withheld by third-party payer		

Under penalties of perjury, I declare that I have examined this return and accompanying documents, and, to the best of my knowledge and belief, they are true, correct, and complete.

Signature ▶ Dave Cougar Title ▶ Comptroller Date ▶ 1/31/95
Telephone number (612) 100-1000

Form **W-3 Transmittal of Wage and Tax Statements 1994**

Department of the Treasury
Internal Revenue Service

Figure 7

DO NOT STAPLE

a Control number		33333		For Official Use Only ▶ OMB No. 1545-0008	
b Kind of Payer ▶	941	Military	943	1 Wages, tips, other compensation	2 Federal income tax withheld
	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	200000.00	20000.00
	CT-1	942	Medicare gov't emp.	3 Social security wages	4 Social security tax withheld
	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	200000.00	12400.00
c Total number of statements	d Establishment number		5 Medicare wages and tips	6 Medicare tax withheld	
			200000.00	2900.00	
e Employer's identification number			7 Social security tips	8 Allocated tips	
10-3456789					
f Employer's name			9 Advance EIC payments	10 Dependent care benefits	
AJAX CO. (Third Party)			11 Nonqualified plans	12 Deferred compensation	
g Employer's address and ZIP code			13 Adjusted total social security wages and tips		
			200000.00		
h Other EIN used this year			14 Adjusted total Medicare wages and tips		
			200000.00		
i Employer's state I.D. No.			15 Income tax withheld by third-party payer		

Under penalties of perjury, I declare that I have examined this return and accompanying documents, and, to the best of my knowledge and belief, they are true, correct, and complete.

Signature ▶ Dave Cougar Title ▶ Comptroller Date ▶ 1/31/95
Telephone number (612) 100-1000

Form **W-3 Transmittal of Wage and Tax Statements 1994**

Department of the Treasury
Internal Revenue Service