13 Labor

Several income and employment tax issues arise when a small business hires employees. This chapter addresses a few of those issues.

I. Employee or Independent Contractor

Classifying a worker as an employee or an independent contractor affects several tax issues, including:

- Income tax withholding
- FICA tax liability and withholding
- Unemployment tax liability
- Railroad retirement tax
- Self-employment tax liability
- Deductibility of worker's expenses
- Excludibility of fringe benefits

The basis for classifying a worker as an employee versus an independent contractor is a list of 20 factors that are set out in Rev. Rul. 87-41, 1987-1 C.B. 296.

> An individual is an employee for federal employment tax purposes if the individual has the status of an employee under the usual common-law rules applicable in determining the employer-employee relationship. Guides for determining that status are found in the following three substantially similar sections of the Employment Tax Regulations: §§31.3121(d)-1(c), 31.3306(i)-1, and 31.3401(c)-1.
>
> These sections provide that generally the relationship of employer and employee exists when the person or persons for whom the services are performed have the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but as to how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if the employer has the right to do so.
>
> Conversely, these sections provide, in part, that individuals (such as physicians, lawyers, dentists, contractors, and subcontractors) who follow an independent trade, business, or profession in which they offer their services

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to the public generally are not employees.

Finally, if the relationship of employer and employee exists, the designation or description of the relationship by the parties as anything other than that of employer and employee is immaterial. Thus, if such a relationship exists, it is of no consequence that the employee is designated as a partner, coadventurer, agent, independent contractor, or the like.

As an aid to determining whether an individual is an employee under the common-law rules, twenty factors or elements have been identified as indicating whether sufficient control is present to establish an employer-employee relationship. The twenty factors have been developed based on an examination of cases and rulings considering whether an individual is an employee. The degree of importance of each factor varies depending on the occupation and the factual context in which the services are performed. The twenty factors are designed only as guides for determining whether an individual is an employee; special scrutiny is required in applying the twenty factors to ensure that formalistic aspects of an arrangement designed to achieve a particular status do not obscure the substance of the arrangement (that is, whether the person or persons for whom the services are performed exercise sufficient control over the individual for the individual to be classified as an employee). The twenty factors are:

- the right of one person to tell a worker when, where, and how he or she is to work;
- one person training the worker;
- integration of the worker's services into the business's general operations;
- the requirement that services be rendered personally;
- direction over hiring, supervising, and paying assistants;
- a worker's continuing relationship with one business;
- set hours which the worker must work;
- the requirement that the worker devote full-time attention to one business;
- performing work on a business's premises;
- control over the order or sequence of work performed;
- the requirement that the worker submit reports to the person for whom work is performed;
- payment by hour, week, or month;
- compensation for business and/or traveling expenses;
- provision of tools and materials;
- the worker's investment in the facilities in which he works;
- a worker's direct interest in the profitability of the work accomplished;
- working for more than one firm at the same time;
- making services available to the general public;
- a person's right to discharge the worker; and
- a person's right to terminate the work relationship.

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Due to the difficulty of classifying a worker under the above factors, Congress provided some relief to taxpayers in the Revenue Act of 1978. Section 530 of that act provides businesses with relief from federal employment tax obligation if certain conditions are met. **It does not provide relief to workers.**

Section 530 of the Revenue Act of 1978 was enacted as interim relief for taxpayers until the classification rules were clarified. Therefore, it is not codified into the Internal Revenue Code, but it was extended indefinitely by the TEFRA of 1982.

To qualify for §530 relief, a taxpayer must meet the following **consistency** and **reasonable basis** requirements.

Consistency. There are two requirements for the consistency test. Both of them must be met.

1. **Reporting consistency.** All required Forms 1099 must be filed.
2. **Substantive consistency.** All workers in similar positions must be treated the same.

Reasonable Basis. The taxpayer must meet **one** of the following requirements.

1. Prior audit safe haven
2. Judicial precedent safe haven
3. Industry practice safe haven
4. Other reasonable basis

Observation. Since §530 relief does not apply to the worker, the worker is bound by the 20 factors listed above and may be classified as an employee even though the business is not obligated to pay employment taxes. In that case, the worker is liable for his or her share of FICA taxes. If the worker paid self-employment taxes, he or she can file for a refund for the difference between the self-employment tax and the worker's share of FICA taxes.

The most recent amendments to §530, by the Small Business Job Protection Act of 1996, **clarify some taxpayer rights.** These changes are reflected in the new Worker Classification Training Guide for IRS Auditors, revised October 30, 1996, and released March 4, 1997. The changes are as follows:

1. **A worker does not have to otherwise be an employee of the taxpayer in order for §530 to apply.**
   - The provision **is intended to reverse** the IRS position, as stated in previous IRS training guides, that there first must be a determination that the worker is an employee under the common-law standards before application of §530.
2. The act modifies the prior audit safe harbor so that **taxpayers may not rely on an audit commencing after December 31, 1996,** unless such audit included an examination for employment tax purposes of whether the worker involved (or any worker holding a position substantially similar to the position held by the worker involved) should be treated as an employee of the taxpayer.

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- The provision does not affect the ability of taxpayers to rely on prior audits that commenced before January 1, 1997, even if the audit was not related to employment tax matters, as under present law.

3. **The act also makes a number of changes to the industry practice safe harbor.**
   - First, the act provides that a significant segment of the taxpayer's industry under the industry practice safe harbor does not require a reasonable showing of the practice of more than 25% of an industry (determined without taking into account the axpayer).
   - The provision is intended to be a safe harbor; a lower percentage may constitute a significant segment of the taxpayer's industry based on the particular facts and circumstances.
   - The act also provides that an industry practice need not have continued for more than 10 years in order for the industry practice to be considered longstanding.
   - As with the significant segment safe harbor, this provision is intended to be a safe harbor; an industry practice in existence for a shorter period of time may be considered long-standing based on the particular facts and circumstances.
   - In addition, the act clarifies that an industry practice will not fail to be treated as long-standing merely because such practice began after 1978. Consequently, the provision clarifies that new industries can take advantage of §530.

4. The act modifies the burden of proof in §530 cases by providing that if a taxpayer establishes a prima facie case that it was reasonable not to treat a worker as an employee for purposes of §530, **the burden of proof shifts to the IRS with respect to such treatment.**
   - For example, the taxpayer must establish a prima facie case that it reasonably satisfies the requirements of §530 for not treating the worker as an employee, including the requirements for reporting consistency and consistency among workers with substantially similar positions, and the requirement that the taxpayer have a reasonable basis for not treating the worker as an employee.
   - In order for the shift in burden of proof to occur, the taxpayer must fully cooperate with reasonable requests by the IRS for information relevant to the taxpayer's treatment of the worker as an independent contractor under §530.
   - It is intended that a request by the IRS will not be treated as reasonable if complying with the request would be impracticable given the particular circumstances and the relative costs involved.
   - The shift in the burden of proof does not apply for the purposes of determining whether the taxpayer had any other reasonable basis for treating the worker as an independent contractor, but does apply to all other aspects of §530.
   - So, for example, provided the taxpayer establishes its prima facie case and fully cooperates with the IRS's reasonable requests, the burden of proof shifts to the IRS with respect to all other aspects of §530, including whether the taxpayer had a reasonable basis for treating the worker as an independent contractor under the judicial or administrative precedent, prior audit, or long-standing industry practice safe harbors; whether the taxpayer filed all federal tax returns on a basis consistent with treating the worker as an independent contractor; and whether the taxpayer treated any worker holding a substantially similar position as an employee.

5. **The act also provides** that if a taxpayer prospectively changes its treatment of workers from

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independent contractors to employees for employment tax purposes, such a change will not affect the applicability of §530 with respect to such workers for prior periods.

6. The act provides that, in determining whether a worker holds a substantially similar position to another worker, the relationship of the parties must be one of the factors taken into account.
7. The "new" IRS Worker Classification Training Guide (10/96) introduced categories of evidence that examining agents must analyze in employment tax audits. These categories are to be used in addition to the 20 common-law factors previously covered in this chapter. The categories of evidence and factors that will be considered by the IRS are listed in the chart below.

Note: The entire 130-page Worker Classification Training Guide (10/96) is available via the Internet.

Categories of Evidence	**Factors**
Behavioral control	Facts that illustrate whether there is a right to direct or control how the worker performs the specific task for which he or she is engaged: • Instructions • Training
Financial control	Facts that illustrate whether there is a right to direct or control how the business aspects of the worker's activities are conducted: • Significant investment • Unreimbursed expenses • Services available to the relevant market • Method of payment • Opportunity for profit or loss
Relationship of the parties	Facts that illustrate how the parties perceive their relationship: • Intent of parties/written contracts • Employee benefits • Discharge/termination • Regular business activity

II. Filing Form W-7 to get an Individual Taxpayer Identification

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Number

An individual Taxpayer Identification Number (ITIN) is a new tax processing number for certain aliens, their spouses, and their dependents. It is a nine-digit number, beginning with the number 9, formatted like a social security number (NNN-NN-NNNN). **Temporary tax identifying numbers previously assigned are no longer valid.**

ITINs are available only to individuals who cannot get a social security number (SSN). They are used **only for processing** U.S. federal income tax returns. They **do not affect** immigration status or authorization to work in the United States. When completing a federal income tax return, an individual enters the ITIN in the space for the SSN.

Form W-7, Application for IRS Individual Taxpayer Identification Number, is used to obtain an ITIN. Documentation substantiating both the foreign status and the identity of the individual is required. The documentation and Form W-7 can be mailed to the Philadelphia Service Center or presented at IRS walk-in offices for transmittal to the service center. Anyone can take a signed application to a walk-in site. The applicant is not required to be present. **Form W-7 should not be attached to an individual's Form 1040.**

Documentation **must include** the full names of the applicant's father and mother (mother's name at birth, not her married name); the date and place of birth of the applicant; the applicant's full name at birth; a recent photograph (within the past five years); and the signature of the applicant or, if the applicant is a minor, of the legal guardian or delegate.

In general, it takes approximately **six weeks to receive an ITIN.**The taxpayer may call (215)516-4846 if the IRS has not acknowledged receipt of the Form W-7 after 14 days.

If an adult is applying for a minor dependent, the documentation must establish the relationship, such as with a birth certificate or adoption papers. The documentation also must prove that the dependent lives in the United States, Canada, or Mexico. Examples of a dependent's documentation include school records, doctor's records, letters from clergy, U.S. baptismal certificates, and day care records. A birth certificate establishes the dependent's relationship to the taxpayer, but proof of continued existence (such as current school or medical records) is also needed.

Dependent's documentation must be original or considered as original (copies certified by the issuing agency or the Department of State). Documentation for primary or secondary filers also can be accepted if it is **legally** notarized by a U.S. (not foreign) notary public. Notarized passports and Immigration and Naturalization Service (INS) documents cannot be accepted.

ITINs are not valid for work purposes. When a job applicant tries to use an ITIN for employment, the employer should advise the applicant to contact the SSA for an SSN if the applicant is legally entitled to work in the United States. However, should an employer hire or continue to employ an employee without INS work authorization, the ITIN should be used for IRS reporting purposes, including Form W-2. If a payroll firm receives payroll data that includes an ITIN, the employer should be advised that

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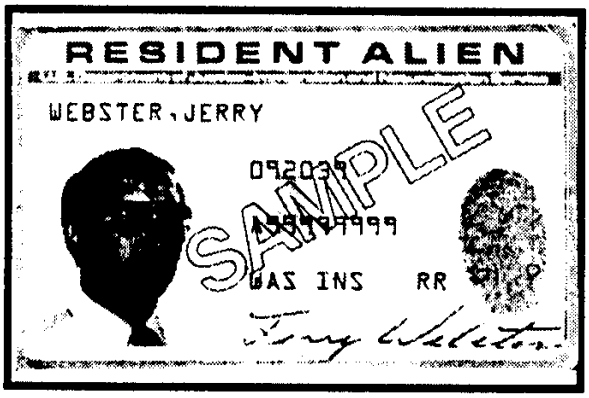
the ITIN is not a valid ID number for work purposes. The firm may suggest that the employer request that the employee secure an SSN. Withholding of payroll taxes should continue.

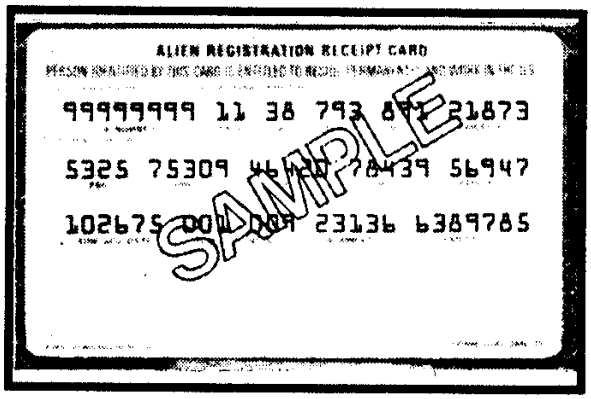
ITIN application information **is not shared with other government agencies.** IRS disclosure rules do not permit the sharing of confidential taxpayer information with other government agencies.

The following are some samples of "green cards" you may see. They are taken from the INS Handbook for Employers.

Alien Registration Receipt Card (Resident Alien Card) I-1551

This card was issued by the INS after March 1977 to lawful permanent resident aliens. Although this card is no longer issued, it is **valid indefinitely.** This card is commonly referred to as a "green card" and is the replacement for the Form I-151. This version is white with a blue logo.





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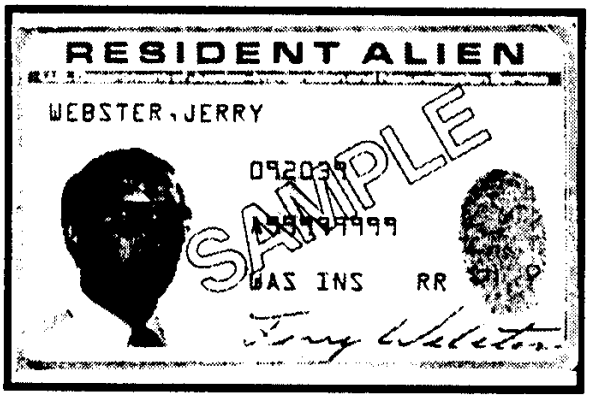
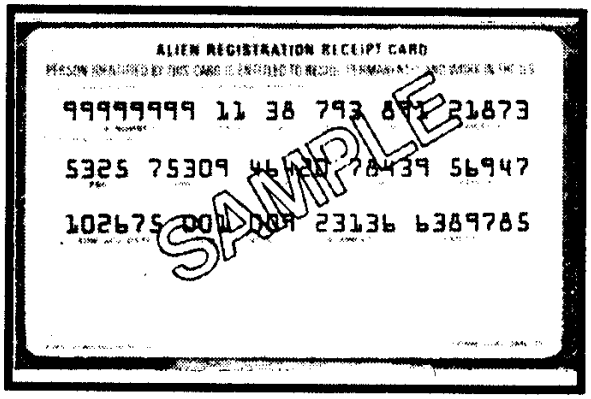
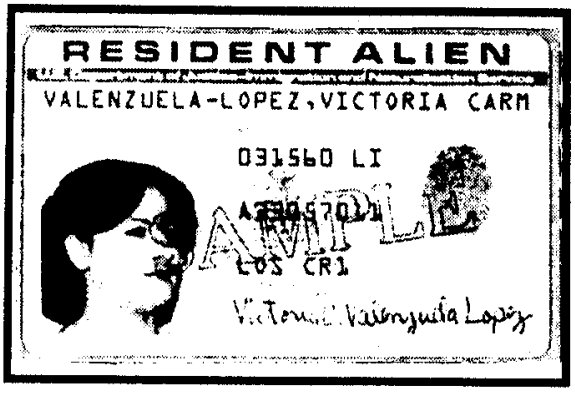
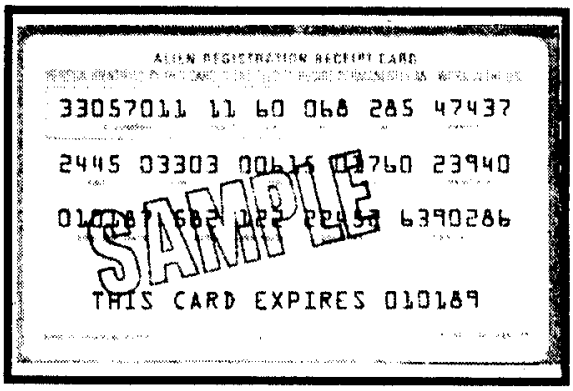




Alien Registration Receipt Card (Conditional Resident Alien Card) I-1551

This card was issued by the INS after January 1987 to conditional permanent resident aliens such as alien spouses of U.S. citizens or lawful permanent resident aliens. It is similar to the I-1551 issued to permanent resident aliens. Although this card is no longer issued, it is valid for two years from the date of admission or adjustment. The expiration date is stated on the back of the card. This version is white with a blue logo.





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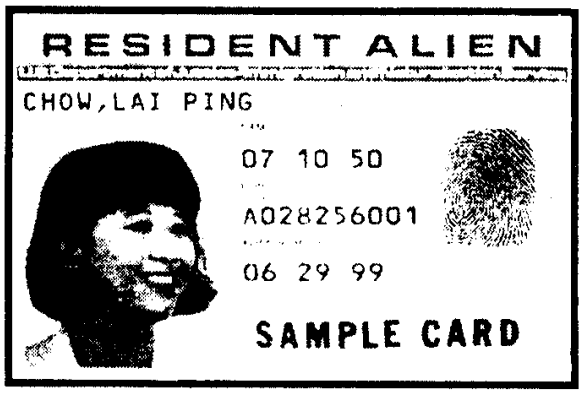
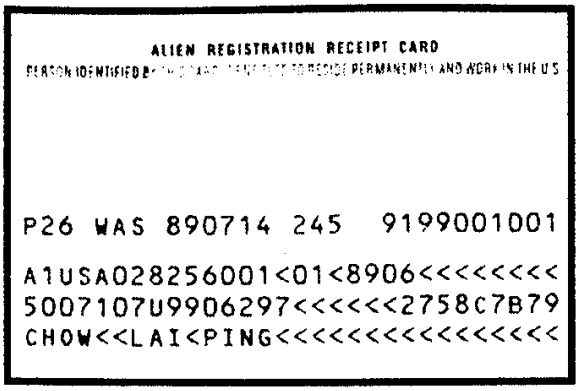
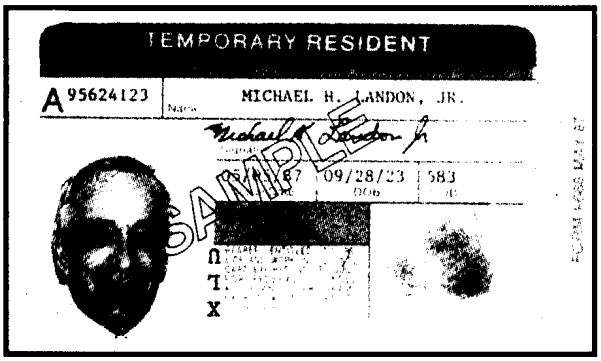
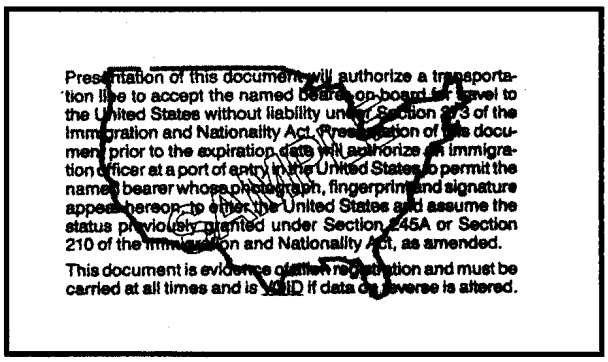




Temporary Resident Card I-688

This card is issued by the INS to aliens granted temporary resident status under the Legalization or Special Agricultural Worker program. It is valid until the expiration date stated on the face of the card or on the sticker(s) placed on the back of the card.





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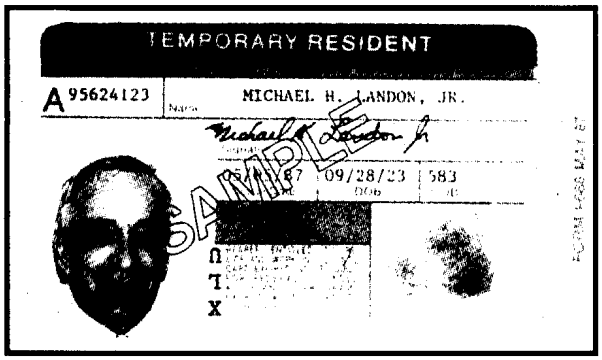
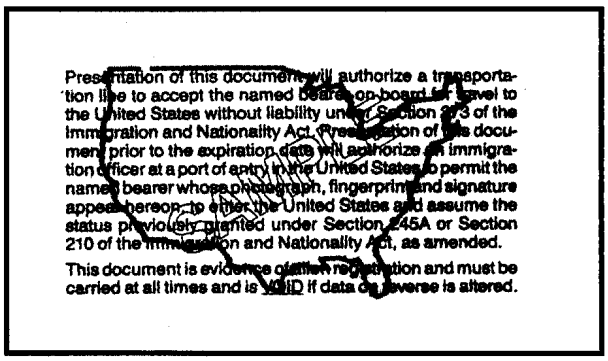
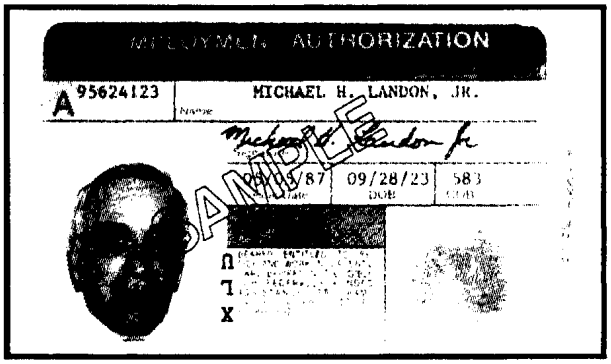
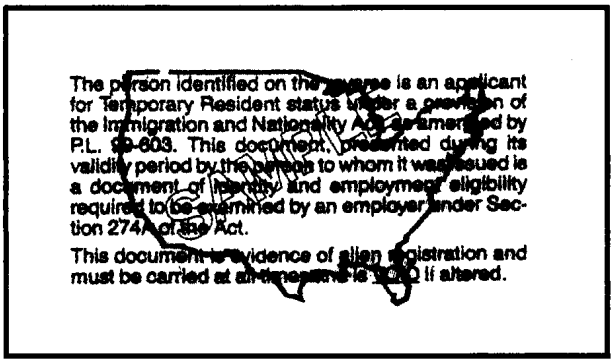




Employment Authorization Card I-688A

This card is issued by the INS to applicants for temporary resident status after their interview for Legalization or Special Agricultural Worker status. It is valid until the expiration date stated on the face of the card or on the sticker(s) placed on the back of the card.





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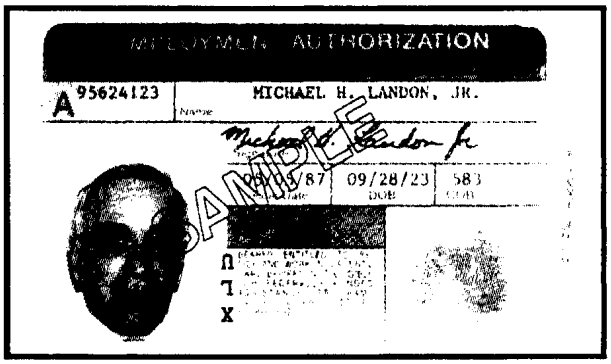

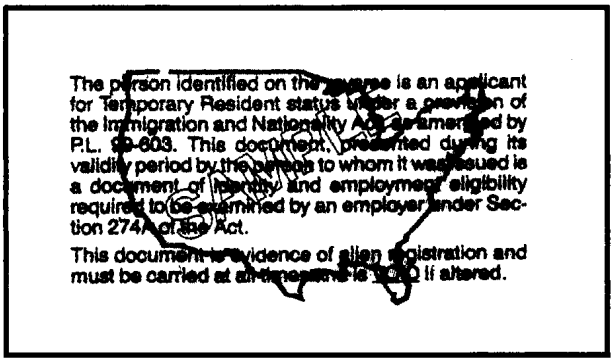

III. Domestic Employees

Who Is a Household Employee?

Some examples of workers who may be household employees are:

- Babysitters
- Caretakers
- Cooks
- Drivers
- Gardeners
- Governesses
- Housekeepers
- Maids

> **Note:** If a worker performs household services in or around the taxpayer's home that are subject to the taxpayer's will and control as to both what must be done and how it must be done, that worker is a household employee.

Who Is Not a Household Employee?

People who work for the taxpayer's trade or business are not household employees. Workers who follow

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an independent trade, business, or profession in which they offer their services to the general public are generally not household employees.

Examples

1. Your client, Joe, pays John Peters to care for his lawn. John offers lawn care services to homeowners in Joe's neighborhood. He provides his own tools and hires and pays helpers as he wishes. Neither John nor his helpers are Joe's household employees.
2. Gardeners, carpenters, plumbers, and painters are generally independent contractors if the facts are similar to those for John Peters (above).
3. Private secretaries, tutors, fitness advisors, and private athletic coaches **would not be defined as household employees.**

Example 1. John and Jane Doe employ Sue Wonder, age 22, as a household employee. She was paid $3,000 for 1997. They employ no other individuals. Sue is paid weekly and worked 48 weeks during 1997. John and Jane withheld Sue's portion of the FICA tax ($229.50) and tax withholding of $229.00.

Schedule H for Example 1

SCHEDULE H (Form 1040)
Department of the Treasury Internal Revenue Service

Household Employment Taxes
(For Social Security, Medicare, Withheld Income, and Federal Unemployment (FUTA) Taxes)
► Attach to Form 1040, 1040A, 1040NR, 1040NR-EZ, 1040-SS, or 1041.
► See separate instructions.

OMB No. 1545-0074
1997
Attachment Sequence No. 44

Name of employer: John and Jane Doe

Social security number: 111 : 11 : 1111
Employer identification number: / / : / / / / / / /

A Did you pay **any one** household employee cash wages of $1,000 or more in 1997? (If any household employee was your spouse, your child under age 21, your parent, or anyone under age 18, see the line A instructions on page 3 before you answer this question.)

☒ **Yes.** Skip questions B and C and go to Part I.
☐ **No.** Go to question B.

B Did you withhold Federal income tax during 1997 for any household employee?

☐ **Yes.** Skip question C and go to Part I.
☐ **No.** Go to question C.

C Did you pay **total** cash wages of $1,000 or more in **any** calendar **quarter** of 1996 or 1997 to household employees? (**Do not** count cash wages paid in 1996 or 1997 to your spouse, your child under age 21, or your parent.)

☐ **No. Stop.** Do not file this schedule.
☐ **Yes.** Skip Part I and go to Part II on the back.

Proof as of July 2097 (subject to change)

Part I Social Security, Medicare, and Income Taxes

1	Total cash wages subject to social security taxes (see page 3)	1	3,000
2	Social security taxes. Multiply line 1 by 12.4% (.124)	2	372
3	Total cash wages subject to Medicare taxes (see page 3)	3	3,000
4	Medicare taxes. Multiply line 3 by 2.9% (.029)	4	87
5	Federal income tax withheld, if any	5	229
6	Add lines 2, 4, and 5	6	688
7	Advance earned income credit (EIC) payments, if any	7	0
8	**Total social security, Medicare, and income taxes.** Subtract line 7 from line 6	8	688

9 Did you pay **total** cash wages of $1,000 or more in **any** calendar **quarter** of 1996 or 1997 to household employees? (**Do not** count cash wages paid in 1996 or 1997 to your spouse, your child under age 21, or your parent.)

☒ **No. Stop.** Enter the amount from line 8 above on Form 1040, line 52, or Form 1040A, line 27. If you are not required to file Form 1040 or 1040A, see the line 9 instructions on page 4.

☐ **Yes.** Go to Part II on the back.

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 12187K Schedule H (Form 1040) 1997

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1997 Workbook

SCHEDULE H (Form 1040)

Department of the Treasury
Internal Revenue Service

Household Employment Taxes

(For Social Security, Medicare, Withheld Income, and Federal Unemployment (FUTA) Taxes)

▶ Attach to Form 1040, 1040A, 1040NR, 1040NR-EZ, 1040-SS, or 1041.

▶ See separate instructions.

OMB No. 1545-0074

1997

Attachment Sequence No. 44

Name of employer

John and Jane Doe

Social security number: 111 11 1111

Employer identification number: 11-1111111

A Did you pay **any one** household employee cash wages of $1,000 or more in 1997? (If any household employee was your spouse, your child under age 21, your parent, or anyone under age 18, see the line A instructions on page 3 before you answer this question.)

☒ **Yes.** Skip questions B and C and go to Part I.
☐ **No.** Go to question B.

B Did you withhold Federal income tax during 1997 for any household employee?

☐ **Yes.** Skip question C and go to Part I.
☐ **No.** Go to question C.

C Did you pay **total** cash wages of $1,000 or more in **any** calendar **quarter** of 1996 or 1997 to household employees? (**Do not** count cash wages paid in 1996 or 1997 to your spouse, your child under age 21, or your parent.)

☐ **No. Stop.** Do not file this schedule.
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☒ **No. Stop.** Enter the amount from line 8 above on Form 1040, line 52, or Form 1040A, line 27. If you are not required to file Form 1040 or 1040A, see the line 9 instructions on page 4.

☐ **Yes.** Go to Part II on the back.

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Form 1040 for Example 1

Other Taxes	47	Self-employment tax. Attach Schedule SE	47		
	48	Alternative minimum tax. Attach Form 6251	48		
	49	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	49		
	50	Tax on qualified retirement plans (including IRAs) and MSAs. Attach Form 5329 if required	50		
	51	Advance earned income credit payments from Form(s) W-2	51		
	52	Household employment taxes. Attach Schedule H	52	688	
	53	Add lines 46 through 52. This is your **total tax** ▶	53		

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	52	Household employment taxes. Attach Schedule H	52	688	
	53	Add lines 46 through 52. This is your **total tax** ▶	53		

Note: Estimated tax penalties **will not apply** to underpayments of estimated tax due to employment taxes reported with Form 1040 through 1997. **Beginning in 1998,** estimated tax penalties **may apply.**

Form W-2 for Example 1

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Form W-2 for Example 1

a Control number	22222	OMB No. 1545-0008	
b Employer's identification number		1 Wages, tips, other compensation: 3000.00	2 Federal income tax withheld: 229.00
c Employer's name, address, and ZIP code: John and Jane Doe		3 Social security wages: 3000.00	4 Social security tax withheld: 186.00
		5 Medicare wages and tips: 3000.00	6 Medicare tax withheld: 43.50
		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: Sue S. Wonder		11 Nonqualified plans	12 Benefits included in box 1
		13 See Instrs. for box 13	14 Other
		15 Statutory employee ☐ Deceased ☐ Pension plan ☐ Legal rep. ☐ Hshld. emp. ☒ Subtotal ☐ Deferred compensation ☐	

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
II	3000.00	90.00			

Form **W-2** Wage and Tax Statement 1997 (O)

Department of the Treasury—Internal Revenue Service

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Note: Employers are not required to withhold income tax from the wages paid to a household worker. However, employees can elect to have income tax withheld if the employer agrees. The employer can pay the FICA tax for the household employee. This results in additional wage income but does not increase FICA wages. (See the example that follows.)

Example 2. John and Jane Doe **do not withhold Sue's share of the FICA tax.** Prepare Sue's Form W-2.

Form W-2 for Example 2

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a Control number	22222	OMB No. 1545-0008	
b Employer's identification number		1 Wages, tips, other compensation: 3229.50	2 Federal income tax withheld: 248.00
c Employer's name, address, and ZIP code: John and Jane Doe		3 Social security wages: 3000.00	4 Social security tax withheld: 186.00
		5 Medicare wages and tips: 3000.00	6 Medicare tax withheld: 43.50
		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: Sue S. Wonder		11 Nonqualified plans	12 Benefits included in box 1
		13 See Instrs. for box 13	14 Other
		15 Statutory employee ☐ Deceased ☐ Pension plan ☐ Legal rep. ☐ Hshld. emp. ☒ Subtotal ☐ Deferred compensation ☐	

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
II	3229.50	96.69			

Form **W-2** Wage and Tax Statement 1997 (O)

Department of the Treasury—Internal Revenue Service

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Question 1. *Jane and John Doe paid a household worker $900 during 1997. What is their tax liability and reporting requirement?*

Answer. None. The Social Security Reform Act of 1994 exempts from FICA tax and reporting requirements payments to a household worker if the total wages for the year do not exceed $1,000.

The act states that household workers under the age of 18 are exempt from social security taxation and coverage regardless of how much they are paid during the year, unless their principal occupation is household employment.

Example 3. The wages of a 17-year-old student who also babysits will be exempt from the reporting and payment requirements, regardless of the amount of wages earned. (In this case, the $1,000

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wage threshold is negated because the employee is under age 18 and babysits as a sideline.)

Example 4. The wages of a 17-year-old mother who leaves school and goes to work as a domestic to support her family will be subject to the reporting and payment requirements, if the amount of wages earned is $1,000 or more per year. (In this case, the "under age 18" provision is negated because the employee's regular occupation is domestic work.)

Question 2. *Jane and John Doe paid two household workers $900 each during 1997. Are they both exempt from FICA tax?*

Answer. Yes. The $1,000 threshold test is applied to each household employee.

Federal Unemployment (FUTA) Tax

Most employers pay both state and federal unemployment tax. However, even if the taxpayer is exempt from the state tax, there may still be a federal tax. It should not be withheld from the employee's wages.

FUTA Tax Rate. The FUTA tax rate is 6.2% of wages subject to FUTA tax. However, a taxpayer may be able to take a credit of up to 5.4% against this tax for making any required payments to the state unemployment fund by the due date for filing the Form 1040. Therefore, the tax rate may be as low as 0.8%.

The credit for payments made to the state after the due date for filing Form 1040 **cannot be more than** 90% of the amount that would have been allowable if the taxpayer had paid the state tax by the due date.

Note: The 5.4% credit is reduced for wages paid in a credit reduction state. If the state of the taxpayer is subject to a credit reduction for 1997, the state's name and the amount of the credit reduction will be shown**in the instructions** for Schedule H, Form 1040.

Wages Exempt from FUTA Tax. FUTA tax does not apply to wages paid in 1997 for household services performed in or around the home by the taxpayer's:

1. Spouse
2. Son or daughter under age 21
3. Mother or father

Wages Subject to FUTA Tax. FUTA tax applies to the first $7,000 of cash wages paid in 1997 to each of the taxpayer's household employees if, as a household employer, the taxpayer meets the $1,000 FUTA test. Do not count wages exempt from tax, discussed earlier, when applying the $1,000 FUTA test or figuring wages subject to FUTA tax.

$1,000 FUTA Test.

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household employees **in any calendar quarter this year or last year** (1996 or 1997).

> **Note:** This test is different from the $1,000 test for wages subject to social security and Medicare taxes. A taxpayer that meets the $1,000 FUTA test may have to pay FUTA tax on wages that are not subject to social security and Medicare taxes.

Reporting and Paying FUTA Tax. Generally, FUTA tax on wages paid to household employees in 1997 is reported and paid using Form 1040 (Schedule H).

If the state is not a credit reduction state for 1997 and the taxpayer is exempt from or has made correct and timely payments of state unemployment taxes, the total FUTA tax will simply be the result of multiplying the wages subject to FUTA by 0.008.

IV. Fringe Benefits Example

Problem

Dave's S corporation employs Ron Worker to maintain 30 apartment units owned by the corporation. Ron is required to report to work at 8:00 A.M. to receive a list of jobs for the day. His workday is completed at 6:00 P.M.; he is generally not available for after-hours calls. The apartments are located in the city of Metropolis. The corporation wants Ron to be close to the apartments for emergencies, so it provides him with the free use of an apartment in the complex, excluding utilities.

The corporation owns a restaurant ½ mile from the units, and Ron eats lunch there each day without charge. Total charges for 1997 of $1,500 ($5 per day maximum).

Ron has to make frequent trips for supplies, so he is provided for the entire year with a company-owned vehicle with a value of $35,000. The vehicle is used 60% for company business and 40% for Ron Worker personally. The vehicle was driven 10,000 miles in 1997. Ron is not required to reimburse the company for personal use of the vehicle.

Prepare Ron's 1997 Form W-2.

Ron's Form W-2 Worksheet

1.	Salary	$25,000
2.	Value of apartment (12 × $300)	3,600
3.	Meals (300 days × $5.00)	1,500
4.	Personal mileage (company uses the annual lease value method)	3,876
		$33,976

Notes

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1. Although it is convenient, living on the premises is unnecessary for Ron to fulfill his employment responsibilities. If he was on call 24 hours a day, the value of the apartment would arguably be excluded from wages.
2. Meals furnished to Ron Worker: To be excludible, the employer must furnish the value of the meals supplied to Ron. This requirement is satisfied. The meals must also be supplied on the business premises of the employer. Although Ron Worker's employer owns the restaurant, Ron performs no significant duties at the restaurant. It is unlikely, therefore, that the restaurant would be considered the business premises of the corporation for purposes of Ron Worker. In addition, the IRS may argue that the purpose for providing the meals is more compensatory than non-compensatory [Regs. §1.119-1(a)(2)(I)]. In this instance, the employer could make the argument that it was necessary to be able to reach Ron Worker during the lunch hour and that he be near the apartment complex during this period of time. This would establish a non-compensatory business reason for providing the meals. If, in addition, Ron provided some maintenance services for the restaurant or met with a corporate officer or manager during lunch to discuss employment-related business, the convenience of the business premises test might also be satisfied. This is a restaurant open to the general public. It would not be considered an employer-operated eating facility therefore qualifying the value of the meal as a de minimis fringe benefit [Regs. §1.132-7(a)(2)].
3. Valuing the vehicle used by Ron Worker: The personal use of the employer-provided vehicle by Ron is compensation income. The method the corporation would use to determine the value of this type of fringe benefit is the annual lease value method [Regs. §1.61-21(d)(1)(i)]. The facts indicate that the fair market value of the automobile is $35,000. This provides an annual lease value of $9,250. Because Ron used the vehicle for personal purposes only 40% of the time, we must use the vehicle allocation rules provided in Regs. §1.132-5(b)(1). In Ron Worker's situation, the business use is $9,250 × 6,000/10,000, or $5,550. The amount includible in Ron's gross income on account of the availability of the vehicle is $3,700. The cents per mile method described in Regs. §1.61-21 is not available because the vehicle's fair market value exceeds $15,200. One other issue relating to the provision of vehicles to employees is the fuel cost. The annual lease value does not include the cost of fuel. This is fair market value of the fuel (under the annual lease value method) where the employer provides the fuel either through a reimbursement arrangement or by having the cost of the fuel charged to the employer. The fair market value is either the amount of reimbursement or the amount charged [Regs. §1.61-21(d)]. In this situation Ron charged the fuel directly to the employer. Assume that the average miles per gallon is 25 and the cost of the fuel is $1.10 per gallon. Ron drove 4,000 personal miles, which meant he used 160 gallons at $1.10 per gallon, for a total cost of $176. This is additional compensation income for Ron. The value of Ron's personal use of the vehicle is $3,700 + $176, or $3,876.

Problem—W-2

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1997 Workbook

a Control number	22222	OMB No. 1545-0008	
b Employer's identification number		1 Wages, tips, other compensation: 33976.00	2 Federal income tax withheld
c Employer's name, address, and ZIP code: Dave S. Corp		3 Social security wages: 33976.00	4 Social security tax withheld
		5 Medicare wages and tips: 33976.00	6 Medicare tax withheld
		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: Ron Worker		11 Nonqualified plans	12 Benefits included in box 1
		13 See Instrs. for box 13	14 Other
		15 Statutory employee ☐ Deceased ☐ Pension plan ☐ Legal rep. ☐ Hshld. emp. ☐ Subtotal ☐ Deferred compensation ☐	

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

(O) Department of the Treasury—Internal Revenue Service

Form **W-2** **Wage and Tax Statement** 1997

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