

## Chapter 9: Employment Taxes

Nanny Tax .....	317	W-2 .....	330
Employee Use of Car .....	319	Fringe Benefits .....	342
Statutory Employees .....	320	Tipped Employees .....	347
Employees versus Independent Contractors.....	320	Becoming a New Employer .....	351
Payroll Tax Penalties .....	321	Endnotes .....	352

Corrections were made to this workbook through January of 2004. No subsequent modifications were made.

### NANNY TAX

#### WHO IS A HOUSEHOLD EMPLOYEE?

If a household employee performs services in or around the taxpayer's home and he is subject to the taxpayer's will and control, such as what must be done and how it must be done, then that worker is a household employee. Consequently, the worker falls under the payroll tax filing requirements.

If an individual pays a household employee less than \$1,400 in 2003, she does not have to report the payment on Form 1040 Schedule H or pay social security and Medicare taxes on that employee's 2003 wages. The threshold is annually adjusted for inflation.

Cash wages of less than \$1,000 paid in any calendar quarter of the current or prior year to all household employees are not subject to FUTA. However, the employer may still be subject to state unemployment tax (depending on individual state thresholds).

**Note.** Although thresholds for FUTA filing or social security and Medicare tax filing are not met, a household employer must still issue a Form W-2 to the employee by the due date (generally January 31 of the following year). The wages are always taxable to the employee, whether or not the employer issues a W-2.

**Example 1.** Jane Nanny is employed in the summer of 2003 to care for Sam and Chuck Meadows. Jane is 21 years old and works summers to help pay for college expenses. She is employed by Raymond and Sue Meadows. The Meadows family tells Jane what hours to work and how she is to care for Sam and Chuck. Jane is paid \$950 in June, \$685 in July, and \$305 in August. The Schedule H of Sue and Raymond Meadows follows:

# 2003 Workbook

## For Example 1

**SCHEDULE H  
(Form 1040)**

Department of the Treasury  
Internal Revenue Service (99)  
Name of employer

**Household Employment Taxes**

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

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

▶ **See separate instructions.**

OMB No. 1545-0074

2003

Attachment  
Sequence No. **44**

Social security number	
695	95 6695
Employer identification number	
:	:

**Raymond and Sue Meadows**

- A** Did you pay **any one** household employee cash wages of \$1,400 or more in 2003? (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 lines B and C and go to line 1.  
 **No.** Go to line B.
- B** Did you withhold Federal income tax during 2003 for any household employee?
- Yes.** Skip line C and go to line 5.  
 **No.** Go to line C.
- C** Did you pay **total** cash wages of \$1,000 or more in **any** calendar **quarter** of 2002 or 2003 to **all** household employees? (Do not count cash wages paid in 2002 or 2003 to your spouse, your child under age 21, or your parent.)
- No. Stop.** Do not file this schedule.  
 **Yes.** Skip lines 1-9 and go to line 10 on the back. (Calendar year taxpayers having no household employees in 2003 do not have to complete this form for 2003.)

**Part 1 Social Security, Medicare, and Income Taxes**

1 Total cash wages subject to social security taxes (see page 3)	1	1,940		
2 Social security taxes. Multiply line 1 by 12.4% (.124)	2		241	
3 Total cash wages subject to Medicare taxes (see page 3)	3	1,940		
4 Medicare taxes. Multiply line 3 by 2.9% (.029)	4		56	
5 Federal income tax withheld, if any	5		0	
6 <b>Total social security, Medicare, and income taxes</b> (add lines 2, 4, and 5)	6		297	
7 Advance earned income credit (EIC) payments, if any	7		0	
8 <b>Net taxes</b> (subtract line 7 from line 6)	8		297	

- 9** Did you pay **total** cash wages of \$1,000 or more in **any** calendar **quarter** of 2002 or 2003 to household employees? (Do not count cash wages paid in 2002 or 2003 to your spouse, your child under age 21, or your parent.)
- No. Stop.** Enter the amount from line 8 above on Form 1040, line 60. If you are not required to file Form 1040, see the line 9 instructions on page 4.
- Yes.** Go to line 10 on the back.

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 12187K

Schedule H (Form 1040) 2003

**Note.** Questions A, B, and C must all be marked "NO" in order to skip Part 1 of Schedule H.

## Social Security and Medicare Tax

For agricultural and household employees, employers may choose to pay the employee's share of social security and Medicare taxes as a fringe benefit. This additional fringe benefit is not taxable for social security or Medicare tax, but is included in Box 1 of the Form W-2 as additional wages.

**Example 2.** Sue Coleman is a housekeeper for the Daniels family. She is paid \$1,000 a month for her work. Keith and Laura Daniels have agreed to pay Sue's share of social security and Medicare tax. Her W-2 is prepared as follows:

a Control number		OMB No. 1545-0008		Safe, accurate, FAST! Use  Visit the IRS Web Site at <a href="http://www.irs.gov">www.irs.gov</a> .	
b Employer identification number <b>37-778899</b>			1 Wages, tips, other compensation <b>12918.00</b>	2 Federal income tax withheld <b>0.00</b>	
c Employer's name, address, and ZIP code  <b>KEITH DANIELS 1850 IRONWOOD DRIVE WORTHINGTON, OH 81806</b>			3 Social security wages <b>12000.00</b>	4 Social security tax withheld <b>744.00</b>	
			5 Medicare wages and tips <b>12000.00</b>	6 Medicare tax withheld <b>174.00</b>	
			7 Social security tips	8 Allocated tips	
d Employee's social security number <b>989-77-6655</b>			9 Advance EIC payment		10 Dependent care benefits
e Employee's first name and initial <b>SUE</b>		Last name <b>COLEMAN</b>		11 Nonqualified plans	
1706 IRONWOOD COURT WORTHINGTON, OH 81806			13 Statutory employee <input type="checkbox"/> Retirement plan <input type="checkbox"/> Third-party sick pay <input type="checkbox"/>		12a See instructions for box 12
			14 Other		12b
					12c
f Employee's address and ZIP code					12d
15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax
<b>OH</b>	<b>9292-9292</b>	<b>12918.00</b>	<b>0.00</b>		
				20 Locality name	

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

# 2003

Department of the Treasury—Internal Revenue Service

Copy B To Be Filed with Employee's FEDERAL Tax Return.  
This information is being furnished to the Internal Revenue Service.

## EMPLOYEE USE OF CAR

If an employee uses an employer-provided automobile for personal use, the value of that use must be determined by the employer and included in the employee's wages. The value of the personal use must be based on FMV or one of three special valuation rules:

1. The automobile lease valuation rule,
2. The vehicle cents per mile rule, or
3. The commuting valuation method.

Generally, the employer must determine the value of the noncash fringe benefit no later than January 31 of the next year. Prior to January 31, he may reasonably estimate the value of the fringe benefits for the purposes of withholding and making timely deposits. The employer can choose to treat fringe benefits as paid on a pay period, quarter, semiannual, or other basis, but at a minimum on an annual basis. He may choose different pay periods for different employees.

# 2003 Workbook

The employer must add the value of fringe benefits to regular wages for a payroll period and compute tax on the total. The employer must withhold the applicable income, social security, and Medicare taxes on the date or dates chosen to treat the benefits as paid.<sup>1</sup>

**Note.** See pages 144–147 in the *2002 University of Illinois Income Tax Workbook* for more information.

## STATUTORY EMPLOYEES

There are **four** categories of individuals known as **statutory employees**, who, for purposes of the social security and Medicare provision, are treated as employees if they meet certain criteria. Categories one and four are also treated as employees for purposes of the federal unemployment tax provisions.<sup>2</sup>

The **four** categories of statutory employees are:

1. An agent driver or commission driver who distributes meat products, vegetable products, bakery products, beverages (other than milk), or laundry or dry cleaning services.
2. A full-time life insurance salesman.
3. A home worker performing work, in his home, according to specifications furnished by the person for whom the work is performed. The finished product is then returned to the person who provided the raw materials and specifications.
4. A traveling or city salesman, other than an agent driver or commission driver, engaged on a full-time basis in the solicitation of orders from wholesalers or other similar establishments for merchandise for resale or supplies for use in his business operations.

A person in any of the four categories is a statutory employee only if the following criteria are met:

- The contract of services contemplates that substantially all such services are to be performed personally by such individual.
- The individual has no substantial investment in facilities used in connection with the performance of the services.
- The services performed are a part of a continuing relationship with the person for whom the services are performed and not simply a single transaction that is not part of such a relationship.<sup>3</sup>

Individuals in one of these categories are likely to be considered statutory employees by the IRS. The distinction is significant because statutory employees may deduct trade and business expenses in arriving at adjusted gross income under IRC §62 and therefore are not subject to the reduction by 2% of adjusted gross income for miscellaneous deductions under IRC §67(a) that is applicable to common law employees.<sup>4</sup>

## EMPLOYEES VERSUS INDEPENDENT CONTRACTORS

In IRS Pub. 15-A, *Employer's Supplemental Tax Guide* (Rev. January 2002) and IRS Pub. 1779, *Independent Contractor or Employee*, the IRS provides current information that must be considered when distinguishing between employees and independent contractors. The determination of whether an individual is classified as an employee or an independent contractor is dependant upon the degree of control and independence.

The degree of control and independence is classified into three categories:

- Behavioral control

- Financial control
- The type of relationship between parties

**Behavioral Control.** Consideration is given to whether the business has a right to direct and control how, when, and where the worker does the work. Instructions and training given to the worker are used to determine whether a worker is an employee or an independent contractor.

**Financial Control.** Consideration is given to whether the worker has:

- Unreimbursed business expenses,
- Invested in tools and facilities used for performing services,
- Made his services available to the relevant market,
- Been paid a flat fee for a job or is paid by a specific period of time, and
- Realized a profit or loss from the work.

**Type of Relationship.** Factors that define the type of relationship include:

- Written contracts describing the relationship,
- Whether the worker is provided with employee-type benefits such as a pension plan, sick pay, or insurance, permanency of the relationship, and
- Whether the services are a key aspect of the company.<sup>5</sup>

**Example 3.** Mike Matthews is laid off from his job as a computer programmer from Super Computer, Inc. after a change in management. He was working on a programming project at the time he was laid off. He has agreed to finish the project. Super Computer, Inc. and Mike have a contract stating he is an independent contractor and will receive no benefits from Super Computer, Inc. He is told the specifications of the software and the date it is to be completed. He will use his own computer and work at home to finish the project. He works on the project whatever hours he chooses provided the project meets the specifications and the due date stated in his contract.

**Mike is an independent contractor.**

**Observation.** The fact that Mike is a former employee of Super Computer, Inc. and that the company is his sole customer could cause IRS to rule that he is a common-law employee.<sup>6</sup>

**Note.** For additional information regarding employees versus independent contractors, see pages 187–191 in the *2002 University of Illinois Income Tax Workbook*.

## PAYROLL TAX PENALTIES

### INTRODUCTION

It is obvious to taxpayers and professionals that the IRS is strictly enforcing payroll tax deposit and filing penalties. In the *IRS Data Book, FY 2002*, the IRS reports 7,763,552 employment tax penalties were assessed in fiscal year 2002. The dollar amount of penalties totaled \$6,216,145,000. However, parts of these penalties were abated. The following table shows the number and amount of net penalties after abatement for 2002.

# 2003 Workbook

## Civil Penalties Assessed and Abated, by Type of Penalty and Type of Tax, Fiscal Year 2002 (Money amounts are in thousands of dollars.)

Type of Penalty and Type of Tax	Civil Penalties Assessed		Reasonable Cause Abatements		Other Abatements		Net Civil Penalties Assessed after Abatements	
	Number	Amount	Number	Amount	Number	Amount	Number	Amount
Employment taxes	7,763,552	\$6,216,145	237,880	\$584,653	1,253,872	\$2,863,742	6,271,800	\$2,767,751
Delinquency	1,445,547	808,658	40,896	59,307	141,886	187,342	1,262,765	562,009
Failure to pay	3,618,126	507,274	56,627	21,485	639,393	129,907	2,922,106	355,882
Federal tax deposits	2,594,659	4,869,436	136,618	500,111	468,423	2,541,825	1,989,618	1,827,500
Bad check	104,157	16,860	3,699	3,659	3,973	3,482	96,485	9,720
Fraud	231	5,755	3	4	31	121	197	5,630
Negligence	16	2,958	0	0	38	504	(22)	2,454
Other	816	5,204	37	87	128	561	651	4,556

Based on these IRS statistics, the average federal tax deposit penalty assessed was \$1,877. However, after abatements, the amount was \$919, for a difference of \$958. This raises the question, "How can the IRS make so many mistakes?"

In reality, the IRS is not making mistakes. The taxpayers are responding to the notice and asking for abatement for a number of reasons, or they are using the provision of Rev. Proc. 99-10 and recalculating the penalty. Obviously, it is worth the trouble to recalculate the penalty and see if there is any valid reason for asking for abatement.

### REASONS FOR PENALTY AND PENALTY RATE

The IRS may assess two types of employment tax penalties. The penalty can either be a civil penalty or a criminal penalty. Civil penalties are normally added to the tax owed and result from the failure to file returns or pay taxes.

**Civil penalties** are only enforced by fines. They are assessed for:

1. Failure to make a required deposit,
  - 2% if 1 to 5 days late
  - 5% if 6 to 15 days late
  - 10% if 16 or more days late
  - 10% if made to an unauthorized financial institution
  - 10% if subject to electronic deposit
  - 15% if still unpaid 10 days after IRS notice
2. The responsible person failing to make payment (100% penalty),
3. Failure to timely file a return,
  - 5% of unpaid tax due with return
  - 0.5% monthly penalty for taxes due
  - 0.25% if installment agreement is in effect
  - 25% maximum penalty
  - 15% fraudulent failure to file

4. Making payment with a bad check (2% of amount of check unless check less than \$750, then \$15),
5. Filing an inaccurate return (20%), or
6. Aiding and abetting to understatement of a tax liability (\$1,000).

**Criminal penalties** include:

1. Willful attempt to evade or defeat taxes (75%) and
2. Willful failures to collect taxes, pay taxes, or file returns (75%).

Criminal penalties are enforceable by fine, imprisonment, or both.

## REASONS FOR ABATEMENT

The IRS can abate penalties for many reasons. While the acceptance of the request must be confirmed by the IRS, and is by no means automatic, some of the most common reasons are:

1. Payment or filing late due to a natural disaster.
2. Payment is by a first time filer if:
  - a. Taxpayer's net worth is \$2 million or less (\$7 million in some instances).
  - b. Return is filed timely and failure occurs during the first quarter the taxpayer is required to deposit.
  - c. Same as **b**, except it is the first time taxpayer is required to change frequency of deposits.
  - d. It is the first time the taxpayer has inadvertently sent the deposit to the IRS rather than to the designated government depository.
3. The failure to deposit was due to reasonable cause and not willful neglect.
4. The failure to deposit is due to financial difficulty; however, this has been overruled by the Sixth Circuit Court of Appeals.

## CALCULATION OF PENALTY

Unless designated by the taxpayer, for deposits made after December 31, 2001, the IRS will apply a deposit to the most recent period or periods to which the payment relates. Any excess payment is applied in period-ending-date order.

This allows taxpayers to control the amount of penalty they pay. Under Rev. Proc. 90-58, deposits are applied in a date-made order against a date-due order. Consequently, deposits are applied to the oldest liability first. While this works to the advantage of some taxpayers, those who missed an early deposit might find themselves paying large penalties.

**Example 4.** The payroll clerk from ABC Corporation was on vacation and failed to tell anyone that the January payroll deposit was due on February 15th. No one in the company realized the omission until they received a penalty notice from IRS in November. Under the date-due order, every deposit was at least one month delinquent, since IRS applied the March payment to February, and so on.

The IRS released Rev. Proc. 99-10 on January 11, 1999. This enabled taxpayers to designate the liability to which their payment is applied. Within 90 days of receiving a penalty notice, taxpayers must notify the IRS to explain how they want their deposit applied.

# 2003 Workbook

**Example 5.** Tom is a semiweekly employment tax depositor within the meaning of Treas. Reg. §31.6302-1. He accumulates the following employment tax deposit liabilities for his biweekly pay dates, and makes the following deposits:

Date	Amt. Due	Amt. Paid	Shifted	Amt. Left	Underpayment
01/03/03	\$ 7,000	\$ 7,000	\$ 0	\$7,000	\$ 0
01/17/03	5,000	4,000	0	4,000	1,000
01/31/03	5,000	5,000	1,000	4,000	1,000
02/14/03	8,000	8,000	1,000	7,000	1,000
02/28/03	6,000	6,000	1,000	5,000	1,000
03/14/03	5,000	4,000	1,000	3,000	2,000
03/28/03	10,000	10,000	2,000	8,000	2,000

During April 2003, Tom completes his Form 941 for the first quarter. He discovers the January 17th and March 14th deposits were short. On April 30, 2003, the due date of the form, Tom files the Form 941 and deposits \$2,000.

The IRS mails Tom a notice dated July 21, 2003, advising him that he is subject to an IRC §6656 failure to deposit penalty as follows:

Date	Underpay	Days	Rate	Amount
01/17/03	\$1,000	13	5%	\$ 50
01/31/03	1,000	15	5%	50
02/14/03	1,000	13	5%	50
02/28/03	1,000	14	5%	50
03/14/03	2,000	14	5%	100
03/28/03	2,000	30	10%	200
TOTAL				\$500

Under IRC §6656(e), Tom has until October 20, 2003 to designate his deposits for the first quarter. He can notify the IRS by calling the toll-free number shown on the tax penalty notice. On August 19, Tom makes the call. He designates his January 31, February 14, February 28, and March 28 payments be applied in their entirety to the tax due of those respective dates. Therefore, he is no longer liable for a penalty on those deposits. He is only liable for the January 17 and March 14 under deposits. His new penalty is calculated as follows:

Date	Underpay	Days	Rate	Amount
01/17/03	\$1,000	103	10%	\$100
03/14/03	1,000	47	10%	100
				\$200

By reallocating his payments, Tom has reduced his penalty by \$300.

**Observation.** If Tom was a farmer and filed Form 943, the amount of penalty assessed and his savings could have been much greater.

# 2003 Workbook

**Example 6.** Samantha, a farmer with a modest payroll, works on her farm 16 hours per day and consequently lets her bookkeeping fall behind. She filed the following Form 943 and 943A on January 21, 2003:

## For Example 6

<p>Form <b>943</b> Department of the Treasury Internal Revenue Service</p>	<p><b>Employer's Annual Federal Tax Return for Agricultural Employees</b></p> <p>▶ See separate Instructions for Form 943 for information on completing this return.</p>	<p>OMB No. 1545-0035</p> <p><b>2002</b></p> <table border="1"> <tr><td>T</td><td></td></tr> <tr><td>FF</td><td></td></tr> <tr><td>FD</td><td></td></tr> <tr><td>FP</td><td></td></tr> <tr><td>I</td><td></td></tr> <tr><td>T</td><td></td></tr> </table>	T		FF		FD		FP		I		T	
T														
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<p>Enter state code for state in which deposits were made <b>only</b> if different from state in address to the right (see page 2 of instructions). If you do not have to file returns in the future, check here <input type="checkbox"/></p>	<p>Name (as distinguished from trade name) <b>Samantha Farmer</b></p> <p>Trade name, if any</p> <p>Address (Number and street) <b>203 Rural Road</b></p>	<p>Calendar year <b>2002</b></p> <p>Employer identification number <b>37-0000000</b></p> <p>City, state and ZIP code <b>Anytown, IL 66666</b></p> <p>If address is different from prior return, check here. <input type="checkbox"/></p>												
<p><b>1</b> Number of agricultural employees employed in the pay period that includes March 12, 2002 ▶</p>		<p><b>1</b> <b>20</b></p>												
<p><b>2</b> Total wages subject to social security tax (see separate instructions) . . . . . <b>2</b> <b>303,543 27</b></p>		<p><b>3</b> <b>37,639 37</b></p>												
<p><b>3</b> Social security tax (multiply line 2 by 12.4% (.124)) . . . . .</p>		<p><b>3</b> <b>37,639 37</b></p>												
<p><b>4</b> Total wages subject to Medicare tax (see separate instructions) . . . . . <b>4</b> <b>303,543 27</b></p>		<p><b>5</b> <b>8,802 75</b></p>												
<p><b>5</b> Medicare tax (multiply line 4 by 2.9% (.029)). . . . .</p>		<p><b>6</b> <b>16,232 02</b></p>												
<p><b>6</b> Federal income tax withheld (see separate instructions) . . . . .</p>		<p><b>7</b> <b>62,674 14</b></p>												
<p><b>7</b> Total taxes before adjustments (add lines 3, 5, and 6) . . . . .</p>		<p><b>8</b></p>												
<p><b>8</b> Adjustment to taxes (see separate instructions). . . . .</p>		<p><b>9</b> <b>62,674 14</b></p>												
<p><b>9</b> Total taxes (line 7 as adjusted by line 8) . . . . .</p>		<p><b>10</b></p>												
<p><b>10</b> Advance earned income credit (EIC) payments made to employees, if any (see separate instructions)</p>		<p><b>11</b> <b>62,674 14</b></p>												
<p><b>11</b> Net taxes (subtract line 10 from line 9) . . . . .</p>		<p><b>12</b> <b>62,674 14</b></p>												
<p><b>12</b> Total deposits for 2002, including overpayment applied from 2001 . . . . .</p>		<p><b>13</b> <b>0 00</b></p>												
<p><b>13</b> Balance due (subtract line 12 from line 11). (See separate instructions.) ▶</p> <p>Overpayment. If line 12 is more than line 11, enter here ▶ \$ and check if to be: <input type="checkbox"/> Applied to next return or <input type="checkbox"/> Refunded</p>														

# 2003 Workbook

## For Example 6

Form **943-A**

(Rev. July 2001)

Department of the Treasury  
Internal Revenue Service

### Agricultural Employer's Record of Federal Tax Liability

► File with Form 943.

OMB No. 1545-0035

Name (as shown on Form 943)

Employer identification number

**Samantha Farmer**

**37-0000000**

You must complete this form if you are required to deposit on a semiweekly schedule, or if your tax liability during any month is \$100,000 or more. Show tax liability here, not deposits. (The IRS gets deposit data from FTD coupons or EFTPS.)

A. Daily Tax Liability—January			B. Daily Tax Liability—February			C. Daily Tax Liability—March				
1	16	<b>2,438.61</b>	1	<b>2,476.57</b>	16	<b>2,476.57</b>	1	<b>2,506.56</b>	16	<b>2,506.56</b>
2	17		2		17		2		17	
3	18		3		18		3		18	
4	19		4		19		4		19	
5	20		5		20		5		20	
6	21		6		21		6		21	
7	22		7		22		7		22	
8	23		8		23		8		23	
9	24		9		24		9		24	
10	25		10		25		10		25	
11	26		11		26		11		26	
12	27		12		27		12		27	
13	28		13		28		13		28	
14	29		14		29		14		29	
15	30		15				15		30	
	31								31	
<b>A Total liability for month ► 2,438.61</b>			<b>B Total liability for month ► 4,953.14</b>			<b>C Total liability for month ► 5,013.12</b>				

D. Daily Tax Liability—April			E. Daily Tax Liability—May			F. Daily Tax Liability—June					
1	<b>2,487.28</b>	16	<b>2,503.60</b>	1	<b>2,503.60</b>	16	<b>2,672.73</b>	1	<b>2,534.58</b>	16	<b>2,703.99</b>
2		17		2		17		2		17	
3		18		3		18		3		18	
4		19		4		19		4		19	
5		20		5		20		5		20	
6		21		6		21		6		21	
7		22		7		22		7		22	
8		23		8		23		8		23	
9		24		9		24		9		24	
10		25		10		25		10		25	
11		26		11		26		11		26	
12		27		12		27		12		27	
13		28		13		28		13		28	
14		29		14		29		14		29	
15		30		15		30		15		30	
						31					
<b>D Total liability for month ► 4,990.88</b>			<b>E Total liability for month ► 5,176.33</b>			<b>F Total liability for month ► 5,238.57</b>					

**General Instructions** not be able to process your return if you have to

# 2003 Workbook

## For Example 6

Form 943-A (Rev. 7-2001)

Page 2

G. Daily Tax Liability—July				H. Daily Tax Liability—August				I. Daily Tax Liability—September			
1	2,703.99	16	2,703.99	1	2,628.65	16	2,598.75	1	2,588.03	16	2,587.97
2		17		2		17		2		17	
3		18		3		18		3		18	
4		19		4		19		4		19	
5		20		5		20		5		20	
6		21		6		21		6		21	
7		22		7		22		7		22	
8		23		8		23		8		23	
9		24		9		24		9		24	
10		25		10		25		10		25	
11		26		11		26		11		26	
12		27		12		27		12		27	
13		28		13		28		13		28	
14		29		14		29		14		29	
15		30		15		30		15		30	
		31				31				31	
G Total liability for month ▶ <b>5,407.98</b>				H Total liability for month ▶ <b>5,227.40</b>				I Total liability for month ▶ <b>5,176.00</b>			
J. Daily Tax Liability—October				K. Daily Tax Liability—November				L. Daily Tax Liability—December			
1	2,679.53	16	2,679.53	1	2,606.81	16	2,833.21	1	2,718.45	16	2,693.49
2		17		2		17		2		17	
3		18		3		18		3		18	
4		19		4		19		4		19	
5		20		5		20		5		20	
6		21		6		21		6		21	
7		22		7		22		7		22	
8		23		8		23		8		23	
9		24		9		24		9		24	
10		25		10		25		10		25	
11		26		11		26		11		26	
12		27		12		27		12		27	
13		28		13		28		13		28	
14		29		14		29		14		29	
15		30		15		30		15		30	256.14
		31				31				31	2,584.95
J Total liability for month ▶ <b>5,359.06</b>				K Total liability for month ▶ <b>5,440.02</b>				L Total liability for month ▶ <b>8,253.03</b>			
M Total tax liability for year (add lines A through L) ▶											<b>62,674.14</b>

9

# 2003 Workbook

On March 17, 2003, Samantha received a notice from the IRS that contained the following information:

*Our records show you owe \$4,077.59 on your return for the above tax period.*

*To avoid additional penalties and/or interest, please allow enough mailing time so that we receive your payment by Apr. 7, 2003. Make your check or money order payable to the United States Treasury. Write your taxpayer identification number on your payment and mail it with the stub portion of this notice.*

*If you think we made a mistake, please call us at the number listed above. When you call, please have your payment information and a copy of your tax return available. This information will help us find any payment you made that we haven't applied.*

## Tax Statement

Tax on Return	\$62,674.14
Total Credits	(62,674.04)
Amount Previously Refunded to You	0
Underpayment	0.10
*Penalty	4,077.49
*Interest	0
Amount You Owe	\$ 4,077.59

*The following is a list of payments we have credited to your account for the above tax and tax period.*

Date of Payment	Amount	Date of Payment	Amount	Date of Payment	Amount
Feb. 20, 2002	\$2,438.61	Mar. 19, 2002	\$4,953.14	Apr. 17, 2002	\$5,013.12
May 16, 2002	4,990.88	Jun. 18, 2002	4,871.17	July 18, 2002	5,054.61
Aug. 16, 2002	5,407.98	Sep. 16, 2002	5,227.40	Oct. 16, 2002	5,176.00
Nov. 19, 2002	5,359.06	Dec. 17, 2002	5,440.02	Jan. 21, 2003	7,997.97
Jan. 31, 2002	744.08				

**About your notice** — the penalty and interest charges on your account are explained on the following pages. If you want a more detailed explanation of your penalties and interest, please call us at the telephone number listed on the top of this notice. You may call your local IRS telephone number if the number shown on your notice is a long-distance call for you. All days mentioned in the paragraphs below are calendar days, unless specifically stated otherwise.

**\$4,077.49 failure to deposit** — federal tax deposits insufficient/late IRC §6656

*We charged a penalty because you didn't deposit the correct amounts of tax on time. We used your record of tax liability to determine where to apply your deposits. We applied your deposits in the date order we received them. We figured the penalty on any tax not deposited, deposited late, or not deposited in the correct amounts.*

*The following table shows the penalty charges on your account. To compute failure to deposit penalty we used amount due × rate.*

# 2003 Workbook

Due Date	Pymt Date	Days Late	Pymt Type	Rate	Amt. Due	Penalty
1/24/2002	NOT PAID			10%	\$ 0.10	\$ 0.01
1/24/2002	1/21/2003	362	EFT	10%	1,694.43	169.44
1/24/2002	1/31/2003	372	EFT	10%	744.08	74.41
2/6/2002	3/19/2002	41	EFT	10%	2,408.62	240.86
2/6/2002	5/16/2002	99	EFT	10%	2.96	0.30
2/6/2002	1/21/2003	349	EFT	10%	64.99	6.50
3/6/2002	3/19/2002	13	EFT	5%	2,506.56	125.33
3/15/2002	3/19/2002	9	EFT	2%	37.96	0.76
3/22/2002	4/17/2002	26	EFT	10%	22.24	2.22
3/22/2002	5/16/2002	55	EFT	10%	2,484.32	248.43
4/5/2002	4/17/2002	12	EFT	5%	2,487.28	124.36
5/8/2002	5/16/2002	8	EFT	5%	2,503.60	125.18
5/22/2002	6/18/2002	27	EFT	10%	2,336.59	233.66
5/22/2002	1/21/2003	244	EFT	10%	336.14	33.61
6/7/2002	6/16/2002	11	EFT	5%	2,534.58	126.73
6/21/2002	8/16/2002	56	EFT	10%	2,425.96	242.60
6/21/2002	9/16/2002	87	EFT	10%	40.62	4.06
6/21/2002	1/21/2003	214	EFT	10%	237.41	23.74
7/8/2002	7/18/2002	10	EFT	5%	2,350.62	117.53
7/8/2002	8/16/2002	39	EFT	10%	353.37	35.34
8/7/2002	8/16/2002	9	EFT	5%	2,628.65	131.43
8/21/2002	9/16/2002	26	EFT	10%	2,598.75	259.88
9/6/2002	9/16/2002	10	EFT	5%	2,588.03	129.40
9/20/2002	10/16/2002	26	EFT	10%	2,496.47	249.65
9/20/2002	11/19/2002	60	EFT	10%	72.72	7.27
9/20/2002	1/21/2003	123	EFT	10%	18.78	1.88
10/4/2002	10/16/2002	12	EFT	5%	2,679.53	133.98
10/23/2002	11/19/2002	27	EFT	10%	2,679.53	267.95
11/6/2002	11/19/2002	13	EFT	5%	2,606.81	130.34
11/22/2002	12/17/2002	25	EFT	10%	2,721.57	272.16
11/22/2002	1/21/2003	60	EFT	10%	111.64	11.16
12/6/2002	12/17/2002	11	EFT	5%	2,718.45	135.92
12/20/2002	4/27/2003	32	EFT	10%	2,693.49	269.35
1/6/2003	1/21/2003	15	EFT	5%	2,841.09	142.05
Total Penalty						\$4,077.49

After recalculating the penalty, using the provisions of Rev. Proc. 99-10, the taxpayer found she only owed a penalty of \$863.10. This is a savings of \$3,214.49. The revised computation was made using TimeValue Software®. Because of the different options available to compute the penalty, this is a perfect application for computer software. The software used in this example runs 257 different computations.

**Note.** Unless taxpayers designate on their late payment of withheld taxes, the IRS will apply the payment first to penalty and interest accrued on the untimely paid tax. Therefore, additional penalties and interest continue to accrue.

The taxpayer should designate on the memo line on the check: "PAYMENT OF WITHHELD TRUST FUND TAXES." The IRS must then apply the payment to the withheld tax.

## W-2

Form W-2 reports information to the IRS, Social Security Administration, and Medicare regarding amounts withheld for taxes as well as the employee's total compensation. All employers that pay (cash and noncash) for services performed by employees must furnish a Form W-2 to each employee, including household employees. Form W-2 must also be provided to employees who are related to the employer. In 2004, the deadline for furnishing Form W-2 to employees is February 2.

**Extension to Furnish Forms W-2 to Employees.** An employer may request an extension of time to furnish Form W-2 to employees by sending a letter to:

IRS-Martinsburg Computing Center  
Information Reporting Program  
Attn: Extension of Time Coordinator  
240 Murall Drive  
Kearneysville, WV 25430

The request should include the employer's name and address, the EIN, the type of return and a statement requesting the extension to furnish Form W-2 to employees, the reason for the delay, and the employer's signature or the signature of the employer's authorized agent.

**Undeliverable Form W-2.** The employer must keep any employee copies of Forms W-2 that were attempted to be delivered, but were unsuccessful for **four** years. Undeliverable Forms W-2 should not be sent to the Social Security Administration.

### COMPLETING FORM W-2

Gathering information for Form W-2 and reporting it accurately has become more complex over recent years. Exactly what is included and excluded for reporting purposes can be confusing for both employers and tax professionals. Following is a box-by-box analysis.

#### Box 1 — Wages, Tips, and Other Compensation

Box 1 reports the total compensation and includes many items such as the following:

- **Total wages, prizes, and awards paid to employees during the calendar year.**
- **Total noncash payments, including taxable fringe benefits.** For example, an employer chooses to pay the employee's share of social security and Medicare tax for an **agricultural or household employee**. In this instance, the additional tax paid is considered a taxable fringe benefit for income tax purposes but is not subject to social security, Medicare, or FUTA tax. See **Example 2**. To calculate the employee's increased wages, divide the actual payment received by the factor for that year. The factor is the inverse of the social security and Medicare tax. For 2003, the amount is 92.35% ( $100\% - 7.65\%$ ).

**Note.** Nonagricultural or nonhousehold employees must include the FICA, Medicare, income tax, and FUTA as additional income in Boxes 1, 3, and 5. See **Example 2** in this chapter.

**Example 7.** Tony, a training director, was paid cash wages of \$80,000. His employer pays Tony's share of social security and Medicare tax. Tony's W-2 reports \$86,626.96 of wages in Boxes 1, 3, and 5. This is calculated by dividing his cash wages of \$80,000 by 92.35%. Social security tax in Box 4 is \$5,370.87 ( $86,626.96 \times 6.2\%$ ) and Medicare tax in Box 6 is \$1,256.09 ( $86,626.96 \times 1.45\%$ ).

# 2003 Workbook

Cash wages received	\$80,000.00
Divided by	0.9235
Cash wages reported on W-2 (reported in Boxes 1, 3, and 5)	\$86,626.96
Cash wages reported on W-2	\$86,626.96
FICA percentage	6.20%
FICA reported in Box 4	\$5,370.87
Cash wages reported on W-2	\$86,626.96
Medicare percentage	1.45%
Medicare reported in Box 7	\$1,256.09

## For Example 7

a Control number		OMB No. 1545-0008		Safe, accurate, FAST! Use  Visit the IRS Web Site at <a href="http://www.irs.gov">www.irs.gov</a> .		
b Employer identification number <b>37-1546821</b>			1 Wages, tips, other compensation <b>86626.96</b>	2 Federal income tax withheld <b>16455.00</b>		
c Employer's name, address, and ZIP code <b>ABC COMPANY 68 W. THIRD STREET FARMTOWN, KS 61822</b>			3 Social security wages <b>86626.96</b>	4 Social security tax withheld <b>5370.87</b>		
			5 Medicare wages and tips <b>86626.96</b>	6 Medicare tax withheld <b>1256.09</b>		
			7 Social security tips	8 Allocated tips		
d Employee's social security number <b>333-22-4444</b>			9 Advance EIC payment		10 Dependent care benefits	
e Employee's first name and initial Last name <b>TONY JONES  125 E. MAIN STREET FARMTOWN, KS 61822</b>			11 Nonqualified plans		12a See instructions for box 12	
			13 Statutory employee <input type="checkbox"/> Retirement plan <input type="checkbox"/> Third-party sick pay <input type="checkbox"/>	12b		
			14 Other		12c	
					12d	
f Employee's address and ZIP code						
15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name
<b>KS</b>	<b>6182-2816</b>	<b>86626.96</b>	<b>2400.00</b>			

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

**2003**

Department of the Treasury—Internal Revenue Service

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If the stated pay is more than the maximum amount for social security tax ( $\$87,000 \times .9235$ ) or  $\$80,344.50$  in 2003, then the excess stated amount is only subject to the Medicare tax. The Medicare gross wage is calculated by subtracting  $\$80,344.50$  from the stated pay and dividing this amount by  $.9855$  or  $(1 - .0145)$ . This amount is then added to  $\$87,000$ , the maximum social security wage.

9

# 2003 Workbook

**Example 8.** Use the same facts as **Example 7**, except Tony is paid \$90,000. Since this amount is over the 2003 social security limit of \$87,000, the amount reported on his W-2 is calculated as follows:<sup>7</sup>

Box 3	Social Security maximum	\$87,000.00
	Multiply by (100% – 7.65%)	<u>92.35%</u>
	Stated pay for social security	\$80,344.50
	Stated pay	\$90,000.00
	Less stated pay for social security	<u>80,344.50</u>
	Excess stated pay for Medicare	\$ 9,655.50
	Excess stated pay for Medicare	\$ 9,655.50
	Divided by (100% – 1.45%)	<u>98.55%</u>
	Excess Medicare wages	\$ 9,797.56
	Excess Medicare wages	\$ 9,797.56
	Add Social Security maximum	<u>87,000.00</u>
Boxes 1 and 5	Wages and Medicare wages	\$96,797.56
	Wages and Medicare wages	\$96,797.56
	Multiplied by Medicare rate	<u>1.45%</u>
Box 6	Medicare withheld	\$ 1,403.56
	Social Security wage	\$87,000.00
	Multiplied by 6.2%	<u>6.20%</u>
Box 6	Social Security withheld	\$ 5,394.00

a Control number		OMB No. 1545-0008		Safe, accurate, FAST! Use 		Visit the IRS Web Site at <a href="http://www.irs.gov">www.irs.gov</a> .	
b Employer identification number <b>37-1546821</b>				1 Wages, tips, other compensation <b>96797.56</b>		2 Federal income tax withheld <b>18544.00</b>	
c Employer's name, address, and ZIP code <b>ABC COMPANY 68 W. THIRD STREET FARMTOWN, KS 61822</b>				3 Social security wages <b>87000.00</b>		4 Social security tax withheld <b>5394.00</b>	
				5 Medicare wages and tips <b>96797.56</b>		6 Medicare tax withheld <b>1403.56</b>	
				7 Social security tips		8 Allocated tips	
d Employee's social security number <b>333-22-4444</b>				9 Advance EIC payment		10 Dependent care benefits	
e Employee's first name and initial      Last name <b>TONY                      JONES</b>  <b>125 E. MAIN STREET FARMTOWN, KS 61822</b>				11 Nonqualified plans		12a See instructions for box 12	
				13 Statutory employee      Retirement plan      Third-party sick pay <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>		12b	
				14 Other		12c	
						12d	
f Employee's address and ZIP code							
15 State      Employer's state ID number <b>KS      6182-2816</b>		16 State wages, tips, etc. <b>96797.56</b>		17 State income tax <b>2718.00</b>		18 Local wages, tips, etc.	
				19 Local income tax		20 Locality name	

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

**2003**

Department of the Treasury—Internal Revenue Service

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- **Total tips.** (Total tips are reported by the employee to the employer.)
- **Certain employee business expense reimbursements.** Payments are generally excluded under an accountable plan. However, if the employee's per diem rate for mileage is in excess of the amount acceptable under IRS rules, the excess is included as taxable income.

**Note.** The substantiated amount (the nontaxable portion) is reported in Box 12 using code L. Payments made under a nonaccountable plan are taxable and are subject to income tax, social security, and Medicare tax.

- **The cost of accident and health insurance premiums** for a 2% or greater shareholder in a sub S corporation.
- **Taxable benefits from an IRC §125 cafeteria plan if the employee chooses cash.**
- **Employee contributions to an Archer MSA.**
- **Employer contribution to an Archer MSA if includable in the income of the employee.**
- **Employer contributions for qualified long-term care services** to the extent that such coverage is provided through a flexible spending or similar arrangement.
- **Group term life insurance in excess of \$50,000.**
- **Payments for non-job-related education expenses or for payments under a nonaccountable plan,** unless excludable under an educational assistance program.
- **Employer payment of FICA and Medicare taxes that were not withheld from the employee.**
- **All other compensation,** including certain scholarship and fellowship grants where the recipient receives payments for teaching, research, or other services as a condition for receiving the scholarship. These payments are subject to income tax but may or may not be subject to social security or Medicare tax depending on the type of organization involved and the services performed.
- **Distributions to an employee or former employee from a nonqualified deferred compensation plan or a nongovernmental IRC §457 plan.**
- **Amounts includable in income under IRC §457(f) because the amounts are no longer subject to substantial risk or forfeiture.**
- **Payments to statutory employees that are subject to federal income tax but not social security or Medicare tax** are shown in Box 1 as other compensation.

## Box 2 — Federal Income Tax Withheld

The amount in Box 2 reports total income tax withheld from the employee's wages for the year. This amount is not reduced by any advance EIC payments made to the employee. Also included is the 20% excise tax withheld on excess golden parachute payments.

## Box 3 — Social Security Wages

The amount in Box 3 includes **total wages paid** before payroll tax deductions, that are subject to employee social security tax. The amount in this box **does not include social security tips or allocated tips.**

Generally, **noncash payments are considered wages.** This includes employee business expense reimbursements reported in Box 1. If the employer paid the employees, share of social security and Medicare taxes, the total of Boxes 3 and 7 cannot exceed \$87,000 in 2003. See **Examples 7 and 8.**

# 2003 Workbook

**Elective deferrals** to certain qualified cash or deferred compensation arrangements and to retirement arrangements described in Box 12 (codes D, F, G, and S) are included. These are included even though the deferral amounts are not included in Box 1. Amounts deferred under a nonqualified or IRC §457 plan must be included in Boxes 3 and/or 5 as social security and/or Medicare wages. They are included when the service giving rise to the deferral is performed or when there is no substantial forfeiture risk, whichever is later. Also included are elective and nonelective deferrals for purposes of IRC §457 plans.

Other amounts included in Box 3 are:

- The taxable cost of group term life insurance over \$50,000 included in Box 1,
- Cost of accident and health insurance premiums for 2% or more shareholders-employees paid by an S corporation, but only if not excludable under IRC §3121(a)(2)(B),
- Employee and nonexcludable employer contributions to an MSA,
- Employee contributions to a SIMPLE retirement plan, and
- Adoption benefits.

Generally, wages for any service performed in the United States by an employee for an employer, regardless of the citizenship or residence of either the employer or employee are subject to FICA tax. The Internal Revenue Code provides exceptions to the general rule that all wages are subject to FICA tax.<sup>8</sup>

Family employment exceptions are:


- Children under age 18 working for a parent or a child under 21 working for a parent providing services that are not in the course of the parent's trade or business or domestic service in the parent's home.
- Wages paid to a spouse, father, or mother who provides services that are not related to the trade or business of the child or spouse or consist of domestic service in the spouse's home. This exception does not apply to domestic service performed by a parent for a son or daughter if the son or daughter has a child who lives in the same house and the child is under 18 or the son or daughter has a mental or physical condition requiring adult supervision.

**Observation.** Wages would not be exempt if the employer were a corporation or a partnership, other than a husband-wife partnership, even if the relationship between parent and child exists.

- Parent paid by adult child for care of the child who needs care because of mental or physical impairments.

**Example 9.** Jim (parent) is employed by his son John (age 26) who needs daily care because of physical impairment. John pays Jim \$500 per month as a caretaker.

# 2003 Workbook

a Control number		OMB No. 1545-0008		Safe, accurate, FAST! Use 		Visit the IRS Web Site at <a href="http://www.irs.gov">www.irs.gov</a> .	
b Employer identification number <b>37-1546822</b>				1 Wages, tips, other compensation <b>6000.00</b>		2 Federal income tax withheld <b>0.00</b>	
c Employer's name, address, and ZIP code <b>JOHN JONES 2682 BANES AVENUE SPRINGVILLE, GA 61833</b>				3 Social security wages <b>0.00</b>		4 Social security tax withheld <b>0.00</b>	
				5 Medicare wages and tips <b>0.00</b>		6 Medicare tax withheld <b>0.00</b>	
				7 Social security tips		8 Allocated tips	
d Employee's social security number <b>444-33-2222</b>				9 Advance EIC payment		10 Dependent care benefits	
e Employee's first name and initial Last name <b>JIM JONES  2680 BANES AVENUE SPRINGVILLE, GA 61833</b>				11 Nonqualified plans		12a See instructions for box 12	
				13 Statutory employee Retirement plan Third-party sick pay <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>		12b	
				14 Other		12c	
f Employee's address and ZIP code				12d			
15 State Employer's state ID number <b>GA 8921-8921</b>		16 State wages, tips, etc. <b>6000.00</b>		17 State income tax <b>0.00</b>		18 Local wages, tips, etc.	
						19 Local income tax	
						20 Locality name	


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

**2003**

Department of the Treasury—Internal Revenue Service

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**Example 10.** Assume the same facts as **Example 9**, except a corporation is formed to provide care for John. The corporation employs Jim (parent) to care for John (son) on a weekly basis. The corporation pays Jim \$500 a month cash to be the caretaker for John.

a Control number		OMB No. 1545-0008		Safe, accurate, FAST! Use 		Visit the IRS Web Site at <a href="http://www.irs.gov">www.irs.gov</a> .	
b Employer identification number <b>37-2286541</b>				1 Wages, tips, other compensation <b>6000.00</b>		2 Federal income tax withheld <b>0.00</b>	
c Employer's name, address, and ZIP code <b>JOHN JONES, INC. 2682 BANES AVENUE SPRINGVILLE, GA 61833</b>				3 Social security wages <b>6000.00</b>		4 Social security tax withheld <b>372.00</b>	
				5 Medicare wages and tips <b>6000.00</b>		6 Medicare tax withheld <b>87.00</b>	
				7 Social security tips		8 Allocated tips	
d Employee's social security number <b>444-33-2222</b>				9 Advance EIC payment		10 Dependent care benefits	
e Employee's first name and initial Last name <b>JIM JONES  2680 BANES AVENUE SPRINGVILLE, GA 61833</b>				11 Nonqualified plans		12a See instructions for box 12	
				13 Statutory employee Retirement plan Third-party sick pay <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>		12b	
				14 Other		12c	
f Employee's address and ZIP code				12d			
15 State Employer's state ID number <b>GA 8921-8921</b>		16 State wages, tips, etc. <b>6000.00</b>		17 State income tax <b>0.00</b>		18 Local wages, tips, etc.	
						19 Local income tax	
						20 Locality name	

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

**2003**

Department of the Treasury—Internal Revenue Service

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# 2003 Workbook

Employment for FICA tax purposes does not include services performed by a student employed by a school, college, or university when he is enrolled and regularly attends classes there. Also, exempt from social security and Medicare are domestic services performed in a local college club or a local chapter of a college fraternity or sorority by a student enrolled at the school.<sup>9</sup> Services performed as a student nurse for a hospital or nurses' training school by an individual enrolled in the school or training are also exempt.

Other exemptions include:

- **Government Service.** Certain services performed for the federal, state, or a foreign government are not subject to FICA tax.
- **International Services.** Services performed in the employ of a foreign government, including service as a consular or other officer or employee or nondiplomatic representative are excepted from the definition of employment.<sup>10</sup>
- **Fishermen.** Certain services (other than services by a child under age 18 working for a parent) performed by an individual on a boat engaged in fishing operations are excepted from the definition of employment for FICA purposes.<sup>11</sup>
- **Services performed by a duly ordained,** commissioned, or licensed minister of a church in the exercise of his ministry generally does not constitute employment for FICA purposes.<sup>12</sup> Earnings are subject to self-employment tax unless the minister has elected to be excluded.
- **Newspaper Delivery or Sales.** Services performed by individuals under age 18 in delivering or distributing newspapers or shopping news generally is not employment for FICA tax purposes. This exception does not apply to delivery or distribution to any point for subsequent delivery or distribution.<sup>13</sup>
- **Agricultural Services.** Agricultural services performed by an individual are excepted for FICA tax purposes under an arrangement with the owner or tenant of land that meets the following requirements:
  - The individual undertakes to produce agricultural or horticultural commodities on the land.
  - The agricultural or horticultural commodities produced by the individual, or the proceeds from those commodities, are divided between the individual and the owner or tenant.
  - The amount of the individual's share depends on the amount of the agricultural or horticultural commodities produced.
- **Miscellaneous.** The following are also excepted from the definition of employment for FICA tax purposes:
  - Domestic services in the home of the employer, if the services are performed by an individual who is under age 18 during any portion of the year, and if such services are not the employee's principle occupation.
  - Service performed as an employee or employee representative under the Railroad Tax Act.
  - Communist action organizations, a Communist front organization, or a Communist infiltrated organization.<sup>14</sup>

## Box 4 — Social Security Tax Withheld

The amount in Box 4 reports the total employee social security tax withheld including social security tax on tips. The withheld social security should not exceed 6.2% of the current year maximum. For 2003, the maximum is \$5,394.00 ( $\$87,000 \times 6.2\%$ ).

## Box 5 — Medicare Wages and Tips

The amount in Box 5 is the same amount reported in Box 3, except there is no wage limit imposed for Medicare tax.

## Box 6 — Medicare Tax Withheld

The amount in Box 6 reports the Medicare tax withheld for current year wages and tips.

## Box 7 — Social Security Tips

Tips reported by the employee to the employer is shown in Box 7. The amount is reported even if the amount is less than the amount required to collect social security tax for the tips.

## Box 8 — Allocated Tips

The amount in Box 8 reports the tips allocated to the employee. This amount is not to be included in Boxes 1, 3, 5, or 7.

## Box 9 — Advance EIC Payment

Box 9 reports the amount paid to the employee as advanced earned income credit.

## Box 10 — Dependent Care Benefits

Shows the total dependent care benefits under a dependent care assistance program (IRC §129) paid or incurred by the employer for their employee. Also included in this box is the FMV of employer-provided or employer-sponsored day care facilities and amounts paid or incurred in an IRC §125 cafeteria plan.

## Box 11 — Nonqualified Plans

Show distributions to an employee from a nonqualified plan or a nongovernmental IRC §407 plan.

## Box 12 — Codes

Box 12 is completed for applicable items that follow. On Copy A of the employee's W-2, no more than four codes are entered. If additional codes are needed, a separate Copy A of the W-2 is used. On other copies of the W-2, all appropriate codes and dollar amounts may be listed. The codes follow:

- Code A: Uncollected social security or RRTA tax on tips
- Code B: Uncollected Medicare tax on tips
- Code C: Cost of group term life insurance over \$50,000
- Code D: Elective deferrals to an IRC §401(k) cash or deferral arrangement
- Code E: Elective deferrals to an IRC §403(b) salary reduction agreement
- Code F: Elective deferrals under an IRC §408(k)(6) salary reduction SEP
- Code G: Elective deferrals and employer contributions (including nonelective deferrals) to an IRC §457(b) deferred compensation plan
- Code H: Elective deferrals to an IRC §501(c)(18)(D) tax exempt organization plan
- Code J: Nontaxable sick pay
- Code K: 20% excise tax on excess golden parachute payments
- Code L: Substantiated employee business expense reimbursement
- Code M: Uncollected social security or RRTA tax on cost of group term life insurance over \$50,000 (for former employees)
- Code N: Uncollected Medicare tax on cost of group term life insurance over \$50,000 (for former employees)
- Code P: Excludable moving expense reimbursements paid directly to employee
- Code R: Employer contributions to an Archer MSA

# 2003 Workbook

- Code S: Employee salary reduction contributions under an IRC §408(p) SIMPLE
- Code T: Adoption benefits
- Code V: Income from the exercise of nonstatutory stock options

## Box 13 — Check Boxes

**Statutory Employee.** This box is checked for statutory employees whose earnings are subject to social security and Medicare taxes, but not subject to federal withholding tax.

**Retirement Plan.** This box is checked if the employee was an active participant for any part of the year in any of the following:

- A qualified pension, profit-sharing, or stock bonus plan described in IRC §401(a) (includes a 401(k) plan)
- An annuity plan described in IRC §403(a)
- An annuity contract or custodial account described in IRC §403(b)
- A simplified employee pension (SEP) plan described in IRC §408(k)
- A SIMPLE retirement account described in IRC §408(b)
- A trust described in IRC §501(c)(18)
- A plan for federal, state, or local government employees or by an agency or instrumentality thereof (other than IRC §457 plan)

**Third Party Sick Pay.** This box is checked only if the reporter is a third party sick pay payer filing a Form W-2 for an insured's employee or is an employer reporting third party sick pay payments made by a third party.

## Box 14 — Other

The lease value of a vehicle provided to an employee and reported in Box 1 must be reported in Box 14 or in a separate statement to the employee in regard to taxable fringe benefits and miscellaneous payments or deductions from pay, such as union dues, education assistance, and so on. These separately stated items usually have a special handling on the employee's personal Form 1040. The employer may also use this box for any other information he wants to give an employee. Each listed item should be labeled.

## Box 15 through Box 20

These boxes report state and local income tax information.

**Example 11.** Sam Murray was employed by Axiom Company. His final 2003 paycheck stub showed the following:

- Gross wages of \$156,329.00.
- Moving expenses of \$2,556.00. A third party moving company was paid directly. Sam was reimbursed \$823.96 for transportation expenses and \$685.00 for premove house hunting costs.
- Employer cost of paid group term life coverage over \$50,000 of \$128.75.
- IRC §401(k) plan contribution \$10,250.00.
- Sign on bonus of \$5,000 for joining the Axiom Company.
- \$1,289.34 for mileage reimbursement for 3,393 miles at the company rate of 38¢ per mile.
- Federal tax withholding of \$28,692.00.
- State income tax withholding of \$4,500.00.

# 2003 Workbook

**Question A.** What is included in Box 1 of his W-2?

**Answer A.** \$151,960.61

Gross Wages	\$156,329.00
Less 401 (k) contributions	(10,250.00)
	<u>\$146,079.00</u>
Plus:	
Sign up bonus	5,000.00
Employer reimbursement of nondeductible moving expense	685.00
Employer cost of term life insurance over \$50,000	128.75
Mileage reimbursement over the standard rate	<u>67.86</u>
Total Box 1	\$151,960.61

**Question B.** What figure is reported in Box 3 of Sam's W-2?

**Answer B.** \$87,000. Although Sam's gross wage, bonus, moving reimbursement for nondeductible expense, and employer-paid group term life insurance over \$50,000 is \$162,210.61, social security wages are limited to \$87,000 in 2003.


**Question C.** What amount should appear in Box 5 of Sam's W-2?

**Answer C.** \$162,210.61. This includes the IRC §401(k) deferral amount.

**Question D.** What codes and amounts are reported in Box 12?

**Answer D.** Code D of \$10,250 for Sam's IRC §401(k) deferral, Code C for cost of employer provided group term life insurance over \$50,000 of \$128.75, Code L for Sam's substantiated business expense reimbursement, and Code P of excludable moving expense reimbursements paid directly to Sam.

9

a Control number		OMB No. 1545-0008		Safe, accurate, FAST! Use  Visit the IRS Web Site at <a href="http://www.irs.gov">www.irs.gov</a> .	
b Employer identification number <b>43-0697822</b>		1 Wages, tips, other compensation <b>151960.61</b>	2 Federal income tax withheld <b>28692.00</b>		
c Employer's name, address, and ZIP code <b>AXIOM COMPANY 8100 EAST CLAIR SOMEVILLE, IN 51802</b>		3 Social security wages <b>87000.00</b>	4 Social security tax withheld <b>5394.00</b>		
		5 Medicare wages and tips <b>162210.61</b>	6 Medicare tax withheld <b>2351.07</b>		
		7 Social security tips	8 Allocated tips		
d Employee's social security number <b>447-99-0000</b>		9 Advance EIC payment		10 Dependent care benefits	
e Employee's first name and initial Last name <b>SAM MURRAY</b>  <b>698 S. BEND DRIVE SOMEVILLE, IN 51802</b>		11 Nonqualified plans		12a See instructions for box 12 <b>D 10250.00</b>	
		13 Statutory employee Retirement plan Third-party sick pay <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>		12b <b>C 128.75</b>	
		14 Other		12c <b>L 1221.48</b>	
				12d <b>P 823.96</b>	
f Employee's address and ZIP code		15 State Employer's state ID number <b>IN 7484-9636</b>	16 State wages, tips, etc. <b>151960.61</b>	17 State income tax <b>4500.00</b>	18 Local wages, tips, etc.
		19 Local income tax	20 Locality name		

Form **W-2 Wage and Tax Statement** **2003** Department of the Treasury—Internal Revenue Service  
 Copy B To Be Filed with Employee's FEDERAL Tax Return.  
 This information is being furnished to the Internal Revenue Service.

## SPECIAL SITUATIONS

### Lost Employment

If an employer goes out of business during the year, they must provide Form W-2 to their employees for the calendar year of the termination by the due date of the employer's final Form 941. Form W-2 must also be filed with the Social Security Administration by the last day of the month that follows the due date of the employer's final Form 941.

**Example 12.** Happy Toy Company was in business 20 years. The company's owners decided to close up shop on May 31, 2003, and retire to Florida. Happy Toy Company has three employees.

**Question A.** What should the Happy Toy Company's owners do regarding filing of final Form W-2s and Form 941?

**Answer A.** Since the Happy Toy Company ceased business on May 31, 2003, its last Form 941 is due July 31, 2003. Form W-2s must be issued by July 31, 2003. The Social Security (Copy A) W-2s must be filed with the Social Security Administration by August 31, 2003 (the last day of the month following the due date of the final Form 941).

### Lost Employee

If an employee dies during the year, an employer must report the accrued wages, vacation pay, and other compensation paid after the date of death.

**Example 13.** Richard O'Neill dies August 31, 2003. He has accrued sick pay, vacation pay, and auto expense reimbursement at the time of his death.

**Question A.** What is his employer required to do?

**Answer A.** The employer must pay the accrued vacation, sick, and expense reimbursement to Richard's estate or to the beneficiaries since these earnings are income in respect of the decedent.

### Lost W-2

If an employee lost his Form W-2, an employer should write "Reissued Statement" on the new copy and furnish it to the employee.

**Example 14.** Debbie Lawson moved in early February of 2003. She lost her Form W-2 issued to her by her employer, Wire Wizard, Inc. She wants to file her income tax return soon since she thinks she will get a big refund and she needs the money to furnish her new apartment.

**Question A.** What should she do to replace her lost W-2?

**Answer A.** Debbie must ask Wire Wizard, Inc. to provide her a new copy of her W-2. Wire Wizard, Inc. will write "Reissued Statement" at the top of the replacement form.

### Lost Boss

A Form 4852 can be used by a taxpayer when his employer gives him an incorrect Form W-2 or when the employer does not give him a W-2.

**Example 15.** Tim Gray spent the summer of 2003 working as a laborer for a roofing company. He was paid by the hour for his labor and received a weekly pay check from the Too Good To Be True Roofing Company. The company withheld federal, social security, Medicare, and state withholding taxes from his gross wages. The withholdings were reported on his paycheck stub. Tim was laid off in November 2003. He had not received his W-2 from the Too Good To Be True Roofing Company by mid-February of 2004. He tried to find George True, his boss. He was unable to find or contact anyone from the company. George left town in December 2003 with no forwarding address.

**Question A.** What should Tim do regarding his W-2 for 2003?

**Answer A.** Tim should complete Form 4852 based on the pay stubs he kept and calculate the wages and withholdings for the pay stubs that were lost over the summer. This form serves as a substitute W-2. He will need to explain attempts he made to secure a W-2 from the Too Good To Be True Roofing Company and how the wages and withholdings were calculated. Form 4852 can also be used when an employer gives an employee an incorrect Form W-2 or 1099.

## For Example 15

Form <b>4852</b> (Revised Oct. 1998)	Department of the Treasury - Internal Revenue Service <b>Substitute for Form W-2, Wage and Tax Statement, or Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, Etc.</b> Attach to Form 1040,1040A, 1040-EZ or 1040X	OMB No. 1545-0458
1. Name (First, middle, last) <b>TIMOTHY J. GRAY</b>		2. Social security number (SSN) <b>666-88-7777</b>
3. Address <b>2409 PARK OVERLOOK DRIVE TRENTON, IL 61787</b>		
4. Please fill in the year at the end of the statement. I have been unable to obtain (or have received an incorrect) Form W-2, Wage and Tax Statement, or Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-sharing Plans IRA's, Insurance Contracts, etc., from my employer or payer named below. I have notified the Internal Revenue Service of this fact. The amounts shown below are my best estimates of all wages or payments paid to me and Federal taxes withheld by this employer or payer during <u>2003</u> . <div style="text-align: right; margin-right: 50px;">(year)</div>		
5. Employer's or payer's name, address and ZIP code <b>TOO GOOD TO BE TRUE ROOFING CO, 125 W. BROADWAY, TRUETOWN, IL 61789</b>		6. Employer's or payer's identification number (if known) <b>NOT KNOWN</b>
7(A) Enter wages, compensations and taxes withheld		
a. Wages (Note: Include (1) the total wages paid (2) noncash payments, (3) tips /reported and (4) all other compensation before deductions for taxes, insurance, etc.)	7859	f. Federal income tax withheld <div style="text-align: right;">1179</div>
b. Social security wages	7859	g. State tax withheld (Name or state) <u>IL</u> <div style="text-align: right;">233</div>
c. Medicare wages	7859	h. Local tax withheld (Name of locality) <div style="text-align: right;">N/A</div>
d. Advance EIC payments		i. Social security tax withheld <div style="text-align: right;">488</div>
e. Social security tips		j. Medicare tax withheld <div style="text-align: right;">112</div>
7(B). Enter distributions from pensions, annuities, retirement or profit-sharing plans, IRAs, insurance contracts, etc.		
1. Gross Distribution		4. Federal Income Tax Withheld
2a. Taxable Amount		5. State Income Tax Withheld
2b. Taxable Amount not determined <input type="checkbox"/>		6. Employee Contribution
Total Distribution <input type="checkbox"/>		7. Net Unrealized Appreciation
3. Capital Gains (included in 2a)		8. Enter Distribution Code
8. How did you determine the amounts in item 7 above? <b>I used paystubs with deductions and wages stated. For lost stubs, I figured what the tax should have been from similar stub amounts.</b>		
9. Explain your efforts to obtain Form W-2, 1099-R, or W-2c, Statement of Corrected Income and Tax Amounts. <b>I went to the house where my boss lived. The neighbors said he left one night and never saw him again. I couldn't find him or anyone from the company.</b>		
<b>Caution Notice:</b> If your employer has ceased operations or filed for bankruptcy, you may wish to send a copy of this form to the		

## FRINGE BENEFITS

No-additional-cost fringe benefits provided by an employer are excluded from the income of an employee. A no-additional-cost benefit is a service provided by the employer to an employee, but only if the employer regularly offers this service for sale to customers and there is no additional cost to the employer to provide this service to employees.<sup>15</sup>

An example of a no-additional-cost fringe benefit is a hotel room furnished to employees working in the hotel business, provided in such a way that external customers are not displaced. Benefits under a no-additional-cost fringe benefit plan need to be made available on a nondiscriminatory basis. For example, “not in use” hotel rooms must be available to all employees on substantially the same terms, not just highly compensated employees.

Reciprocal agreements can be established between two unrelated employers for no-additional-cost fringe benefits if there is a written agreement in effect. For example, two airlines might allow free standby flights to each other’s employees. This reciprocal agreement can only be for the same type of service. It cannot be an available exchange for an employee from a hotel industry to receive free standby flights from an airline business.

Fringe benefits reporting requirements can be found in the following tables.

Fringe Benefit	Code Section	Explanation	FICA/Medicare	Withholding	Returns	FUTA
Awards and prizes — Employees	74					
Cash	74(a)		Taxable	Taxable	W-2	Taxable
Non-cash over \$25	74(a)		Taxable	Taxable	W-2	Taxable
Length of service or safety achievement	74(c)/132(a)(3)	Exempt to the extent it is reasonable to believe the employee will be able to exclude the benefit as an achievement award or as a de minimus fringe. \$400 limit	Exempt/3121(a)(20)	Exempt/3401(a)(19)	N/A	
Awards and prizes — Nonemployees	132(e)					
			Exempt	Exempt	1099-MISC	Exempt
Back pay		Treated as wages in year paid	Taxable	Taxable	W-2	Taxable
Bonuses — employees	61(a)(1)		Taxable	Taxable	W-2	Taxable
Cafeteria plans	125					
Cash			Taxable	Taxable	W-2	Taxable
Dependent care assistance	129	Employer provided	Exempt/3121(a)(18)	Exempt/3401(a)(18)	W-2 (Box 10)	Taxable *
Accident and health plan	106	Employer provided	Exempt	Exempt	N/A	Exempt
Adoption assistance	137	Employer provided	Exempt	Exempt	N/A	Exempt
Flexible spending accounts						
Dependent care	129	\$5,000 maximum (\$2,500 married filing separately)	Exempt/3121(a)(18)	Exempt/3401(a)(18)	W-2 (Box 10)	Taxable *
Health	106		Exempt	Exempt	N/A	Exempt
Cars	132	Employer-provided vehicle				
Business use		Announcement 85-113, 1985-31 I.R.B. 31	Exempt	Exempt	N/A	Exempt
Personal use		Publication 535 — Business Expenses	Taxable	Taxable/Unless taxpayer elects not to withhold (3402(s))	W-2	Taxable
Clothing allowance — Accountable plan	162/132	Publication 17 — Qualified Clothing	Exempt	Exempt	N/A	Exempt

\* Exempt up to \$5,000 (\$2,500 married filing separately).

Fringe Benefit	Code Section	Explanation	FICA/Medicare	Withholding	Returns	FUTA
Conventions						
Substantiated expenses		Employment-related expenses	Exempt/ 31.3121(a)-1(h)	Exempt/ 31.3401(a)-1(b)(2)	N/A	Exempt
Unsubstantiated expenses		IRS Notice 894	Taxable	Taxable	W-2	Taxable
Dependent care assistance	129	Employer provided	Exempt/3121(a)(18)	Exempt/3401(a)(18)	W-2 (Box 10)	Exempt
Eating facility	132(a)(4) 1.132-7(a)(1)		Exempt	Exempt	N/A	Exempt
Education assistance						
Education assistance programs	127/1.127-2	Limited to \$5,250 annually. Courses beginning after Dec. 2001. Need not be job related.	Exempt/3121(a)(18)	Exempt/3401(a)(18)	N/A	Exempt
Scholarships and fellowships	117	Publication 520 — Scholarships and Fellowships	Exempt/3121(a)(20)	Exempt/3401(a)(19)	N/A	Exempt
	117(c)	Related to payments for teaching, research, or other services required as a condition for receiving the qualified scholarship.	Depends on the nature of employment and type of organization	Taxable	W-2	Taxable
Tuition reduction programs: Educational institution as employer	117		Exempt/3121(a)(20)	Exempt/3401(a)(19)	N/A	Exempt
Educational reimbursement plans	132	Job-related education or training expenses. The reimbursement must be made to maintain or improve skills required by the employee's job. No dollar limitations or nondiscrimination requirements.	Taxable	Taxable	Taxable	Taxable
Accountable plan			Exempt/3121(a)(20)	Exempt/3401(a)(19)	N/A	Exempt
Nonaccountable plan	132		Taxable	Taxable	W-2	Taxable

Fringe Benefit	Code Section	Explanation	FICA/Medicare	Withholding	Returns	FUTA
Employee business expense reimbursement	132		Exempt	Exempt	N/A	Exempt
Accountable plan			Taxable	Taxable	W-2	Taxable
Nonaccountable plan			Exempt	Exempt	W-2 (Box 12-Code L)	Exempt
Per diem or other fixed allowance		Established by Federal Government. Only enter the nontaxable portion.	Taxable	Taxable	W-2	Taxable
Excess over federal established amount		Enter the amount that is taxable	Taxable	Taxable	W-2	Taxable
Employer payment of employee taxes			Taxable	Taxable	W-2	Taxable
Health and accident insurance	106	Employer-paid accident and health coverage	Exempt	Exempt	N/A	Exempt
Jury duty pay		Amount received from the employer in excess of the amount received for jury duty. (Rev. Rul. 68-425, 1968-2 C.B. 20)	Taxable	Taxable	W-2	Taxable
Leave sharing plan		Amounts paid to recipients of the leave are wages.	Taxable	Taxable	W-2	Taxable
Life insurance	79				W-2 (Box 12 Code C)	
Value over \$50,000			Taxable	Exempt/3401(a)(14)	W-2	Taxable
Value under \$50,000			Exempt/3121(a)(2)(C)	Exempt/3401(a)(14)	N/A	Exempt
Lodging provided by employer	119	For the convenience of the employer, on employer's premises and must be accepted as condition of employment.	Exempt/3121(a)(19)	Exempt/31.3401(a)-1(b)(9)	N/A	Exempt
Meal allowances or reimbursements	119	For the convenience of the employer and on employer's premises.	Exempt/3121(a)(19)	Exempt	N/A	Exempt
Supper money		In order to be excluded, it must qualify as a de minimis fringe benefit. It must be reasonable in amount and provided on an occasional basis. If payments are calculated on the basis of the number of hours worked, payments cannot be excluded.	Exempt/3121(a)(19)	Exempt	N/A	Exempt

Fringe Benefit	Code Section	Explanation	FICA/Medicare	Withholding	Returns	FUTA
Membership fees paid by employer						
Professional and trade organizations	132(a)(3)		Exempt/3121(a)(20)	Exempt/3401(a)(19)	N/A	Exempt
Clubs organized for business, pleasure, recreation, or other social purposes			Taxable	Taxable	W-2	Taxable
Moving expenses — paid to third party	217	If at the time of payment it is reasonable to believe the employee can deduct the expense. Pub 521 — Moving Expenses	Exempt/3121(a)(11)	Exempt/3401(a)(15)	N/A	Exempt
Paid directly to employee	217	IRS Announcement 97-77, I.R.B. 1997-33, August 18, 1997	Exempt/3121(a)(11)	Exempt/3401(a)(15)	W-2 (Box 12, Code P)	Exempt
Nonqualified reimbursement plan			Taxable	Taxable	W-2	Taxable
Nonqualified deferred compensation		At the time actually or constructively received.	Taxable	Taxable	W-2 (Box 11)	Taxable
Sick pay	104		Taxable	Taxable	W-2	Taxable
Payments per workers compensation law			Exempt	Exempt	N/A	Exempt
Employee contribution			Exempt	Exempt	N/A	Exempt
Third-party payor						
Agent		Employer responsibility	Taxable	Taxable	W-2	Taxable
Not an agent		Third-party payor responsible	Taxable	Exempt	W-2	Taxable
Disability	104					
Long-term disability		Over 6 months	Exempt/3121(a)(2)(A) and 3121(a)(4)	Taxable/ 31.3401(a)-1(b)(8)	W-2	Taxable
Third-party payor						
Agent			Exempt	Taxable/ 31.3401(a)-1(b)(8)	W-2	Taxable
Not an agent			Exempt	Exempt	N/A	Exempt
Vacations			Taxable/ 31.3121(a)-1(g)	Taxable/ 31.3401(a)-1(b)(3)	W-2	Taxable

## TIPPED EMPLOYEES

The 2002 Supreme Court decision allowing the IRS to use any reasonable method to estimate the amount of tips received by employees has created an interest in accurately reporting the amount of tips employees actually receive.<sup>16</sup> Employers with tipped employees may want to obtain copies of IRS Pub. 531, *Reporting Tip Income*, and IRS Pub. 1875, *Tips on Tips, A Guide to Reporting Tip Income*. Both publications are available from the IRS website.

The easiest way to avoid the IRS making a tip allocation is to have employees keep accurate tip records. Typically the actual amount of tips received is less than what the IRS allocates in an audit. Tip reporting is not unique to the restaurant industry. Other tipped employees include:

Airport skycaps	Hotel housekeepers
Bartenders	Manicurists
Hair stylists	Masseuses
Bellhops	Parking attendants
Casino workers	Railroad redcaps
Delivery service people	Taxi drivers
Golf caddies	

## EMPLOYEE REPORTING

If an employee receives \$20 or more in tips in any one month, he must report them to his employer within 10 days after the end of the month. The tips must be included in gross income whether received directly from customers, from the employer as recorded from charge sales, or a share of tips received under a tip-splitting or tip-pooling arrangement. The value of noncash tips, such as tickets, passes, or other items of value are also subject to tax. The employee should:

1. Keep a daily tip record,
2. Report tips to his employer, and
3. Report all tips on his income tax return.

The report given the employer should include:

1. The employee's name, address, and SSN,
2. The employer's name and address,
3. The month or period the report covers, and
4. The total tips.

The employee should obtain a copy of IRS Pub. 1244, *Employer's Daily Record of Tips and Report to Employer*, which includes Form 4070, to use in reporting the tips to the employer. Even if an employee reports all tips to the employer, he should keep a daily log in case of an examination. In the event the employer is audited and it is determined that employees are not reporting their tips accurately, the employer may be required to allocate tips to the employees. In this case the amount reported to the IRS for an employee may be substantially more than he actually received. The daily log serves as evidence that the tips are overstated.

Once the employee has reported the tip amount to the employer, the employer will make the appropriate tax calculations and include the tip amounts on the payroll tax forms.

# 2003 Workbook

## Failure to Report

If an employee forgets to report all of her tips to her employer, but includes them on her Form 1040, she may owe a 50% social security and Medicare penalty and be subject to a negligence penalty and a possible estimated tax penalty. In addition, she places her employer at risk for a possible assessment of the employer's share of social security and Medicare taxes.

If an employee reports all tips, and her taxes on the tips are greater than her wages, she may either give part of the tip money to the employer to apply to withheld taxes or she can pay the additional tax when she files her Form 1040. Waiting until the Form 1040 is filed may result in an estimated tax penalty.

## EMPLOYER REPORTING

Once the employer receives record of the tips for an employee, he includes this amount on his next Form 941. The employer should also collect income tax, social security, and Medicare on the employee's tips. These taxes can be collected either from the employee's wages or from funds given by the employee. The employer is responsible for the employer's share of the social security and Medicare tax.

If by the 10th of the month, the employer receives the record of tips, but does not have enough employee funds available to deduct the employee tax, he no longer has to collect the tax. If there are not enough funds available, he must withhold taxes in the following order:

1. Withhold on regular wages and other compensation
2. Withhold social security and Medicare taxes on tips
3. Withhold income tax on tips

The tips and uncollected social security and Medicare taxes are shown on Form W-2 and on lines 6c, 6d, 7a, and 7b of Form 941. The employer should report an adjustment on line 9 of Form 941 for the uncollected social security and Medicare taxes. The uncollected amount should also be reported in box 12 of Form W-2 with codes A and B.

**Example 16.** Toby began working as a waiter for Sandy's Fine Dining, Inc. on December 2, 2002. He earned \$300.00 in regular wages and \$450.00 in tips prior to his termination on December 16, 2002. Since his Form 4070 was turned in to his employer after he received his final pay check, the employer was unable to deduct the social security tax, Medicare tax, and federal income tax from his final pay. Assuming Toby was the only employee for 2002 and based on the following Form 4070, Form 941 and Form W-2 are completed as follows.

Form <b>4070</b> (Rev. June 1999) Department of the Treasury Internal Revenue Service		<b>Employee's Report of Tips to Employer</b>		OMB No. 1545-0065
Employee's name and address <b>Toby Tyler</b>		Social security number <b>111 22 3333</b>		
Employer's name and address (include establishment name, if different) <b>Sandy's Fine Dining, Inc.</b> <b>111 Easton Road</b> <b>Louisville, OH 44444</b>		1 Cash tips received <b>350.00</b>		
		2 Credit card tips received <b>100.00</b>		
		3 Tips paid out <b>0.00</b>		
Month or shorter period in which tips were received from <b>December 2, 2002</b> to <b>December 16, 2002</b>		4 Net tips (lines 1 + 2 - 3) <b>450.00</b>		
Signature		Date <b>12/24/2002</b>		

# 2003 Workbook

## For Example 16

Form **941**  
(Rev. October 2001)  
Department of the Treasury  
Internal Revenue Service (99)

### Employer's Quarterly Federal Tax Return

▶ See separate instructions revised January 2001 for information on completing this return.

Please type or print.

Enter state code for state in which deposits were made **only** if different from state in address to the right ▶ (see page 2 of instructions).

Name (as distinguished from trade name)

**Sandy's Fine Dining, Inc.**

Trade name, if any

Address (number and street)

**111 Easton Rd.**

Date quarter ended

**12/31/2002**

Employer identification number

**55-1111111**

City, state, and ZIP code

**Louisville, OH 44444**

OMB No. 1545-0029

T

FF

FD

FP

I

T

If address is different from prior return, check here ▶

IRS Use

1	1	1	1	1	1	1	1	1	1	2	3	3	3	3	3	3	3	3	4	4	4	5	5	5
6	7	8	8	8	8	8	8	8	8	8	9	9	9	9	9	9	9	9	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 1 of the instructions and check here ▶

<b>1</b>	Number of employees in the pay period that includes March 12th . . . ▶	<b>1</b>	<b>1</b>	
<b>2</b>	Total wages and tips, plus other compensation . . . . .	<b>2</b>	<b>750 00</b>	
<b>3</b>	Total income tax withheld from wages, tips, and sick pay . . . . .	<b>3</b>	<b>20 00</b>	
<b>4</b>	Adjustment of withheld income tax for preceding quarters of calendar year . . . . .	<b>4</b>		
<b>5</b>	Adjusted total of income tax withheld (line 3 as adjusted by line 4—see instructions) . . . . .	<b>5</b>	<b>20 00</b>	
<b>6</b>	Taxable social security wages . . . . .	<b>6a</b>	<b>300 00</b>	$\times 12.4\% (.124) =$
	Taxable social security tips . . . . .	<b>6c</b>	<b>450 00</b>	$\times 12.4\% (.124) =$
<b>7</b>	Taxable Medicare wages and tips . . . . .	<b>7a</b>	<b>750 00</b>	$\times 2.9\% (.029) =$
<b>8</b>	Total social security and Medicare taxes (add lines 6b, 6d, and 7b). Check here if wages are not subject to social security and/or Medicare tax . . . . . ▶ <input type="checkbox"/>	<b>8</b>	<b>114 75</b>	
<b>9</b>	Adjustment of social security and Medicare taxes (see instructions for required explanation) Sick Pay \$ _____ $\pm$ Fractions of Cents \$ _____ $\pm$ Other \$ <b>34.43</b> =	<b>9</b>	<b>(34 43)</b>	
<b>10</b>	Adjusted total of social security and Medicare taxes (line 8 as adjusted by line 9—see instructions) . . . . .	<b>10</b>	<b>80 32</b>	
<b>11</b>	<b>Total taxes</b> (add lines 5 and 10) . . . . .	<b>11</b>	<b>100 32</b>	
<b>12</b>	Advance earned income credit (EIC) payments made to employees . . . . .	<b>12</b>		
<b>13</b>	Net taxes (subtract line 12 from line 11). <b>If \$2,500 or more, this must equal line 17, column (d) below (or line D of Schedule B (Form 941))</b> . . . . .	<b>13</b>	<b>100 32</b>	
<b>14</b>	Total deposits for quarter, including overpayment applied from a prior quarter . . . . .	<b>14</b>	<b>100 32</b>	
<b>15</b>	<b>Balance due</b> (subtract line 14 from line 13). See instructions . . . . .	<b>15</b>		
<b>16</b>	<b>Overpayment.</b> 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.			

<b>17 Monthly Summary of Federal Tax Liability.</b> Do not complete if you were a semiweekly schedule depositor.			
(a) First month liability	(b) Second month liability	(c) Third month liability	(d) Total liability for quarter
		<b>100.32</b>	<b>100.32</b>


**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 ▶ \_\_\_\_\_ Print Your Name and Title ▶ \_\_\_\_\_ Date ▶ \_\_\_\_\_

For Privacy Act and Paperwork Reduction Act Notice, see back of Payment Voucher. Cat. No. 17001Z Form **941** (Rev. 10-2001)

# 2003 Workbook

## For Example 16

a Control number		OMB No. 1545-0008		Safe, accurate, FAST! Use 		Visit the IRS Web Site at <a href="http://www.irs.gov">www.irs.gov</a> .	
b Employer identification number <b>55-1111111</b>		1 Wages, tips, other compensation <b>750.00</b>		2 Federal income tax withheld <b>20.00</b>			
c Employer's name, address, and ZIP code <b>SANDY'S FINE DINING, INC. 111 EASTON ROAD LOUISVILLE, OH 44444</b>		3 Social security wages <b>300.00</b>		4 Social security tax withheld <b>22.95</b>			
		5 Medicare wages and tips <b>750.00</b>		6 Medicare tax withheld <b>10.88</b>			
		7 Social security tips <b>450.00</b>		8 Allocated tips			
d Employee's social security number <b>111-22-3333</b>		9 Advance EIC payment		10 Dependent care benefits			
e Employee's first name and initial Last name <b>TOBY TYLER</b>  <b>303 PARIS AVENUE LOUISVILLE, OH 44444</b>		11 Nonqualified plans		12a See instructions for box 12 <b>A 27.90</b>			
		13 Statutory employee Retirement plan Third-party sick pay <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>		12b <b>B 6.53</b>			
		14 Other		12c			
f Employee's address and ZIP code				12d			
15 State <b>OH</b>	Employer's state ID number <b>1111-8888</b>	16 State wages, tips, etc. <b>750.00</b>	17 State income tax <b>2.00</b>	18 Local wages, tips, etc.	19 Local income tax	20 Locality name	

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

**2003**

Department of the Treasury—Internal Revenue Service

Copy B To Be Filed with Employee's FEDERAL Tax Return.  
This information is being furnished to the Internal Revenue Service.

If the employee reports \$20 or more in tips in a month, the tips are also subject to the FUTA tax.

### Compliance Program

Some employers have entered into a compliance agreement with the IRS concerning tips. The Tip Rate Determination/Education Program was developed in 1995 to help employees receiving tip income and their employers understand the law. Under this program, and depending on the specific business, the employer may enter into one of two arrangements — the Tip Rate Determination Agreement (TRDA) or the Tip Reporting Alternative Commitment (TRAC).

An employee, as a participant in TRDA, agrees to an IRS-specified tip rate for the employer's establishment. To remain a participant, the employee must continue to report tips at or above the agreed-upon rate. In addition, the employer is required to report the employee's name to the IRS if the employee fails to report tips at or above this rate.

### Credit for Employer Social Security and Medicare Taxes

Participation in the TRDA or TRAC programs can mean a credit for social security and Medicare taxes paid on certain employee tips. The employer must complete Form 8846 to claim the credit. The credit equals the amount of employer social security and Medicare taxes paid or incurred by the employer on tips received by the employee. However, the employer social security and Medicare taxes on tips that are used to meet the federal minimum wage rate applicable to the employee under the Fair Labor Standards Act are not included in the computation. The federal minimum wage rate is \$5.15 per hour.

**Example 17.** An employee worked 100 hours and received \$350 in tips for October 2003. The worker received \$375 in wages (excluding tips) at the rate of \$3.75 an hour. Because the federal minimum wage rate was \$5.15 per hour, the employee would have received wages, excluding tips, of \$515 had the employee been paid at the federal minimum wage rate. Thus, only \$210 of the employee's tips for October 2003 is taken into account for credit purposes.

# 2003 Workbook

Assuming this is the only transaction for the year, the Form 8846 is completed as follows:

Form <b>8846</b>	<b>Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips</b>	OMB No. 1545-1414
Department of the Treasury Internal Revenue Service	▶ Attach to your tax return.	<b>2003</b> Attachment Sequence No. <b>98</b>
Name(s) shown on return <b>Hungry Hank's Grill, Inc.</b>		Identifying number <b>55-1111111</b>
<b>Note:</b> Claim this credit <b>only</b> for social security and Medicare taxes paid by a food or beverage establishment where tipping is customary for providing food or beverages. See the instructions for line 1.		
<b>Part I Current Year Credit</b>		
1 Tips received by employees for services on which you paid or incurred employer social security and Medicare taxes during the tax year (see instructions)	1	<b>350</b>
2 Tips not subject to the credit provisions (see instructions)	2	<b>140</b>
3 Creditable tips. Subtract line 2 from line 1	3	<b>210</b>
4 Multiply line 3 by 7.65% (.0765). If you had any tipped employees whose wages (including tips) exceeded \$87,000, see instructions and check here <input type="checkbox"/>	4	<b>16</b>
5 Form 8846 credits from pass-through entities:		
If you are a—	Then enter the Form 8846 credits from—	
a Shareholder	Schedule K-1 (Form 1120S) lines 12d, 12e, or 13	
b Partner	Schedule K-1 (Form 1065) lines 12c, 12d, or 13	
6 Current year credit. Add lines 4 and 5	6	<b>16</b>
<b>Part II Allowable Credit</b> (See <b>Who must file Form 3800</b> to find out if you complete Part II or file Form 3800.)		
7 Regular tax before credits:		

## BECOMING A NEW EMPLOYER

9

After making a decision to employ workers, a business owner must attend to the following **employment tax** activities:

- Complete and file Form I-9, *Employment Eligibility Verification*, for each new employee.
- Request each new employee complete Form W-4, *Employee Withholding Allowance Certificate*, and verify employee identification information (SSN or TIN). **Form W-4 is filed** each quarter with Form 941 **if** an employee claims **more than 10 withholding allowances** or an **exemption from withholding**.
- For applicable new employee(s), complete Form W-5, *Earned Income Credit Advance Payment Certificate*. This form is retained by the employer.
- Calculate, withhold, and timely deposit federal income tax payments, and file quarterly returns using Form 941, *Employer's Quarterly Federal Tax Return*.
- Calculate, withhold, match, and timely deposit social security and Medicare tax payments.
- Calculate, withhold, and timely make state or local income tax payments.
- Pay state unemployment taxes.
- Complete appropriate state form for reporting new hires and submit to appropriate state reporting agency.

At the **end of the calendar year** the following employment tax activities must be completed:

- File Form(s) W-2, *Wage and Tax Statement*.
- File Form(s) W-3, *Transmittal of Wage and Tax Statement*.
- File and pay federal unemployment taxes (FUTA) using Form 940, *Employer's Annual Federal Unemployment Tax Return*.

# 2003 Workbook

- File Form 945, *Annual Return of Withheld Federal Income Tax*.
- File Form 8027, *Employer's Annual Informational Return of Tip Income and Allocated Tips*, if applicable.
- File required informational returns applicable to the business.

IRS publications contain information useful to employers. Following is a list of **employment tax publications**:

Pub. 15	<i>Circular E, Employer's Tax Guide</i>
Pub. 15-A	<i>Supplemental Employer's Tax Guide</i>
Pub. 15-B	<i>Employer's Tax Guide to Fringe Benefits</i>
Pub. 15-T	<i>New Withholding Tables</i>
Pub. 51	<i>Circular A, Agricultural Employer's Tax Guide</i>
Pub. 80	<i>Circular SS, Federal Tax Guide for Employers in the U.S. Virgin Islands, Guam, American Samoa, and the Commonwealth of Northern Mariana</i>
Pub. 505	<i>Tax Withholding and Estimated Taxes</i>
Pub. 510	<i>Excise Taxes for 2003</i>
Pub. 515	<i>Withholding of Tax on Nonresident Aliens and Foreign Corporations</i>
Pub. 517	<i>Social Security and Other Information for Members of the Clergy &amp; Religious Workers</i>
Pub. 531	<i>Reporting Tip Income</i>
Pub. 533	<i>Self-Employment Tax</i>
Pub. 583	<i>Starting a Business and Keeping Records</i>
Pub. 926	<i>Household Employer's Tax Guide</i>
Pub. 937	<i>Employment Taxes</i>
Pub. 952	<i>Sick Pay Reporting</i>
Pub. 954	<i>Tax Incentives for Empowerment Zones and Other Distressed Communities</i>
Pub. 957	<i>Reporting Back Pay and Special Wage Payments to the Social Security Administration</i>
Pub. 966	<i>Electronic Federal Tax Payment System (Answers to the Most Commonly Asked Questions)</i>
Pub. 1635	<i>Understanding Your EIN</i>
Pub. 3953	<i>Q &amp; As About Tax Court Proceedings for Determination of Employment Status Under IRC §7436</i>

## ENDNOTES

- 1 IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits*
- 2 IRC §3306(i)
- 3 IRC §3121(d)(3)
- 4 Rev. Rul. 90-93
- 5 IRS Pub. 15-A
- 6 Ltr. Rul. 9707019, November 15, 1996

# 2003 Workbook

- 7 IRS Pub. 15-A
- 8 IRC §3121(b)(3)
- 9 IRC §3121(b)(2)
- 10 IRC §3121(b)(11)
- 11 IRC §3121(b)(20)
- 12 IRC §3121(b)(8)
- 13 IRC §3121(b)(14)(a)
- 14 IRC §3121(b)(17)
- 15 IRC §132(b)
- 16 *U.S. v. Fior D'Italia Inc.*, U.S. Supreme Court (June 17, 2002), AFTR 2d 2002-2883, 2002-1 USTC

# 2003 Workbook