Chapter 2: Employment Issues

Please note. Corrections were made to this workbook through January of 2018. No subsequent modifications were made. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

About the Author

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Chapter Summary

When possible, businesses prefer to classify workers as independent contractors rather than employees because this results in financial savings (e.g., employment taxes, benefits, etc.) and administrative savings. The factors that determine appropriate worker classifications are described in this chapter.

Workers with multiple employers in the same year may have excessive social security tax withholdings. The procedure for recovering this excess is explained.

When an employee receives property instead of wages, compensation is recognized for the fair market value (FMV) of the property, less any amount paid by the employee. The taxation of various types of noncash payments are explained.

Only legal expenses associated with an income-producing activity are currently deductible. Personal legal expenses are nondeductible, whereas those associated with the acquisition or sale of capital assets must be capitalized.

The taxation of a legal award or damage claim depends on its nature. Court-awarded amounts for back pay are generally considered wages subject to payroll tax withholdings. Awards for punitive damages are also taxable. However, settlements for personal injuries or sickness are usually excludable from gross income. Employer-paid medical insurance premiums are also excluded from employees' income, and the self-employed can claim a deduction for medical insurance premiums. Insurance reimbursements for medical expenses of the taxpayer, taxpayer's spouse, or dependents are excludable.

Generally, the FMV of a fringe benefit provided by an employer is included in the employee's income, less any amount contributed by the employee. However, some fringe benefits are tax-free and others qualify for partial tax relief.

Employer tax withholding obligations vary depending on the category of the worker. Common-law employees are generally subject to federal and FICA withholdings. Statutory employees are not subject to federal income tax withholding but may be subject to FICA and FUTA. Statutory nonemployees are not treated as employees for FICA, FUTA, or federal income tax withholding purposes.

Employers of household workers are required to obtain an employer identification number. Federal income tax withholding is not required but FICA withholding may be necessary. Relevant tax compliance procedures are covered in this chapter.

Due to increased law enforcement efforts, U.S. employers should be especially vigilant regarding the identity and employment eligibility of foreign workers, while respecting antidiscrimination provisions of the law. Employers are subject to civil penalties for failure to comply with employee verification requirements or for knowingly hiring or continuing to employ ineligible workers.

EMPLOYEE OR INDEPENDENT CONTRACTOR

RIGHT-TO-CONTROL TEST

A worker is an employee for federal employment tax purposes if the worker qualifies as an employee under common law. Under common law, an employer-employee relationship exists when the firm or person for whom the worker performs the services has the right to control and direct the worker in how the worker performs the services.[1] Right to control refers to the degree of control over the means and details of the worker's tasks. Such control is the hallmark of an employer-employee relationship. It is not necessary for the employer to actually exercise this control. Merely having the right to control the worker is sufficient to conclude that the worker is an employee and not an independent contractor.[2]

20 FACTORS

The IRS uses 20 factors to determine whether a worker is an employee or an independent contractor. The IRS notes that these factors are only **a guide** and that the degree of importance of each factor varies depending on the particular circumstances of each case. The following factors indicate the various aspects of a typical work relationship.[3]

1. **Instructions.** If an employer can instruct the worker about when, where, and how the worker performs work, this indicates an employer-employee relationship. Independent contractors have more control over their work.
2. **Training and meetings.** Providing worker training and requiring the worker to attend meetings indicates the existence of an employer-employee relationship.
3. **Integration of work performed into firm operations.** Strong integration of the worker's services into operations of the person who hired the worker indicates an employer-employee relationship.
4. **Personal performance of services.** Employees must personally perform services. The same requirement might not be expected of an independent contractor, although there are exceptions. This factor alone is frequently not determinative.
5. **Personnel control.** A firm's control over the hiring, supervision, and payment of the worker's assistants suggests an employer-employee relationship. Independent contractors typically maintain and control their own staff.
6. **Length of working relationship.** A continual, long-term work relationship implies an employer-employee relationship. Such a long-term relationship may also exist with an independent contractor. Therefore, this factor taken alone is not determinative.
7. **Work schedule.** An established work schedule for the worker indicates that an employer-employee relationship exists. Independent contractors generally retain more freedom in scheduling the performance of their services to a firm.
8. **Hours of service required.** Requiring substantially full-time work from the worker in the performance of services to the firm is indicative of an employer-employee relationship. Conversely, part-time hours worked for one firm or person while the worker also provides work for other firms or persons indicate that the worker may be an independent contractor.

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1. Rev. Rul. 87-41, 1987-1 CB 296.
2. Ibid.
3. Ibid.

9. **Location of services.** Requiring the worker to perform services at the firm's or person's own location suggests an employer-employee relationship. However, because employees can only perform some types of work at the firm's or person's worksite, this factor alone is not determinative.

10. **Control over work technique.** Control by the firm or person over the worker's technique or order of tasks indicates that an employer-employee relationship exists. A worker who has control over the technique or task order in the performance of services suggests that the worker may be an independent contractor.

11. **Periodic reporting.** Requiring regular written or verbal reports from the worker to other firm personnel or persons associated with the person for whom the worker provides services indicates an employer-employee relationship. However, requiring progress reports by an independent contractor is also common. Therefore, this factor alone is not determinative.

12. **Payment method.** Payment at regular intervals (hourly, weekly, or monthly) suggests an employer-employee relationship. Alternatively, payment to the worker based on the particular job or project or based on invoices issued by the worker suggests an independent contractor relationship.

13. **Work-related expenses.** Payment of the worker's business and travel expenses suggests an employer-employee relationship. However, this type of arrangement may also exist between a firm or person and an independent contractor.

14. **Provision of tools.** Tools furnished by the worker indicate that the worker is an independent contractor. If the person for whom the services are performed provides the worker with tools, this suggests the existence of an employer-employee relationship.

15. **Work facilities.** A worker who invests in and provides work facilities is likely to be an independent contractor, particularly if the facilities are of a type not generally maintained by employees. The lack of investment in facilities indicates dependence on the person for whom the services are performed to provide such facilities, which suggests an employer-employee relationship.

16. **Profit potential and risk of loss.** Workers who profit from the success of a business and bear the risk of loss from failure are more likely to be independent contractors than employees. Employers typically pay employees a fixed amount without regard to profits or losses.

17. **Providing services to multiple firms.** An employee tends to provide services to a single firm or person. In contrast, an independent contractor frequently provides services to several firms or persons.

18. **Providing service to the general public.** Workers who regularly and consistently offer their services to the public are more likely to be independent contractors.

19. **Right of discharge.** The ability of a firm or person to terminate the worker for any reason and without penalty suggests an employer-employee relationship. The presence of penalties to the firm upon termination without cause may be indicative of a higher degree of worker independence, which is more characteristic of an independent contractor relationship.

20. **Worker's right of termination.** If the worker has the ability to terminate the relationship with the firm or person at any time without penalty, this indicates an employer-employee relationship.

TAX COURT TEST

The IRS outlines its "20 factor" test in Rev. Rul. 87-41. The Tax Court is not bound by pronouncements in revenue rulings. The weight the Tax Court gives to a revenue ruling in a case depends upon "the persuasiveness and consistency" of the IRS's position over time.[4]

To determine whether a worker is an employee or independent contractor, the Tax Court considers the following seven factors.[5]

1. The degree of the firm's (or person's) control over the worker
2. The worker's investment in work facilities
3. Profit or loss potential for the worker
4. The degree of ease with which the firm or person can discharge the worker
5. The degree of integration of the worker's services to the firm's (or person's) principal function
6. The temporary or permanent nature of the relationship
7. The parties' understanding of the nature of their relationship

CLARIFYING WORKER STATUS

Requesting IRS Determination[6]

If the status of the worker is unclear, the worker or the firm can obtain an IRS determination letter resolving this issue. The worker or firm makes a request by filing Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding.* A firm can request a determination for the status of a single worker or an entire class of workers. There is no fee in connection with this request. To complete Form SS-8, the requesting party must provide details about the nature of the worker's services and the relationship between the worker and the firm. The focal point of several questions involves the degree of control the firm has over the worker's performance of services. A blank Form SS-8 follows.

4. *Taproot Administrative Services, Inc. v. Comm'r,* 133 TC 202 (2009), *aff'd* 679 F.3d 1109 (9th Cir. 2012).
5. *Herman v. Comm'r,* TC Memo 1986-590 (Dec. 18, 1986).
6. See Instructions for Form SS-8.

Form **SS-8**
(Rev. May 2014)
Department of the Treasury
Internal Revenue Service

Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding

▶ **Information about Form SS-8 and its separate instructions is at *www.irs.gov/formss8*.**

OMB. No. 1545-0004

For IRS Use Only:
Case Number:

Earliest Receipt Date:

Name of firm (or person) for whom the worker performed services		Worker's name	
Firm's mailing address (include street address, apt. or suite no., city, state, and ZIP code)		Worker's mailing address (include street address, apt. or suite no., city, state, and ZIP code)	
Trade name	Firm's email address	Worker's daytime telephone number	Worker's email address
Firm's fax number	Firm's website	Worker's alternate telephone number	Worker's fax number
Firm's telephone number (include area code)	Firm's employer identification number	Worker's social security number	Worker's employer identification number (if any)

Note. If the worker is paid for these services by a firm other than the one listed on this form, enter the name, address, and employer identification number of the payer. ▶ ----------

Disclosure of Information

The information provided on Form SS-8 may be disclosed to the firm, worker, or payer named above to assist the IRS in the determination process. For example, if you are a worker, we may disclose the information you provide on Form SS-8 to the firm or payer named above. The information can only be disclosed to assist with the determination process. If you provide incomplete information, we may not be able to process your request. See *Privacy Act and Paperwork Reduction Act Notice* in the separate instructions for more information. **If you do not want this information disclosed to other parties, do not file Form SS-8.**

Parts I–V. All filers of Form SS-8 must complete all questions in Parts I–IV. Part V must be completed if the worker provides a service directly to customers or is a salesperson. If you cannot answer a question, enter "Unknown" or "Does not apply." If you need more space for a question, attach another sheet with the part and question number clearly identified. Write your firm's name (or worker's name) and employer identification number (or social security number) at the top of each additional sheet attached to this form.

Part I General Information

1 This form is being completed by: ☐ Firm ☐ Worker; for services performed _____ (beginning date) to _____ (ending date).

2 Explain your reason(s) for filing this form (for example, you received a bill from the IRS, you believe you erroneously received a Form 1099 or Form W-2, you are unable to get workers' compensation benefits, or you were audited or are being audited by the IRS). ----------

3 Total number of workers who performed or are performing the same or similar services: _____.

4 How did the worker obtain the job? ☐ Application ☐ Bid ☐ Employment Agency ☐ Other (specify) _____

5 **Attach copies of all supporting documentation (for example, contracts, invoices, memos, Forms W-2 or Forms 1099-MISC issued or received, IRS closing agreements or IRS rulings).** In addition, please inform us of any current or past litigation concerning the worker's status. If no income reporting forms (Form 1099-MISC or W-2) were furnished to the worker, enter the amount of income earned for the year(s) at issue $ _____. If both Form W-2 and Form 1099-MISC were issued or received, explain why. ----------

6 Describe the firm's business. ----------

For Privacy Act and Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 16106T Form **SS-8** (Rev. 5-2014)

Part I **General Information** (continued)

7 If the worker received pay from more than one entity because of an event such as the sale, merger, acquisition, or reorganization of the firm for whom the services are performed, provide the following: Name of the firm's previous owner: _____

Previous owner's taxpayer identification number: _____ Change was a: ☐ Sale ☐ Merger ☐ Acquisition ☐ Reorganization ☐ Other (specify) _____

Description of above change: _____

Date of change (MM/DD/YY): _____

8 Describe the work done by the worker and provide the worker's job title. _____

9 Explain why you believe the worker is an employee or an independent contractor. _____

10 Did the worker perform services for the firm in any capacity before providing the services that are the subject of this determination request?
☐ **Yes** ☐ **No** ☐ **N/A**
If "Yes," what were the dates of the prior service? _____
If "Yes," explain the differences, if any, between the current and prior service. _____

11 If the work is done under a written agreement between the firm and the worker, attach a copy (preferably signed by both parties). Describe the terms and conditions of the work arrangement. _____

Part II **Behavioral Control** (Provide names and titles of specific individuals, if applicable.)

1 What specific training and/or instruction is the worker given by the firm? _____

2 How does the worker receive work assignments? _____

3 Who determines the methods by which the assignments are performed? _____

4 Who is the worker required to contact if problems or complaints arise and who is responsible for their resolution? _____

5 What types of reports are required from the worker? Attach examples. _____

6 Describe the worker's daily routine such as his or her schedule or hours. _____

7 At what location(s) does the worker perform services (for example, firm's premises, own shop or office, home, customer's location)? Indicate the appropriate percentage of time the worker spends in each location, if more than one. _____

8 Describe any meetings the worker is required to attend and any penalties for not attending (for example, sales meetings, monthly meetings, staff meetings). _____

9 Is the worker required to provide the services personally? . . . . . ☐ **Yes** ☐ **No**

10 If substitutes or helpers are needed, who hires them? _____

11 If the worker hires the substitutes or helpers, is approval required? . . . . . ☐ **Yes** ☐ **No**
If "Yes," by whom? _____

12 Who pays the substitutes or helpers? _____

13 Is the worker reimbursed if the worker pays the substitutes or helpers? . . . . . ☐ **Yes** ☐ **No**
If "Yes," by whom?

Part III **Financial Control** (Provide names and titles of specific individuals, if applicable.)

1 List the supplies, equipment, materials, and property provided by each party:
The firm: _____
The worker: _____
Other party: _____

2 Does the worker lease equipment, space, or a facility? . . . . . ☐ **Yes** ☐ **No**
If "Yes," what are the terms of the lease? (Attach a copy or explanatory statement.) _____

3 What expenses are incurred by the worker in the performance of services for the firm? _____

4 Specify which, if any, expenses are reimbursed by:
The firm: _____
Other party: _____

5 Type of pay the worker receives: ☐ Salary ☐ Commission ☐ Hourly Wage ☐ Piece Work
☐ Lump Sum ☐ Other (specify) _____
If type of pay is commission, and the firm guarantees a minimum amount of pay, specify amount. $ _____

6 Is the worker allowed a drawing account for advances? . . . . . ☐ **Yes** ☐ **No**
If "Yes," how often? _____
Specify any restrictions. _____

7 Whom does the customer pay? . . . . . ☐ Firm ☐ Worker
If worker, does the worker pay the total amount to the firm? ☐ **Yes** ☐ **No** If "No," explain. _____

8 Does the firm carry workers' compensation insurance on the worker? . . . . . ☐ **Yes** ☐ **No**

9 What economic loss or financial risk, if any, can the worker incur beyond the normal loss of salary (for example, loss or damage of equipment, material)? _____

10 Does the worker establish the level of payment for the services provided or the products sold? . . . . . ☐ **Yes** ☐ **No**
If "No," who does? _____

Part IV **Relationship of the Worker and Firm**

1 Please check the benefits available to the worker: ☐ Paid vacations ☐ Sick pay ☐ Paid holidays
☐ Personal days ☐ Pensions ☐ Insurance benefits ☐ Bonuses
☐ Other (specify) _____

2 Can the relationship be terminated by either party without incurring liability or penalty? . . . . . ☐ **Yes** ☐ **No**
If "No," explain your answer. _____

3 Did the worker perform similar services for others during the time period entered in Part I, line 1? . . . . . ☐ **Yes** ☐ **No**
If "Yes," is the worker required to get approval from the firm? . . . . . ☐ **Yes** ☐ **No**

4 Describe any agreements prohibiting competition between the worker and the firm while the worker is performing services or during any later period. Attach any available documentation. _____

5 Is the worker a member of a union? . . . . . ☐ **Yes** ☐ **No**

6 What type of advertising, if any, does the worker do (for example, a business listing in a directory or business cards)? Provide copies, if applicable. _____

7 If the worker assembles or processes a product at home, who provides the materials and instructions or pattern? _____

8 What does the worker do with the finished product (for example, return it to the firm, provide it to another party, or sell it)? _____

9 How does the firm represent the worker to its customers (for example, employee, partner, representative, or contractor), and under whose business name does the worker perform these services? _____

10 If the worker no longer performs services for the firm, how did the relationship end (for example, worker quit or was fired, job completed, contract ended, firm or worker went out of business)? _____

Form SS-8 (Rev. 5-2014) Page 4

Part V **For Service Providers or Salespersons.** Complete this part if the worker provided a service directly to customers or is a salesperson.

1 What are the worker's responsibilities in soliciting new customers? _____

2 Who provides the worker with leads to prospective customers? _____

3 Describe any reporting requirements pertaining to the leads. _____

4 What terms and conditions of sale, if any, are required by the firm? _____

5 Are orders submitted to and subject to approval by the firm? . . . . . ☐ Yes ☐ No

6 Who determines the worker's territory? _____

7 Did the worker pay for the privilege of serving customers on the route or in the territory? . . . . . ☐ Yes ☐ No

If "Yes," whom did the worker pay? _____

If "Yes," how much did the worker pay? . . . . . $ _____

8 Where does the worker sell the product (for example, in a home, retail establishment)? _____

9 List the product and/or services distributed by the worker (for example, meat, vegetables, fruit, bakery products, beverages, or laundry or dry cleaning services). If more than one type of product and/or service is distributed, specify the principal one. _____

10 Does the worker sell life insurance full time? . . . . . ☐ Yes ☐ No

11 Does the worker sell other types of insurance for the firm? . . . . . ☐ Yes ☐ No

If "Yes," enter the percentage of the worker's total working time spent in selling other types of insurance . . . . . _____ %

12 If the worker solicits orders from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments, enter the percentage of the worker's time spent in the solicitation . . . . . _____ %

13 Is the merchandise purchased by the customers for resale or use in their business operations? . . . . . ☐ Yes ☐ No

Describe the merchandise and state whether it is equipment installed on the customers' premises. _____

Sign Here

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

▶ _____ Title ▶ _____ Date ▶ _____

Type or print name below signature.

Form **SS-8** (Rev. 5-2014)

After receiving the completed Form SS-8, the IRS acknowledges its receipt. The determination of worker status for federal tax purposes affects the worker and the firm. Therefore, the IRS may attempt to obtain further relevant information from all affected parties by sending them a blank Form SS-8 and requesting information. The IRS may also request information from other unaffected parties who can clarify the relationship between the worker and the firm. The IRS may share information provided on Form SS-8 with other parties.

The case is assigned to an IRS technician who reviews the information from the various Forms SS-8 submitted. The technician applies the relevant law and renders a decision on worker status by issuing a formal determination letter to the firm. The IRS forwards a copy of the determination letter to the worker. The determination letter applies only to the worker or class of workers who are the subject of the request, and the determination is binding on the IRS.

> **Note.** The IRS may issue an information letter instead of a determination letter. Unlike a determination letter, an information letter is not binding on the IRS. The parties may use the information letter to ensure they fulfill all payroll and income tax obligations.

The IRS will not issue a determination letter in connection with a tax year for which the statute of limitations has expired or concerning a hypothetical or proposed set of circumstances.

The Form SS-8 determination process, including the acquisition of additional information and the review of relevant records, does not constitute an audit of a tax return. Appeal rights do not exist with a letter of determination. However, a party who disagrees with a determination can supply additional information and request a redetermination.

Misclassified Workers

An independent contractor generally receives a Form 1099-MISC, *Miscellaneous Income,* in connection with the services rendered. The amount included on the information form is typically reported on Schedule C, *Profit or Loss From Business,* or Schedule F, *Profit or Loss From Farming.* The independent contractor pays applicable self-employment (SE) tax on the net profit, calculated using Schedule SE, *Self-Employment Tax.* However, the employer might treat the worker as an independent contractor when, in fact, the worker should be classified as an employee.

An employer that has misclassified an employee as an independent contractor has not withheld the employee's share of social security and Medicare taxes or matched it with the employer's share.[7] A misclassified employee uses Form 8919, *Uncollected Social Security and Medicare Tax on Wages,* to calculate their share of these taxes that the employer should have collected and paid. A misclassified employee can file Form 8919 if the employee meets **one** of the following conditions.

1. The IRS sent the worker correspondence (such as a Form SS-8 determination letter) indicating that they are an employee instead of an independent contractor.
2. The worker filed a Form SS-8 but has not yet received an IRS response.
3. The IRS designated the worker as a "section 530 employee" before January 1, 1997. (Section 530 is discussed in detail later in this chapter.)
4. The worker received a Form W-2 and a Form 1099-MISC from the employer for the same tax year, and the Form 1099-MISC amount should have been included as wages on the Form W-2.

Example 1. In 2015, Elliott worked for KBT Industries, Ltd. as an unskilled laborer in the manufacturing department, assembling front-fender kits for automobiles. KBT Industries terminated all 45 employees in the department, including Elliott, and rehired them on January 1, 2016. However, for 2016, KBT characterized the 45 manufacturing workers as independent contractors. Elliott performed the same work in 2016 as he did in 2015. He had the same floor supervisors.

For 2015, Elliott received a Form W-2 showing gross wages of $30,000, along with applicable social security, Medicare, and income tax amounts withheld. For 2016, he received a Form 1099-MISC showing $30,000 of gross income with no income tax or payroll tax withholding.

During 2016, Elliott taught a welding course at a local community college. He received a Form W-2. His gross teaching wages were $17,500.

A tax advisor indicated to Elliott that KBT misclassified him as an independent contractor and that he should file a Form SS-8, which he filed in early 2017 after he received his Form 1099-MISC. Elliott has not yet received a response from the IRS. Rather than pay SE tax on his earnings, Elliott took the position that he is still an employee at KBT. His tax preparer calculated Elliott's share of social security and Medicare tax on his earnings for 2016. His tax preparer completed the following Form 8919 for Elliott, which he filed with his 2016 tax return.

7. See Instructions for Form 8919.

For Example 1

Form **8919**

Department of the Treasury
Internal Revenue Service

Uncollected Social Security and Medicare Tax on Wages

► **Information about Form 8919 and its instructions is at *www.irs.gov/form8919.***

► **Attach to your tax return.**

OMB No. 1545-0074

2016

Attachment Sequence No. **61**

Name of person who must file this form. If married, complete a separate Form 8919 for each spouse who must file this form.	**Social security number**
Elliott Mendoza	**012-34-5678**

Who must file. You must file Form 8919 if **all** of the following apply.

- You performed services for a firm.
- You believe your pay from the firm wasn't for services as an independent contractor.
- The firm didn't withhold your share of social security and Medicare taxes from your pay.
- One of the reasons listed below under *Reason codes* applies to you.

Reason codes: For each firm listed below, enter in column (c) the applicable reason code for filing this form. If none of the reason codes apply to you, but you believe you should have been treated as an employee, enter reason code G, and **file Form SS-8 on or before the date you file your tax return.**

A I filed Form SS-8 and received a determination letter stating that I am an employee of this firm.

C I received other correspondence from the IRS that states I am an employee.

G I filed Form SS-8 with the IRS and haven't received a reply.

H I received a Form W-2 and a Form 1099-MISC from this firm for 2016. The amount on Form 1099-MISC should have been included as wages on Form W-2. **(Don't file Form SS-8 if you select reason code H.)**

	(a) Name of firm	(b) Firm's federal identification number (see instructions)	(c) Enter reason code from above	(d) Date of IRS determination or correspondence (MM/DD/YYYY) (see instructions)	(e) Check if Form 1099-MISC was received	(f) Total wages received with no social security or Medicare tax withholding and not reported on Form W-2
1	KBT Industries, Ltd.	38-0000000	G		☒	30,000
2					☐	
3					☐	
4					☐	
5					☐	

6	**Total wages.** Combine lines 1 through 5 in column (f). Enter here and include on Form 1040, line 7; Form 1040NR, line 8; or Form 1040NR-EZ, line 3			6	30,000
7	Maximum amount of wages subject to social security tax	7	118,500 00		
8	Total social security wages and social security tips (total of boxes 3 and 7 on Form(s) W-2), railroad retirement (RRTA) compensation (subject to the 6.2% rate), and unreported tips subject to social security tax from Form 4137, line 10. See instructions	8	17,500		
9	Subtract line 8 from line 7. If line 8 is more than line 7, enter -0- here and on line 10			9	101,000
10	Wages subject to social security tax. Enter the smaller of line 6 or line 9			10	30,000
11	Multiply line 10 by .062 (social security tax rate for 2016)			11	1,860
12	Multiply line 6 by .0145 (Medicare tax rate)			12	435
13	Add lines 11 and 12. Enter here and on Form 1040, line 58; Form 1040NR, line 56; or Form 1040NR-EZ, line 16. (Form 1040-SS and Form 1040-PR filers, see instructions) ►			13	2,295

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 37730B Form **8919** (2016)

IRS ENFORCEMENT

The IRS's voluntary classification settlement program (VCSP) provides payroll tax relief to employers who are currently treating their workers (or a group of workers) as independent contractors and want to prospectively treat the workers as employees. This amnesty program offers the employer a low-cost way of reclassifying their workers.

To be eligible for the program, the employer must satisfy **all** of the following requirements.[8]

- Consistently treated the workers in the past as independent contractors or other nonemployees
- Filed all required Forms 1099-MISC for the workers for the previous **three** years
- Not currently under IRS employment tax audit
- Not currently under audit by the Department of Labor or a state agency concerning the classification of these workers

Employers previously subject to an IRS, Department of Labor, or state agency audit may still qualify for this amnesty program if they complied with the results of that audit.

> **Example 2.** For the last five years, Jerry has been a sole proprietor who reported his business activity on Schedule C, *Profit or Loss From Business.* All Jerry's workers have been treated as independent contractors and necessary Forms 1099-MISC were filed for all five years.
>
> In 2015, the IRS audited Jerry regarding the classification of his workers. The result of that audit was reclassification of the independent contractor payments Jerry made in 2015 as wages. Jerry complied with all requests of the IRS audit and did not contest the outcome of the audit. Jerry, who is not under an employment tax audit for 2016, decides to apply for the VCSP for 2016 and later years. He meets the qualifications to participate in the VCSP.

An employer can apply for the program by filing Form 8952, *Application for Voluntary Classification Settlement Program (VCSP).* The employer should file the application at least 60 days before they want to begin treating the workers as employees.

An employer accepted into the program pays an amount effectively equal to just over 1% of the wages paid to the reclassified workers over the past year. No interest or penalties are due and the IRS will not audit the employer for payroll taxes related to these workers for the prior years. For the first three years under the program, an employer is subject to a special 6-year statute of limitations, rather than the usual three years that generally applies to payroll taxes.[9]

Misclassification Penalties

The IRS can assert substantial penalties if it determines an employer has misclassified an employee as an independent contractor. The total amount the employer must pay includes all of the following.[10]

- 1.5% of each misclassified employee's wages because income taxes were not withheld
- 20% of each misclassified employee's FICA taxes that were not withheld
- The amounts of the employer's FICA and FUTA taxes
- Any other applicable penalties and interest, such as late payment penalties

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8. IRS Ann. 2012-45, 2012-51 IRB 724.
9. IRS News Rel. IR-2011-95 (Sep. 21, 2011).
10. IRC §3509.

Example 3. Perry has a very successful lawn mowing service. He has 20 workers who mow for him. In 2015, he treated the workers as independent contractors and paid them a total of $400,000. In 2016, he paid the workers $380,000. In 2017, he has paid them $200,000 to date. No employee earned over the FICA wage base. If the IRS determines the workers are employees, Perry will owe all of the following penalties.

- $14,700 for income taxes not withheld (1.5% × ($400,000 + $380,000 + $200,000))
- $14,994 for FICA taxes not withheld (7.65% × ($400,000 + $380,000 + $200,000) × 20%)
- $74,970 (7.65% × ($400,000 + $380,000 + $200,000)) for the employer's share of FICA tax
- FUTA tax
- Any other applicable penalties and interest

Perry would owe the IRS at least $104,664 ($14,700 + $14,994 + $74,970).

Perry can apply for the VCSP. He completes and files Form 8952 and requests the beginning date to be January 1, 2018. His payment is based on his 2016 payroll because 2017 is not yet ended. He bases his VCSP payment on the 2016 payroll of $380,000. Following the instructions on the form, he pays the IRS $4,058. Perry's potential savings by voluntarily reclassifying his employees is at least $100,606 ($104,664 – $4,058). He must continue to classify the workers as employees to stay in compliance with the VCSP.

Perry's Form 8952 follows.

For Example 3

Form **8952**
(Rev. November 2013)
Department of the Treasury
Internal Revenue Service

Application for Voluntary Classification Settlement Program (VCSP)

▶ **Do not** send payment with Form 8952.
▶ **Information about Form 8952 and its separate instructions is at *www.irs.gov/form8952*.**

OMB No. 1545-2215

Caution. *Taxpayer must make certain representations in order to be eligible to participate in the VCSP. These representations can be found in Part V on page 2.*

Part I Taxpayer Information

1 Taxpayer's name
Perry's Lawn Service

2 **Employer identification number (EIN)**
11-1234567

3 Number and street (or P.O. box number if mail is not delivered to a street address)
101 Wright Road

Room/Suite

4 City, town or post office, state, and ZIP code
New Madison, TN 44444

5 Telephone number
999-555-1212

6 Website address (optional)

7 Fax number (optional)

8 Email address (optional)

9 Type of entity. Check the applicable box:

- ☒ Sole proprietorship
- ☐ Joint venture
- ☐ Partnership
- ☐ C corporation
- ☐ S corporation
- ☐ Cooperative organization described in section 1381 of the Internal Revenue Code
- ☐ Tax-exempt organization
- ☐ State or local government (for worker class or position not covered under a section 218 agreement)
- ☐ Other (specify here) _____

10 Are you a member of an affiliated group?
☐ Yes ☒ No
If "Yes," complete the common parent information on lines 11-14.
If "No," skip to Part II.

11 Name of common parent of the affiliated group

12 EIN of common parent

13 Number and street (or P.O. box number if mail is not delivered to a street address) of common parent

14 City, town or post office, state, and ZIP code of common parent

Part II Contact Person

Attach a properly completed Form 2848, Power of Attorney and Declaration of Representative, if applicable. Also see *Special instructions for Form 2848* in the instructions.

- Name and title of contact person _____
- Contact person's number and street (or P.O. box number if mail is not delivered to a street address) _____
- Contact person's city, town or post office, state, and ZIP code _____
- Contact person's telephone number _____
- Contact person's fax number (optional) _____
- Contact person's email address (optional)

Part III General Information About Workers To Be Reclassified

15 Enter the total number of workers from all classes to be reclassified. A class of workers includes all workers who perform the same or similar services.
20

16 Enter a description of the class or classes of workers to be reclassified. If more space is needed, attach separate sheets (see instructions).
Day laborers

17 Enter the beginning date of the employment tax period (calendar year or quarter) for which you want to begin treating the class or classes of workers as employees. This date should be at least 60 days after the date you file Form 8952 (see instructions).
01 / 01 / 2018

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 37772H Form **8952** (Rev. 11-2013)

For Example 3

Form 8952 (Rev. 11-2013) Page **2**

Taxpayer's name	Employer identification number (EIN)
Perry's Lawn Service	**11-1234567**

Part IV Payment Calculation Using Section 3509(a) Rates (see instructions)

18	Enter total compensation paid in the most recently completed calendar year to all workers to be reclassified (see instructions)	**18**	**380,000**		
19	Multiply line 18 by 3.24% (.0324)			**19**	**12,312**
20	Enter any compensation included on line 18 that exceeded the social security wage base for any worker or workers for the most recently completed calendar year (see instructions)	**20**			
21	Subtract line 20 from line 18	**21**	**380,000**		
22	Multiply line 21 by 7.44% (.0744) [7.04% (.0704) for compensation paid prior to 2013]			**22**	**28,272**
23	Add lines 19 and 22			**23**	**40,584**
24	Multiply line 23 by 10% (.10). This is the VCSP payment you will pay when you submit your signed closing agreement (see instructions)			**24**	**4,058**

Part V Taxpayer Representations

Caution. *Since the representations include the penalty of perjury statement, the representations under Part V must be signed by the taxpayer, not the taxpayer's representative.*

A Treatment of Workers

1 Taxpayer wants to voluntarily reclassify certain workers as employees for federal income tax withholding, Federal Insurance Contributions Act, and Federal Unemployment Tax Act taxes (collectively, federal employment taxes) for future tax periods.

2 Taxpayer is presently treating the workers as nonemployees.

3 Taxpayer has filed all required Forms 1099 for each of the workers to be reclassified for the 3 preceding calendar years ending before the date of this application.

4 Taxpayer has consistently treated the workers as nonemployees.

5 There is no current dispute between the taxpayer and the IRS as to whether the class or classes of workers are nonemployees or employees for federal employment tax purposes.

B Examination

1 Taxpayer or, if applicable, any member of the taxpayer's affiliated group, is not under employment tax examination by the IRS.

2 Taxpayer is not under examination by the Department of Labor or any state agency concerning the proper classification of the class or classes of workers.

3a Taxpayer has not been examined previously by the IRS or the Department of Labor concerning the proper classification of the class or classes of workers; or,

b Taxpayer has been examined previously by the IRS or the Department of Labor concerning the proper classification of the class or classes of workers and the taxpayer has complied with the results of the prior examination.

Caution. ***Do not*** *send payment with Form 8952. You will submit payment later with your signed closing agreement. If you submit payment with Form 8952, it may cause a processing delay.*

Sign Here	Under penalties of perjury, I declare that I have examined this submission, including any accompanying documents, and to the best of my knowledge and belief, all of the facts contained herein are true, correct, and complete. Taxpayer's signature ▶			Date	
Paid Preparer Use Only	Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
	Firm's name ▶		Firm's EIN ▶		
	Firm's address ▶		Phone no.		

Form **8952** (Rev. 11-2013)

SECTION 530 RELIEF

If an employer has no reasonable basis for classifying an employee as an independent contractor, the IRS may hold the employer liable for employment taxes for that worker. If the employer had a reasonable basis for treating the employee as an independent contractor, then relief from paying employment taxes may be available under Section 530 of the Revenue Act of 1978. This section was amended twice since 1978; once with the Tax Reform Act of 1986, and again with the Small Business Job Protection Act of 1996.[11]

IRS REQUIREMENTS

In a worker classification examination, the IRS examiner must consider the applicability of Section 530 relief even if the taxpayer does not raise the issue. The examiner must provide IRS Pub. 1976, *Do You Qualify for Relief under Section 530?,* to the taxpayer at the beginning of an examination of worker classification.[12] This publication is a plain language summary of Section 530.

TAX CONSEQUENCES FOR WORKERS

Section 530 provides **relief to businesses,** not to workers. Section 530 does not convert a worker from the status of employee to the status of independent contractor. Workers may find that the business misclassified them as independent contractors, and they are actually employees. A worker classified as an employee is only liable for the employee share of FICA rather than tax under the Self-Employed Contributions Act (SECA).[13]

For the period that the business misclassified an employee as an independent contractor, the employee may have actually filed and paid their own employment tax. If the worker paid SE tax, they may file a claim for refund for the difference between SE tax and the employee's share of FICA using Form 843, *Claim for Refund and Request for Abatement.*[14]

> **Note.** See the Form 843 instructions for information on **timely filing** a request for a refund.

Other tax consequences for the worker include the following.[15]

- **Unreimbursed Business Expenses.** Workers classified as employees generally cannot deduct unreimbursed business expenses on Schedule C. If expenses are deductible, they are reported as miscellaneous itemized deductions on Schedule A, subject to the 2% of adjusted gross income (AGI) limitation. This sometimes results in an alternative minimum tax (AMT) liability.
- **Self-Employed Retirement Plans.** The worker classified as an employee cannot adopt or maintain a self-employed retirement plan.
- **Self-Employed Health Insurance.** The worker classified as an employee cannot deduct self-employed health insurance premiums.
- **Employee Benefits.** An employee may be able to exclude certain benefits provided by the business from income due to specific Code exclusions available only to employees.

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11. *Section 530: Its History and Application in Light of the Federal Definition of the Employer-Employee Relationship for Federal Tax Purposes.* National Association of Tax Reporting and Professional Management. Feb. 28, 2009. [www.irs.gov/pub/irs-utl/irpac-br_530_relief_-_appendix_natrm_paper_09032009.pdf] Accessed on Dec. 15, 2016.
12. IRM 4.23.5.2.1 (2013).
13. *Status of Workers Treated as Independent Contractors by Their Employer.* Social Security Administration. [secure.ssa.gov/poms.nsf/lnx/0302101808] Accessed on Dec. 29, 2016.
14. Rev. Proc. 85-18, 1985-1 CB 518, section 3.08; *Social Security Tax / Medicare Tax and Self-Employment.* IRS. [www.irs.gov/individuals/international-taxpayers/social-security-tax-medicare-tax-and-self-employment] Accessed on Feb. 28, 2017.
15. IRM 4.23.5.2.3 (2013).

ELIGIBILITY

To be eligible for Section 530 relief, the business must meet **three** tests.[16]

1. **Reporting Consistency Test.** For the period under examination, the business must have filed all federal tax returns, including information returns, related to the worker in a manner consistent with the business classifying the worker as an independent contractor.
2. **Substantive Consistency Test.** The business (and any predecessor business) must have consistently treated similarly situated workers as independent contractors. A business that treats a similarly situated worker as an employee is not eligible for Section 530 relief.
3. **Reasonable Basis Test.** The business must have a reasonable basis for not treating the worker as an employee. This may consist of reliance on:
   - A judicial precedent or published ruling, letter ruling, or technical advice memorandum issued to the taxpayer;
   - The results of a past IRS audit of the employer;
   - A long-standing recognized practice of a significant segment of the industry in which the taxpayer is engaged; or
   - Any other reasonable basis.

If the business meets these three tests, it will not owe employment taxes for workers whose status is in question.

If the business starts to treat misclassified workers as employees, relief is available under Section 530 for the years it treated them as independent contractors, provided it meets all three tests for the years prior to the change in treatment.[17]

> **Planning Tip.** Even if it appears that all tests are not clearly met, the business may seek partial relief. Based on facts and circumstances, the IRS may allow partial relief.

Reporting Consistency Test

The first requirement a business must meet to obtain relief under Section 530 is to timely file all required federal tax returns, including Forms 1099, for workers not classified as employees for a particular year.[18] The relief provision applies only for that year.

If a business fails to file all required returns for a tax year but in a subsequent year files all required returns on a basis consistent with treating workers as independent contractors, then the business may qualify for Section 530 relief for the subsequent year. **If a business is not required to file, the fact it did not file a return does not preclude relief.**[19]

> **Example 4.** Charles owns a small insurance agency. Four times per year, Charles mails information packets to all current and prospective clients. In 2016, Charles employs four high school students to stuff envelopes. He pays each student a total of $400 for the year. Charles treats the students as independent contractors. Because he pays less than $600 to each student, Charles is not required to file Forms 1099.
>
> In this case, the IRS will not deny Section 530 relief based on Charles's failure to file information returns.

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16. IRS Pub. 1976, *Do you Qualify for Relief under Section 530?*
17. Rev. Proc. 85-18, 1985-1 CB 518, Sec. 3.04.
18. Section 530(a)(1)(B) of the Revenue Act of 1978.
19. IRM 4.23.5.2.2.1 (2012).

Example 5. Use the same facts as **Example 4.** In 2017, Charles increased the number of mailings to five per year and raised each student's payment to $750 for the year. Charles continued to treat the four students as independent contractors.

In 2017, Charles did not file any Forms 1099 for the $750 paid to each student.

The insurance agency is **not entitled** to Section 530 relief for 2017 because Charles did not file the required information returns.

A business that does not timely file Forms 1099 consistent with treating a worker as an independent contractor may **not** obtain relief under the provisions of Section 530 for that worker in that year. However, if a business in good faith mistakenly files the wrong type of Form 1099, it does not lose Section 530 eligibility.[20]

Substantive Consistency Test

If a business or the business's predecessor treated a worker holding a **substantially similar position** as an employee at any time after December 31, 1977, then Section 530 relief is **not available.** The treatment of a class of workers must be consistent with the business's belief that the workers were independent contractors. A **substantially similar position** exists if the job functions, duties, and responsibilities are substantially similar, and the control and supervision of those duties and responsibilities are substantially similar.[21]

The relationship between a business and its workers is one of the factors considered to determine whether workers hold substantially similar positions.[22] This can include the degree of supervision and control, although there are other factors as well. The IRS takes into account differences in managerial responsibilities, reporting requirements, and job duties when deciding if workers hold substantially similar positions. The IRS also considers the contractual relationship and the provision of employee benefits.[23]

Determining what constitutes **substantially similar work** depends on an analysis of the facts. The day-to-day services that a worker performs and the method by which they perform those services are relevant in determining whether a worker treated as an independent contractor holds a substantially similar position to workers treated as employees.[24]

Example 6. The IRS examined Victor Corporation's 2016 return. The examiner discovered that Victor Corporation treated 100 workers, all doing the same job, as independent contractors. The examiner also discovered that in 2010, the corporation treated five of these 100 workers as employees. These five performed substantially the same job in 2016.

Victor Corporation cannot claim Section 530 relief in 2016 for any of these 100 workers because it treated some of the workers inconsistently between 2010 and 2016.

The IRS provided the following guidelines for use in determining whether a worker is treated as an employee.[25]

1. Withholding federal income tax or FICA tax from a worker's wages is treating the worker as an employee, regardless of whether the tax is paid to the government.
2. Filing federal employment tax returns for a certain period with respect to a worker, regardless of whether the employer withheld tax from the worker, is treating the worker as an employee for that period.

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20. Rev. Rul. 81-224, 1981-2 CB 197.
21. Rev. Rul. 87-41, 1987-1 CB 296; CCA 200215053 (Apr. 17, 2002).
22. Section 530(e)(6) of the Revenue Act of 1978.
23. CCA 200215053 (Apr. 17, 2002).
24. IRM 4.23.5.2.2.2 (2012).
25. Rev. Proc. 85-18, 1985-1 CB 518.

The IRS does **not** consider the following actions to be treatment of a worker as an employee.[26]

1. Filing a delinquent or amended employment tax return for a tax period with respect to the worker if the filing was a result of IRS compliance procedures
2. Using a substitute return the IRS prepared under IRC §6020(b) or signing Form 2504, *Agreement to Assessment and Collection of Additional Tax and Acceptance of Overassessment*

When determining **substantive consistency,** the IRS takes into account the treatment of workers by predecessor entities.[27] This ensures that the employer does not avoid the substantive consistency rule by forming new entities.

Reasonable Basis Test

To qualify for Section 530 relief, a business must have a reasonable basis for not treating the worker as an employee.[28] It may reasonably rely on one of three **safe havens** to meet the reasonable basis test.[29]

- **Judicial Precedent.** This safe haven includes reasonable reliance on judicial precedent, published rulings, or a technical advice memorandum or private letter ruling pertaining to the business.
- **Past Audit.** This safe haven allows reasonable reliance on a past IRS employment tax audit of the business. The safe haven is available if the audit entailed consideration of, but no assessment attributable to, the business's employment tax treatment of workers holding positions substantially similar to the position held by the worker whose status is at issue.
- **Industry Practice.** This safe haven allows reasonable reliance on a long-standing recognized practice of a significant segment of the industry in which the business engages.

A business that fails to meet any of the three safe havens may nevertheless be entitled to relief. It must be able to demonstrate, in some other manner, any reasonable basis for not treating the worker as an employee.[30]

Burden of Proof

Under Section 530, a business's burden of proof differs from that in an ordinary tax case. Section 530(e)(4) **shifts the burden of proof to the IRS if the taxpayer satisfies two requirements.**

1. The business taxpayer establishes a prima facie case that it was reasonable not to treat an individual as an employee. This is accomplished by meeting the reporting consistency test, the substantive consistency test, and one of the three reasonable basis safe havens.
2. The taxpayer cooperates fully with reasonable requests from the examiner.

If the taxpayer meets the preceding requirements, the IRS bears the burden of proving that the taxpayer's treatment is inaccurate.[31]

Relief for Dual Status Workers

Sometimes workers perform outside services for their employer. For example, a business might contract its bookkeeper to design and print an advertising brochure. The fact that the company treats the bookkeeper as an employee for the bookkeeping services does not preclude it from treating the worker as an independent contractor for the design and printing services.[32]

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26. Ibid.
27. IRM 4.23.5.2.2.2 (2012).
28. Section 530(a)(1) of the Revenue Act of 1978.
29. Section 530(a)(2) of the Revenue Act of 1978.
30. Social Security Program Operations Manual System RS 02101.808.
31. IRM 4.23.5.2.2 (2013).
32. IRS INFO Letter 2012-0069 (Sep. 28, 2012).

EXCESS SOCIAL SECURITY TAX PAYMENTS

For 2017, the social security wage base is $127,200.[33] Both the employer and employee pay their respective share of social security tax. The rate of social security tax that applies to all wages up to the $127,200 wage base is 6.2% for the employer and 6.2% for the employee. Neither the employer nor the employee pay social security tax on wages above $127,200. The maximum amount of social security tax paid by both the employer and employee is $7,886 ($127,200 × 6.2%).

Medicare tax, however, is payable on wages for the year without any income limitation. The Medicare tax rate is 1.45% for both the employer and the employee.

MULTIPLE EMPLOYERS

A taxpayer with more than one employer during the tax year who earns total wages in excess of the wage base can overpay their social security tax. Each employer applies the social security tax rate on the respective wages paid to the taxpayer without regard to what any other employer withheld.

Example 7. Frank is an architect who was an employee at two different jobs during 2017. He worked for Creative Design Associates on a full-time basis. He also accepted a weekend job for part of the year with Modular Building Solutions. Both employers paid the respective social security tax at 6.2%. Each employer also withheld 6.2% from Frank's earnings. Frank received a Form W-2 from each employer. The wage amounts and social security tax withheld as shown on the Forms W-2 are as follows.

Employer	Wages (Box 1)	Social Security Tax (Box 4)
Creative Design Associates	$ 97,460	$6,043
Modular Building Solutions	36,890	2,287
Total	$134,350	$8,330

Frank earned a total of $134,350 in wages for 2017. However, he is only obligated to pay social security tax on $127,200. Therefore, his total 2017 social security tax obligation is $7,886 ($127,200 × 6.2%). Because he had more than one employer and had earnings in excess of the social security wage base of $127,200, he paid social security tax in excess of the required amount. He overpaid $444 ($8,330 actually paid − $7,886 maximum 2017 social security tax).

Recovering the Excess Amount

The excess social security tax paid is calculated and shown on Form 1040, line 71 ("excess social security and tier 1 RRTA tax withheld").[34] Before the IRS issues a refund, it will first apply some or all of the excess against any income tax owed.

Example 8. Use the same facts as **Example 7.** Frank calculated his $444 social security tax overpayment and reported it on Form 1040, line 71. His total 2017 income tax liability shown on Form 1040 is $27,757. The federal income tax withheld by both employers for 2017 was $27,500. He still owes $257 in federal income tax ($27,757 – $27,500). Therefore, the IRS applies $257 of his $444 social security tax overpayment against the remaining income tax. Frank receives a refund of $187 ($444 − $257).

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33. *Contributions and Benefit Base.* Social Security Administration. [www.ssa.gov/oact/cola/cbb.html]. Accessed on Nov. 29, 2016.

34. Instructions for Form 1040.

SINGLE EMPLOYER[35]

If the taxpayer works for a single employer and this employer overwithheld an employee's social security tax, the employee should request that the employer make an appropriate adjustment and refund the overpayment. If the employer refuses to make the adjustment and refund the overpayment, the employee can recover the overpayment by filing Form 843.

RECEIPT OF PROPERTY AS COMPENSATION

PROPERTY INSTEAD OF WAGES

If an employee receives property instead of wages in exchange for services, IRC §83(a) specifies that the employee must recognize additional compensation in the amount of the fair market value (FMV) of the property less any amount the employee may have paid for it. The term **property** for this purpose includes real and personal property other than either money or an unfunded, unsecured promise to pay money or property in the future.[36]

The recognition of compensation takes place at the time of the transfer and when the property has become substantially vested in the employee. The property is "substantially vested" at the earliest time that the employee either:[37]

- Obtains a transferable interest in the property received, or
- Has no substantial risk of forfeiture.

Whether a substantial risk of forfeiture exists depends on the facts and circumstances. A requirement to return the property to the employer if the employee leaves for a competing firm generally does not constitute a substantial risk of forfeiture. An example of a substantial risk of forfeiture is a requirement to return the property to the employer if earnings are below a specified amount.[38]

STOCK OPTIONS

Stock options are generally rights to purchase a stock at a specified price within a certain period or upon the completion of a vesting period. Stock options are a type of property under IRC §83. Stock options provided to employees can be either nonstatutory or statutory options. Each type is treated differently for tax purposes.

Nonstatutory Stock Options

Nonstatutory stock options, sometimes referred to as "nonqualified stock options" (NQSOs), are addressed by IRC §83(a). With a nonstatutory stock option, a taxpayer realizes additional compensation at the time the option is granted only when the requirements of §83(a) are met and if the option has a readily ascertainable value at the time the option is granted.[39] If the value of the option is not readily ascertainable at the time of the grant, the taxpayer realizes income at the time the taxpayer exercises or sells the option.[40] Although it is possible for a nonmarket-traded option to have a readily ascertainable value,[41] as a practical matter, most small business options do not have an ascertainable value at the time of grant. These options therefore do not constitute income until exercised.

> **Note.** The taxpayer receiving a nonstatutory stock option without a readily ascertainable value has no taxable event until the taxpayer exercises the option. However, a special tax election is available under IRC §83(b) to report the additional compensation in income in the year the option is granted. This election is available for stock options and any other property received that is covered by §83(a). The election is generally irrevocable.[42]

35. IRS Pub. 505, *Tax Withholding and Estimated Tax.*
36. Treas. Reg. §1.83-3(e).
37. IRC §83(a).
38. Treas. Reg. §1.83-3(c).
39. Treas. Reg. §1.83-7(a).
40. Ibid.
41. Treas. Reg. §1.83-7(b).
42. See Treas. Reg. §1.83-2.

IRC §83 generally provides an offsetting tax benefit equal to the amount required to be included in the employee's compensation. For a shareholder, this offset is an increase in the basis of the shareholder's interest in the stock.[43]

Example 9. Monday Morning, Inc. (MMI) employs Bob as its chief financial officer. MMI is a publicly listed company. In 2016, MMI grants Bob an option to purchase 100 shares of MMI stock at an exercise price of $40 per share when MMI stock has an FMV of $100 per share. The option is valued at $6,120 at the time of the grant. Bob paid $500 for the option.

Bob exercises the option in January 2017, when the market value of MMI shares is still $100 per share. He buys 100 shares of stock with an FMV of $10,000 and pays the option exercise price of $4,000 ($40 × 100 shares).

Because the value of this option is readily ascertainable at the time of the grant, Bob realizes additional compensation at the time the option is granted. He must report the FMV of the option when it was granted less the amount he paid for it. He, therefore, has additional 2016 compensation income of $5,620 ($6,120 option FMV – $500 paid for the option).

Bob's exercise of the option in 2017 is not taxable. He calculates his basis in the stock as follows.

Amount paid for the stock	$ 4,000
Amount of additional 2016 compensation reported	5,620
Amount paid for option	500
Total stock basis	$10,120

Observation. Employers providing stock options to employees generally use software to calculate the FMV of the option. This involves complex calculations using option valuation models.

Example 10. On January 3, 2016, Myra receives a NQSO from her employer, Smalltown Metal Fabricating, Inc. Smalltown is a family-owned business that is not publicly listed. Myra's stock option provides her with the right to purchase 100 shares of Smalltown common stock at an exercise price of $20. Myra exercises her option on July 12, 2017. On that date, Smalltown common shares have an established FMV of $35 per share.

Because the NQSO does not have a readily ascertainable value on the January 3, 2016 grant date, the grant is a nontaxable event. However, Myra has additional compensation income to report in 2017 when she exercises her option. Her additional compensation is $1,500 (($35 FMV – $20 exercise price) × 100 shares).

Example 11. Use the same facts as **Example 10.** However, after Myra exercises the option on July 12, 2017, she sells her 100 Smalltown shares on July 15, 2017. Through a broker, she finds a buyer who pays her $40 per share. The broker's commission is $40.

Myra has the same additional compensation income of $1,500 in 2017 as explained in **Example 10.** The details of Myra's 2017 short-term capital gain on the sale of 100 shares follow.

Basis in shares:	
Amount paid upon option exercise	$2,000
Amount of additional 2017 compensation reported	1,500
Total basis	$3,500
Capital gain on sales of shares:	
Proceeds from the sale of shares ($40 per share × 100 shares)	$4,000
Less: basis	(3,500)
Less: broker commission	(40)
Capital gain (short-term)	$ 460

The $460 capital gain recognized by Myra in 2017 is a short-term capital gain because she held the shares for less than one year.

43. CCA 003586 (May 30, 1995).

W-2 Reporting. The difference between the FMV of the shares and the option exercise price is called the "spread." When an employee exercises a nonstatutory stock option, the employer generally must report the spread as additional employee compensation.[44]

At the time the taxpayer exercises the option, this compensation is subject to social security, Medicare, and federal unemployment taxes. On the employee's Form W-2, the employer adds the spread amount to other compensation for the year in box 1 (wages), and it is also included in boxes 3 (social security wages) and 5 (Medicare wages). The employer also reports the amount of the spread in box 12 with code "V."[45]

Statutory Stock Options

Statutory stock options, often called incentive stock options (ISOs), are governed by IRC §§421 and 422. The two Code sections provide additional tax advantages that are not associated with nonstatutory stock options. The stock option must meet the following requirements to be statutory.[46]

- The company granting the option must employ the taxpayer at the time the company grants the option.
- The taxpayer must remain an employee of the company (or of a parent or subsidiary company) continuously throughout the option period until at least three months before they exercise the option.
- The option granted must be nontransferable, except upon the taxpayer's death.

If the option does not meet these requirements, it is treated as nonstatutory.

A taxpayer receiving a statutory stock option does not report income either when the company grants the option or when the taxpayer exercises the option. The taxpayer acquires stock by exercising the option. The subsequent sale of that stock is a taxable event. Capital gains tax treatment applies to the share sale if the taxpayer holds the shares until the end of the later of:[47]

- One year after they are transferred, or
- Two years after the date the business grants the option.

If the taxpayer sells the stock before meeting the holding period requirements, this results in a **disqualifying disposition.**[48] The company reports this as additional compensation to the taxpayer. However, compensation from a disqualifying disposition, although included in box 1 of Form W-2, is not subject to payroll tax withholding.[49]

Even if a taxpayer meets the holding period requirement, they may still be required to include additional compensation in income if the option was granted at a discount. The taxpayer must include additional compensation in income if, at the time the option was granted:[50]

- The option price per share was less than 100%, but not less than 85%, of the FMV of the share; and
- The taxpayer disposed of the share after meeting the holding period requirement or the taxpayer died while owning the share.

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44. Treas. Reg. §1.83-7.
45. Instructions for Form W-2.
46. IRS Pub. 525, *Taxable and Nontaxable Income;* IRC §422(a)(2).
47. Ibid.
48. Ibid.
49. IRC §421(b).
50. IRS Pub. 525, *Taxable and Nontaxable Income.*

The compensation the taxpayer includes in income is the lesser of the following amounts.[51]

- The excess of the FMV of the share when the option was granted over the option price
- The excess of the FMV of the share when the disposition or death occurred over the amount paid for the share under the option

If the option price was not fixed or determinable when the option was granted, the option price is calculated as if the option were exercised when it was granted. Any excess gain is capital gain. A loss from the sale is a capital loss, and the taxpayer does not have any ordinary income.[52]

Example 12. On January 1, 2015, Double U Tools Corp. granted Brad an option under its employee stock purchase plan to buy 100 shares of Double U stock for $20 per share. At the time the option was granted, the stock had a value of $22 per share.

On June 1, 2016, Brad exercised his option when the stock was valued at $23 per share. He sold 50 shares of his stock on August 1, 2017, for $30 per share. In 2017, Brad's Form W-2 reports additional compensation of $100 (($22 grant price − $20 option price) × 50 shares).

Brad must also report a capital gain, which is calculated as follows.

Selling price ($30 × 50 shares)	$1,500
Less: option price ($20 × 50 shares)	(1,000)
Gain	$ 500
Less: amount reported as compensation	(100)
Capital gain	$ 400

Note. For more information about stock options, see the 2017 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: Investments.

PAYMENT-IN-KIND WAGES

Farmers and ranchers have rules that may allow them to pay some employees in kind (livestock or grain) rather than in cash. These are called payment-in-kind (PIK) wages. The rules are very specific, and the employer must adhere to them explicitly. PIK wages are not subject to social security or Medicare withholding or matching by the employer. However, the employee receives no credit for social security or Medicare and there is no income tax withholding. PIK wages are reported in box 1 of the employee's Form W-2.

Note. For more information on PIK wages, see the 2014 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 4: Agricultural Issues and Rural Investments. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

51. Ibid.

52. Ibid.

LEGAL EXPENSES IN CONNECTION WITH EMPLOYMENT

BASIC RULES

Legal fees associated with personal matters are **not deductible.**[53] In addition, legal fees related to the acquisition or disposition of a capital asset are not deductible. Instead, the taxpayer capitalizes the legal fees. This includes legal fees incurred to perfect a title, recover property, or to develop or improve property.[54] Although legal fees associated with the acquisition or recovery of capital assets are not deductible, legal costs associated with the **recovery of investment property or income** from property are deductible.[55]

Legal fees associated with an income-producing activity or to establish or protect a source of **taxable** income for the taxpayer are **generally deductible.**[56] This includes legal fees associated with performing or maintaining a job either as an employee or as a self-employed worker.[57] In order for the legal costs to be deductible, they must be "ordinary and necessary." This means the legal fees must bear a close relationship to the production of income and must be reasonable.[58]

2-FACTOR TEST

To determine whether legal fees are personal or whether there is a sufficient relationship between the legal fees and an income-producing activity of the taxpayer, two factors are considered.[59]

1. The origin of the claim
2. The character of the controversy

Taxpayers claim deductible legal fees in connection with employment as a miscellaneous itemized deduction on Schedule A, line 23. These fees are subject to the 2%-of-AGI threshold.[60]

Example 13. Graham is the regional vice president of sales for Muddy River Software (MRS). One weekend, Graham drove home from a friend's party and caused an automobile accident. Graham's blood alcohol level was beyond the legal limit, and the police arrested him for drunk driving. He incurred legal fees to defend his subsequent criminal charge for driving under the influence of alcohol.

Graham's legal fees are not tax deductible. The origin and character of the controversy are **personal.** The claim arose from an incident arising on Graham's personal time while traveling from a personal event having nothing to do with his business or employment.

Example 14. Use the same facts as **Example 13.** Before Graham's trial date pertaining to his DUI charge, MRS suspended Graham without pay because of the criminal charges against him.

Graham hired a lawyer to sue MRS for back pay and reinstatement. The origin and character of this claim involves Graham's employment and the recovery of income from his employment. The legal fees in connection with Graham's case against MRS are deductible as a 2%-of-AGI miscellaneous itemized deduction.

Caution. Tax practitioners should consider the AMT implications of miscellaneous itemized deductions.

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53. IRC §262; Instructions for Schedule A.
54. Treas. Reg. §1.212-1(k).
55. Ibid.
56. IRC §212.
57. See IRS Pub. 529, *Miscellaneous Deductions.*
58. Treas. Reg. §1.212-1(d).
59. *U.S. v. Gilmore,* 372 U.S. 39 (1963).
60. Instructions for Schedule A; IRS Pub. 529, *Miscellaneous Deductions.*

DIVISIBILITY[61]

Legal fees that involve both personal matters (for which the legal fees are not deductible) and business, employment, or income-related matters (for which the legal fees may be deductible), can be divided into deductible and nondeductible amounts.

However, legal fees in connection with income that is tax-exempt are nondeductible.

> **Example 15.** During 2017, Ornella incurred legal fees of $5,000 to establish her social security disability (SSD) benefit. Ornella is successful and receives $10,000 in SSD benefits in 2017. Only 40% of her SSD benefit is taxable in 2017. Because only 40% of her SSD benefit is taxable, she can deduct only 40%, or $2,000 (40% × $5,000) of her legal fees in connection with her SSD case.

PERSONAL INJURY OR SICKNESS

Gross income is broadly defined to include all income from whatever source derived[62] and includes the amount of any legal award or settlement unless some specific exception exists. Amounts awarded to employees for back pay under a court order or order of the National Labor Relations Board are generally considered wages and are subject to payroll tax withholding.[63] The amounts awarded are subject to federal payroll tax withholding at the rates in effect at the time the payments are made, not when the back pay was originally earned.[64] Interest on back pay awards is not considered wages if it is separately identified.[65]

IRC §104 provides several exceptions to the basic income inclusion rule for legal awards received for injury or sickness. The exceptions do not apply to the extent that a taxpayer deducted related medical expenses in prior tax years.[66]

DAMAGE AWARDS

A taxpayer excludes personal injury or sickness damage awards from gross income.[67] However, any punitive **damages**[68] or **prejudgment interest**[69] received along with such an award is included in income. A taxpayer reports punitive damages on **Form 1040, line 21** ("other income").[70]

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61. IRC §265.
62. IRC §61.
63. Rev. Rul. 78-336, 1978-2 CB 255; Rev. Rul. 57-55, 1957-1 CB 304; Rev. Rul. 75-64, 1975-1 CB 16.
64. Rev. Rul. 78-336, 1978-2 CB 255.
65. *G.J. Hemelt v. U.S.,* 122 F.3d 204 (4th Cir. 1997).
66. Treas. Reg. §1.104-1(a).
67. IRC §104(a)(2); Treas. Reg. §1.104-1(c).
68. Ibid.
69. *C.A. Chamberlain v. U.S.,* 286 F.Supp.2d 764 (E.D.La. 2003).
70. IRS Pub. 4345, *Settlements – Taxability.*

WORKERS' COMPENSATION BENEFITS

Employees exclude from gross income amounts received from a statutory workers' compensation arrangement that provides benefits to employees for personal injuries or sickness.[71] This income exclusion also applies to such payments made to survivors of a deceased employee.[72] However, the income exclusion does not apply to benefits that:[73]

- Constitute a retirement pension or annuity determined by the employee's age or length of service, or the employee's prior contributions;
- Are received in connection with a nonoccupational injury or sickness; or
- Exceed the amount provided for under the statutory workers' compensation arrangement.

DISABILITY INSURANCE

Rev. Rul. 2004-55 addresses the income tax treatment of long-term and short-term disability benefits under IRC §§104(a)(3) and 105(a).

The taxability of proceeds from long-term and short-term disability plans depends on who made the contributions to the plan.[74]

- When a plan is funded solely by an employer, proceeds are includable in the employee's gross income to the extent that such amounts are attributable to employer contributions not includable in the employee's gross income.[75]
- When both the employer and the employee contribute to a plan, proceeds are includable in the employee's gross income to the extent that such amounts are attributable to employer contributions not includable in the employee's gross income.[76]
- When an individual purchases a plan out of their own funds, plan proceeds subsequently received for personal injuries or sickness are excludable from the individual's gross income under IRC §104(a)(3).[77]

ACCIDENT OR HEALTH INSURANCE

An employee excludes from income the cost of employer-provided healthcare coverage.[78] Under IRC §105(a), the taxpayer's gross income includes accident or health insurance benefits or proceeds if:

- The taxpayer's employer paid the premiums, or
- The proceeds are attributable to contributions by the employer that were not includable in the employee's gross income.

Amounts paid to **reimburse** the taxpayer for expenses incurred for the medical care of the taxpayer, taxpayer's spouse, or dependent are excludable.[79] "Dependent" includes any child of the taxpayer who has not attained age 27 at the end of the tax year.[80]

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71. IRC §104(a)(1); Treas. Reg. §1.104-1(b).
72. Treas. Reg. §1.104-1(b).
73. Ibid.
74. Treas. Reg. §1.104-1(d).
75. IRC §105(a).
76. Treas. Reg. §1.105-1(a).
77. Treas. Reg. §1.104-1(d).
78. IRC §106(a).
79. Treas. Reg. §1.105-2; IRC §105(b)
80. IRC §162(l)(1)(D).

In addition, a payment may be excludable from the taxpayer's income under IRC §105(c) if it:

- Compensates the taxpayer for permanent disfigurement or total loss or loss of the use of a body part or bodily function of the taxpayer, spouse, or a dependent; and
- Is calculated based on the nature of the injury without regard to work absence.

Example 16. Sarita's employer, Diversified Engineering, pays 100% of her healthcare coverage. Sarita does not include the premiums in her income. Part of the healthcare coverage is an accidental death and dismemberment (AD&D) policy, which specifies the payment of various lump-sum amounts in connection with the loss or loss of use of various parts of the body or bodily function.

Sarita was supervising the machining of a custom engine part. The fracture of a large drill bit caused severe injury to Sarita's left eye. Sarita lost the use of her eye.

Her **employer-provided** AD&D coverage specified that it would pay $10,000 for the loss of an eye. Sarita received the $10,000 AD&D payment. The $10,000 AD&D payment is for the loss of use of a body part and is unrelated to work absence. It is excludable under §105(c).

Example 17. Use the same facts as **Example 16,** except Sarita's eye injury occurred at home while she was making muffins using a faulty blender. Her AD&D coverage pays $10,000 for the loss of a body part or bodily function. The $10,000 is still excludable under §105(c).

Note. A particular AD&D policy may cover only work-related injuries or it may cover injuries occurring anywhere. However, the location where the injury occurred is not relevant for purposes of the income exclusion available for an AD&D payment under §105(c).

Example 18. Use the same facts as **Example 16,** except that the AD&D policy was not structured to pay a lump sum. Instead, the policy specified that it would pay $1,000 per week during an injury-related work absence, up to a maximum of 10 weeks. Sarita missed more than 10 weeks of work and received the maximum $10,000 benefit. Under §105(c)(2), the $10,000 AD&D benefit is included in Sarita's income because it is based on work absence and not on the nature of the injury.

Prorating Costs of Individual Policies[81]

When the employer and taxpayer each pay for part of the premium of an **individual policy,** the benefit amount is divided into includable and excludable portions. The portion paid by the employer is includable in the employee's gross income and the portion paid by the employee is excludable.

Example 19. Manfred works for AGT Industries (AGT). He has health insurance coverage through AGT. In 2017, Manfred pays 40% of his annual premium and AGT pays the remaining 60%.

During 2017, Manfred receives $10,000 of benefits that are not a reimbursement of actual expenses. Because Manfred pays 40% of the premium, 40% of the insurance benefits, or $4,000 (40% × $10,000), is attributable to the portion of the annual premium he paid. This $4,000 is excludable under IRC §104(a)(3) to the extent that Manfred has not deducted any of the amount as medical expenses.

The remaining 60% of the benefits, or $6,000, is the amount attributable to the premium paid by AGT. This amount is subject to IRC §105(a) and is includable in Manfred's income.

81. Treas. Reg. §1.105-1(d)(1).

Self-Employed Taxpayers

Self-employed taxpayers may be able to deduct their healthcare premiums paid during the year up to the amount of net earned SE income.[82] A self-employed taxpayer can claim a deduction for the cost incurred for health insurance for the taxpayer, taxpayer's spouse, dependents, and any child of the taxpayer who has not attained age 27 by the end of the tax year.[83] Self-employed taxpayers who can claim the self-employed health insurance deduction include the following.[84]

- Self-employed taxpayers reporting income on Schedules C or F
- Partners in a partnership
- Taxpayer using either the farm optional method or nonfarm optional method to figure net earnings from self-employment on Schedule SE
- Employees of an S corporation who own more than 2% of the corporation's stock

The health insurance plan must be established, or considered to be established, by the business. The following requirements apply.[85]

- For sole proprietors filing a Schedule C, C-EZ, or F, the policy must be in the name of the business or the individual.
- For partners, the policy can be in the name of the partnership or the partner. The partner can pay the premium or the partnership can pay the premiums and report the cost as a guaranteed payment on Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.* However, a partnership must reimburse a partner who pays the premium and has the policy in their name. The reimbursed premium amount must be reported on Schedule K-1 as guaranteed payments. Otherwise, the insurance plan is not considered to be established by the business.
- For more than 2% shareholders, the policy can be either in the name of the S corporation or the shareholder. The shareholder can pay the premiums or the S corporation can pay the premiums and report the amount on Form W-2 as wages. However, if the policy is in the shareholder's name and the shareholder pays the premiums, the S corporation must reimburse the shareholder and report the amount of the premium on Form W-2 as wages. Otherwise, the insurance plan is not considered to be established by the business.

> **Note.** A self-employed individual can deduct Medicare Part B premiums, in addition to other Medicare premiums.[86]

The self-employed health insurance deduction is treated as an adjustment to income rather than being treated as an itemized deduction. A taxpayer cannot use this deduction to reduce net earned income for purposes of calculating the applicable SE tax for the year. Moreover, this deduction is not available for any month in which the self-employed person is eligible to participate in a subsidized health plan of their employer or spouse's employer.[87]

> **Caution.** Taxpayers who have deducted various amounts of health insurance premiums as self-employed health insurance may have taxable income from policies that have a refund provision.

82. IRC §162(l)(2)(A).
83. IRC §162(l)(1).
84. IRS Pub. 535, *Business Expenses.*
85. Ibid.
86. CCA 201228037 (May 1, 2012).
87. IRC §162(l)(2)(B).

For purposes of the employees' income exclusion for accident or health insurance benefits or proceeds, the IRS specifically excludes self-employed taxpayers from the definition of "employee."[88] However, the same exclusion is available to self-employed taxpayers if an insurance company pays the accident or health benefits under an insurance contract or similar arrangement.[89]

MOVING EXPENSES

An employee or a self-employed individual may deduct moving expenses in connection with the "commencement of work" at a new principal place of work.[90]

Commencement of work includes the following.[91]

- Beginning employment or self-employment for the first time
- Beginning full-time employment or self-employment after a substantial period of part-time employment or unemployment
- Beginning employment with a different employer
- Beginning work for the same employer in a new location
- Engaging in a new trade or business as a self-employed individual
- Engaging in self-employment at a new location

Moving expenses include only reasonable expenses for the following.[92]

- Moving **household goods** and **personal items** from the **old residence to the new residence**
- Traveling between the old and new residences (including any lodging)

Taxpayers use Form 3903, *Moving Expenses,* to report unreimbursed moving expenses. A taxpayer cannot deduct moving expenses unless the following conditions are satisfied.[93]

- The taxpayer's commute from their former home to the new work location is at least 50 miles longer than the commute to the former workplace. If the taxpayer had no former principal place of work, the new work location must be at least 50 miles from the former residence.
- The taxpayer is employed full-time:
  - For at least 39 weeks in the year immediately following the move, **or**
  - Performs services as an employee or self-employed individual for at least 78 weeks in the 2-year period following the move with at least 39 of those weeks within the first year.

> **Note.** Additional rules associated with the deduction of moving expenses are found in Treas. Reg. §1.217-2.

88. IRC §105(g); Treas. Reg. §1.105-5(b); Treas. Reg. §1.105-1(a).
89. Treas. Reg. §1.72-15(g).
90. IRC §217(a).
91. Treas. Reg. §1.217-2(a)(3).
92. IRC §217(b)(1).
93. IRC §217(c).

TAXATION OF FRINGE BENEFITS

The IRS taxes workers on fringe benefits unless a specific exclusion from income exists. Generally, the FMV of the fringe benefit must be included in income to the extent it exceeds the following.[94]

- The amount for which there is a specific exclusion
- The amount, if any, that the worker paid for the fringe benefit

Fringe benefits not specifically excluded from income are subject to payroll taxes.[95]

The following forms are used to report the taxable value of fringe benefits received by various workers.

Worker	Form
Employee	Form W-2
Partner	Schedule K-1 (for Form 1065)
Independent contractor	Form 1099-MISC

Note. Additional information on the tax treatment of various fringe benefits can be found in IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits,* and IRS Pub. 525, *Taxable and Nontaxable Income.*

STATUTORY FRINGE BENEFITS

Specific statutory exclusions exist for the following fringe benefits, which are called "statutory fringe benefits."

Statutory Fringe Benefit	Tax Code Section Providing Income Exclusion
No-additional-cost services	§132(b)
Qualified employee discounts	§132(c)
Working condition fringe benefits	§132(d)
De minimis fringe benefits	§132(e)
Qualified moving expense reimbursements	§132(g)
Qualified retirement planning services	§132(m)
Qualified transportation	§132(f)

When an employer provides these statutory fringe benefits to an employee, the benefits are excludable from gross income and are not subject to payroll taxes.

Definition of Employee

An **employee** is an individual employed by the employer. However, the definition of employee is expanded for some of the preceding statutory fringe benefits. For specific guidance on who is considered an employee for purposes of the statutory fringe benefits, see Treas. Reg. §1.132-1(b).

94. Treas. Reg. §1.61-21(b)(1).

95. IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits.*

No-Additional-Cost Services

A no-additional-cost service is typically a benefit provided to employees from the employer's excess capacity.[96] It is a fringe benefit provided to an employee under the following circumstances.[97]

- The service provided to the employee is the same service that the employer provides to its general business customers.
- The employer does not lose revenue or incur a substantial additional cost in providing the service to the employee.

If the fringe benefit meets the preceding conditions, the employee's income does not include the value of the fringe benefit.[98]

Example 20. FlyByNight Airlines Corp. provides its employees with the ability to travel from airport to airport by using unsold seats. These seats are part of FlyByNight's excess capacity and FlyByNight does not lose revenue or incur substantial additional costs by providing them to employees. The airline seats provided to employees are a tax-free no-additional-cost benefit.

Nondiscrimination. Highly compensated employees receiving a no-additional-cost benefit cannot exclude the benefit from their income unless the company makes that benefit available on substantially the same terms to either:[99]

- All employees of the employer, or
- A group of employees of the employer defined in a nondiscriminatory manner.

Note. Details regarding the nondiscrimination rules applicable to certain fringe benefits are outlined in Treas. Reg. §1.132-8.

Qualified Employee Discounts

A qualified employee discount is excludable from the employee's gross income. A **qualified employee discount** is a discount provided to employees in connection with "qualified property or services." Employee discount fringe benefits are also subject to the nondiscrimination requirements mentioned in the last section.[100]

Qualified property or services is defined as any property or services that the employer offers to its customers in the ordinary course of the line of business in which the employee performs substantial services.[101] The definition of qualified property specifically excludes real property and personal property commonly held for investment, such as commodities, securities, or currency.[102] Property or services that the employer only offers to employees at an employee store or in an employee catalog do not qualify.[103]

A **qualified employee discount** for qualified **property** is an employee discount that does not exceed the employer's gross profit percentage (GPP) multiplied by the property's normal price to customers.[104]

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96. Treas. Reg. §1.132-2(a)(2).
97. IRC §132(b)(1) and Treas. Reg. §1.132-2(a).
98. Ibid.
99. Treas. Reg. §1.132-8.
100. Treas. Reg. §1.132-3(a).
101. Treas. Reg. §1.132-3(a)(2)(i).
102. Treas. Reg. §1.132-3(a)(2)(ii).
103. Treas. Reg. §1.132-3(a)(2)(iii).
104. Treas. Reg. §§1.132-3(a)(1)(i) and (c)(1)(1).

GPP is calculated as follows.

$$\text{GPP} = \frac{\text{Aggregate sales price} - \text{Aggregate cost}}{\text{Aggregate sales price}}$$

The amount of excludable employee discount is calculated as follows.[105]

$$\text{Amount of excludable employee discount} = \text{GPP} \times \text{Normal sales price}$$

Example 21. Bargain Bob's retail computer outlet has merchandise with a total cost of $100,000 and a total sales price of $130,000. In 2017, Bargain Bob's gave an employee, Myron, a $400 discount on a laptop that has a sales price of $1,000. The amount of excludable employee discount is calculated as follows.

$$\begin{aligned}\text{Bob's GPP} &= \frac{\text{Aggregate sales price} - \text{Aggregate cost}}{\text{Aggregate sales price}} \\ &= \frac{\$130{,}000 - \$100{,}000}{\$130{,}000} \\ &= 23.08\%\end{aligned}$$

$$\begin{aligned}\text{Amount of excludable employee discount} &= \text{GPP} \times \text{Normal sales price} \\ &= 23.08\% \times \$1{,}000 \\ &= \$231\end{aligned}$$

Therefore, of Myron's total $400 employee discount, **$231 is excludable from his income.** The remaining **$169 ($400 – $231) must be included in Myron's income** and is taxable to him in 2017.

A **qualified employee discount** for qualified services is an employee discount that does not exceed 20% of the service's normal price to customers.[106]

Example 22. Use the same facts as **Example 21,** except Bargain Bob's also gives Myron an employee discount on software installation in 2017. Bargain Bob's charges customers $100 for this service. Myron was only charged $30. The amount of excludable discount is $20 (20% × $100). Of Myron's $70 discount ($100 – $30), $20 is excludable from income and the remaining $50 ($70 – $20) is taxable in 2017.

> **Note.** Additional rules in connection with employee discounts can be found in Treas. Reg. §1.132-3.

105. Treas. Reg. §1.132-3(c).

106. Treas. Reg. §1.132-3(a)(1)(ii).

Working Condition Fringe Benefits

A **working condition fringe benefit** is any property or service an employer provides to an employee that the employee could deduct under IRC §§162 or 167 if the employee paid for the property or service.[107] The §§162 or 167 deduction that the employee could have taken must be related to employment provided by the employer rather than another trade or business of the employee.[108] The employee's gross income does not include a working condition fringe benefit.[109] An amount that would be deductible under Code sections other than §§162 or167 is not a working condition fringe benefit.[110]

> **Note.** IRC §162 provides a deduction for ordinary and necessary expenses to carry on a trade or business. IRC §167 allows a depreciation deduction for property used in a trade or business or property held for the production of income. In addition, IRC §274(d) and related regulations require substantiation for some of these deductions. Any §274(d) substantiation requirement necessary under §§162 or 167 is also necessary for a working condition fringe benefit under these Code sections.

Example 23. Walter works as a financial planner for Northern Capital Planners (NCP). NCP pays for Walter's annual subscriptions to various financial planning periodicals as well as for subscriptions to *The Wall Street Journal* and *The Financial Times.* NCP also pays Walter's professional dues required for his state mutual fund sales license. The cost of the subscriptions and the amount of Walter's dues paid by NCP are working condition fringe benefits. If Walter paid for these items directly, he would be entitled to deduct them as business or trade expenses under §162.

Cash payments by the employer to employees qualify as a working condition fringe benefit only if the employee is required to do all of the following.[111]

- Spend the cash payment in accordance with a specific or prearranged event or activity that would give rise to an allowable deduction under §§162 or 167
- Verify that the payment has in fact been used for such an event or activity
- Return any part of the payment that was not used for the event or activity to the employer

De Minimis Fringe Benefits

A **de minimis fringe benefit** is any property or service provided to the employee that has such a small value that accounting for it is unreasonable or impracticable.[112] Examples of de minimis benefits include the following.[113]

- Occasional typing of personal letters by a company secretary
- Occasional parties or group meals for employees and their guests
- Birthday or holiday gifts of low value
- Occasional sporting event or theater tickets
- Flowers, fruit, or books provided to employees for special circumstances

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107. Treas. Reg. §1.132-5(a)(1).
108. Treas. Reg. §1.132-5(a)(2)(i).
109. Treas. Reg. §1.132-5(a)(1).
110. Treas. Reg. §1.132-5(a)(1)(iii).
111. Treas. Reg. §1.132-5(a)(1)(v).
112. IRC §132(e)(1).
113. Treas. Reg. §1.132-6(e).

The value of the benefit and the frequency with which it is provided to the employee are considered in determining whether the benefit is de minimis.[114] Frequency must be considered on an individual employee basis.[115] If the fringe benefit is too valuable or frequent for the employee to exclude, then the entire value is included in gross income.

Example 24. Katie is one of 78 administrative employees of HGT Plastics, Inc. (HGT). HGT provides all 78 administrative employees with a simple dinner for Thanksgiving and Christmas holidays. The meals constitute a de minimis fringe benefit for each of the 78 employees.

Example 25. Use the same facts as **Example 24,** except Katie also receives an employer-provided meal twice weekly in addition to the Thanksgiving and Christmas meals with the other 77 administrative employees. All of Katie's meals, including those given for Thanksgiving and Christmas, constitute a taxable fringe benefit to her. Because the other 77 employees only receive the holiday meals, the benefit is de minimis for them.

Items that **do not** constitute de minimis fringe benefits include the following.[116]

- Season tickets for sporting events or theater productions
- Use of an employer-provided vehicle to commute more than once per month
- Country club or athletic facility membership
- Use of employer facilities for a weekend or vacation
- Cash or credit card use[117]

Qualified Moving Expense Reimbursements

A qualified moving expense reimbursement is any amount the employee receives from the employer for expenses that the employee could deduct as a moving expense under IRC §217 if the employee directly paid for the expenses.[118] These amounts are reported using code P in box 12 of Form W-2.[119]

> **Note.** The general rules regarding moving expenses are provided earlier in this chapter.

Employer moving expense reimbursements are subject to the same substantiation requirements as a flexible savings account. These requirements are discussed later in this chapter.

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114. IRC §132(e)(1).
115. Treas. Reg. §1.132-6(e).
116. Ibid.
117. Treas. Reg. §1.132-6(c).
118. IRC §132(g).
119. Instructions for Form W-2.

Qualified Retirement Planning Services

Employer-provided financial counseling services **are** a taxable benefit to the employee[120] **unless** the services are excludable qualified retirement planning services. Qualified retirement planning services consist of any retirement planning information and advice provided by an employer maintaining a qualified retirement plan.[121] Qualified retirement plans include the following.[122]

- Qualified pension plans under IRC §401(a)
- Qualified annuity plans under IRC §403(a)
- Governmental plans
- IRC §403(b) accounts
- SEP and SIMPLE IRAs

> **Note.** IRC §457 deferred compensation plans, available to certain state and local government employees, are not considered qualified retirement plans.

The exclusion applies to qualified retirement planning services provided to the employee and the employee's spouse. The exclusion **does not apply** to related services such as tax preparation, accounting, legal, or brokerage services.[123]

Qualified Transportation

Employer-provided qualified transportation benefits are excludable from the employee's income.[124] Specifically, qualified transportation benefits and the inflation-adjusted maximum monthly exclusion for the 2017 tax year are as follows.

Qualified Transportation Benefit	2017 Maximum Monthly Exclusion
Commuter highway vehicle	$255 [125]
Transit passes	255 [126]
Qualified parking	255 [127]
Qualified bicycle commuting reimbursement	20 [128]

This exclusion covers employer-provided transportation and cash reimbursements.[129] However, the exclusion does not cover cash advances for transportation benefits.[130]

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120. Ltr. Rul. 199929043 (Apr. 22, 1999).
121. IRC §132(m).
122. Ibid; IRC §219(g)(5).
123. Conference Committee Report to PL 107-16 (2001), H.R. Conf. Rep. No. 107-84.
124. IRC §132(f).
125. Rev. Proc. 2016-55, 2016-45 IRB 707.
126. Ibid.
127. Ibid.
128. IRC §132(f)(5)(F)(iii).
129. IRC §132(f)(3).
130. Treas. Reg. §1.132-9(b), IRS Pub. 5137, *Fringe Benefit Guide.*

The employer can simultaneously provide the employee with any combination of the first three benefits listed above.[131] However, the employer cannot provide a bicycle commuting reimbursement benefit to the employee during a month when the employee receives any of the other three benefits.[132]

Employers that make cash reimbursements must have a bona fide reimbursement arrangement in place to substantiate that their employees have in fact incurred costs associated with commuter highway vehicles, transit passes, or qualified parking. Whether a reimbursement arrangement is bona fide is based on a facts and circumstances analysis.[133] An employer distributing transit passes to employees has no substantiation requirements.[134]

OTHER FRINGE BENEFITS

In addition to the statutory fringe benefits discussed previously, several other fringe benefits may be available to employees. A description of some of these benefits follows.

Dependent Care Assistance

A taxpayer may qualify for a tax credit for household or dependent care expenses that the taxpayer incurs in order to maintain gainful employment.[135] To obtain this tax credit under IRC §21, the expenses must be for household services or for the care of a qualifying individual.[136] A "qualifying individual" is generally:[137]

- A dependent under age 13, or
- The taxpayer's spouse or other dependent of any age who is mentally or physically impaired and who lived with the taxpayer for more than half of the year.

An employee may exclude up to a maximum of $5,000 of dependent care assistance received from an employer under a qualified plan.[138] **Dependent care assistance** is a payment an employer makes for services that would qualify for the household and dependent care tax credit under §21 if the employee had paid for those services directly.[139] The employer reports the amount provided on the employee's Form W-2 in box 10 ("dependent care benefits"). The employee must reduce the allowable dependent care tax credit claimed on Form 2441, *Child and Dependent Care Expenses,* by the amount of dependent care benefits that they exclude from their income.

Flexible spending accounts (FSAs) for healthcare are discussed later in this chapter. Individuals use FSAs most frequently for the reimbursement of medical and dental expenses. However, an individual may also use a similar FSA arrangement for the reimbursement of dependent care expenses. **Although married spouses can each have a dependent care FSA, their combined contributions cannot exceed the $5,000 limit.** Amounts over this limit are reported on Form 1040, line 7, with "DCB" written on the line.[140]

In order for the employee to benefit from the income exclusion, a qualified dependent care assistance plan must provide dependent care assistance and be nondiscriminatory. A nondiscriminatory plan is one that does not favor highly compensated employees in connection with benefits provided or the ability to participate in the plan.[141]

> **Note.** The general nondiscrimination rules for a dependent care assistance plan can be found in IRC §129(d).

131. Ibid.
132. IRC §132(f)(5)(F)(iii).
133. Treas. Reg. §1.132-9.
134. Treas. Reg. §1.132-9(b), Q&A 18.
135. IRC §21.
136. IRC §21(b)(2)(A).
137. IRC §21(b)(1).
138. IRS Pub. 503, *Child and Dependent Care Expenses.*
139. IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits.*
140. Instructions for Form 2441.
141. IRC §129(d).

Group-Term Life Insurance Benefits

An employee can exclude from gross income the cost of up to $50,000 of employer-provided group-term life insurance coverage on the employee's life.[142] An employee for purposes of this rule is limited to a person presently working for an employer within a legal employer-employee relationship or a former employee who worked within a legal employer-employee relationship.[143]

Group-term life insurance that qualifies for the exclusion is generally life insurance that:[144]

- Provides a general death benefit that is excludable from gross income under IRC §101(a),
- Is provided to a group of employees, and
- Is provided under a policy carried by the employer either directly or indirectly.

The cost of any group-term life insurance coverage in excess of $50,000 must be included in the employee's income.[145] The amount includable in income is reduced by any amount the employee paid for group-term coverage[146] and is subject to FICA taxes.[147]

The cost that is includable in the employee's income is not based on the actual cost of the policy for the excess coverage.[148] Instead, the income inclusion amount is calculated by reference to Treas. Reg. §1.79-3, table I, which follows.

Uniform Premiums for $1,000 of Group-Term Life Insurance Protection

5-Year Age Bracket	Cost per $1,000 of Life Insurance per Month
Under 25	$0.05
25 to 29	0.06
30 to 34	0.08
35 to 39	0.09
40 to 44	0.10
45 to 49	0.15
50 to 54	0.23
55 to 59	0.43
60 to 64	0.66
65 to 69	1.27
70 and above	2.06

142. IRC §79(a).

143. Treas. Reg. §1.79-0.

144. Treas. Reg. §1.79-1(a).

145. Treas. Reg. §1.79-3(a).

146. IRC §79(a).

147. IRC §3121(a)(2)(C); *Group-Term Life Insurance.* Feb. 11, 2016. IRS. [www.irs.gov/government-entities/federal-state-local-governments/group-term-life-insurance] Accessed on Jan. 12, 2017.

148. Treas. Reg. §1.79-3(d).

Example 26. Hilda is 52 years old and is employed by MegaDiversified Industries Corporation (MDIC). MDIC provided Hilda with group-term life insurance coverage of $200,000 for 2017. Under the group-term plan, Hilda pays $1.50 annually for each $1,000 of coverage and MDIC pays the rest of the cost. Hilda's taxable income inclusion is calculated as follows using Table I as a reference.

Cost of $200,000 of group-term life coverage under Table I ($200 × .23 × 12 months)	$552
Cost of $50,000 of coverage under Table I ($50 × .23 × 12 months)	(138)
Cost of coverage in excess of $50,000	$414

The amount that Hilda must include in her 2017 income is initially calculated as $414. However, this amount is reduced by the amount Hilda paid during the year for group-term coverage, as follows.

Initial income inclusion for coverage in excess of $50,000	$414
Less: amount Hilda paid for group-term coverage in 2017 ($1.50 × 200)	(300)
Amount includable in Hilda's income for 2017	$114

The exclusionary rule for group-term life insurance plans applies to nondiscriminatory plans. A group-term plan is discriminatory if it favors key employees over others in connection with the ability to participate in the plan or the amount of plan benefits.[149] With a discriminatory plan, the amount includable in key employee's income is the actual cost or the Table I cost of benefits, whichever is greater.[150] The amount is reported using code C in box 12 on Form W-2.[151]

> **Note.** Details on what constitutes a discriminatory plan, including the definition of a "key employee," can be found in IRC §79(d) and Temp. Treas. Reg. §1.79-4T.

Sick Pay

Sick pay is defined as amounts paid under a **plan** to an employee due to temporary absence from work because of injury, disability, or sickness.[152]

A sick pay plan is a regular system established by the employer under which sick pay is available to some or all employees. An employer may establish a sick pay plan by a formal written document, longstanding practice, or a benefit that has otherwise been made known to employees through a bulletin board posting, pamphlet, or other means. Mere occasional benefits provided to particular workers in need are **not enough to constitute a plan.**[153]

The following items are not sick pay.[154]

- Disability retirement benefits
- Worker's compensation payments and payments from similar programs
- Health or accident insurance payments not related to work absence
- Medical or hospitalization plan payments to cover medical expenses

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149. IRC §79(d)(2).
150. IRC §79(d)(1).
151. Instructions for Form W-2.
152. IRC §3402(o)(2)(C).
153. IRS Pub. 15-A, *Employer's Supplemental Tax Guide.*
154. Ibid.

Income and Payroll Taxes.[155] If the employer pays sick pay, it is subject to federal income tax withholding and payroll taxes. The amount the employer withholds is typically based on the employee's Form W-4, *Employee's Withholding Allowance Certificate.*

A **third-party agent** of the employer may pay sick pay to the employee. A third party is an agent of the employer if that third party only administers the payments to employees without providing sick pay insurance. A third party that determines employee eligibility for such payments can be an agent of the employer. If the employer's third-party agent makes the payments, those payments are subject to federal tax withholding and payroll taxes. These payments may also be subject to state income tax.

If a non-agent third party makes the payments, the payments are not subject to mandatory federal income tax withholding. An insurance company that provides sick pay coverage and payments to employees is an example of a non-agent third-party payor. An employee, however, can voluntarily request to have federal income tax withheld by using Form W-4S, *Request for Federal Income Tax Withholding From Sick Pay.* The non-agent third party should withhold the requested tax amount from all payments of sick pay made eight or more days after the receipt of the Form W-4S. Tax withholding on payments made prior to the eighth day of receipt is discretionary.

The following payments are not subject to federal tax withholding, regardless of whether they are paid by the employer or a third party.

- Payments made to the employee's estate or survivor any time after the employee's death
- Payments arising from after-tax contributions made by the employee to a sick pay plan

W-2 Reporting.[156] Sick pay can be combined with other wages and employee compensation on a single Form W-2. Sick pay can also be reported on a separate Form W-2.

For sick pay that is subject to federal income tax withholding and payroll taxes, the amount of sick pay is included on Form W-2 in boxes 1, 3, and 5. Employers show the amounts of federal income, social security, and Medicare taxes withheld in boxes 2, 4, and 6, respectively.

Any sick pay that was paid by a third party and was not includable in the employee's income because the employee made after-tax contributions is reported in box 12, using code "J."

The "third party sick pay" box within box 13 must be checked when the payments were made by a third party.

Flexible Spending Accounts for Health Care

An FSA can be offered to employees either alone or as part of a more comprehensive cafeteria plan.[157] Self-employed taxpayers cannot use an FSA. Taxpayers most frequently use an FSA for medical and dental expenses but can also use another FSA for dependent care costs and other limited purposes.[158]

Typically, an employee voluntarily contributes to the FSA through a salary reduction agreement. Employee contributions to an FSA are not subject to federal income tax withholding or payroll taxes.

The contribution amount is determined at the beginning of each FSA plan year. The employer withholds the required amount each pay period and deposits that amount into the employee's respective FSA. The employee can change or revoke the amount at the beginning of a plan year or if employment or family status changes occur as specified by the terms of the plan. If the FSA plan so specifies, the employer may also contribute to the employee's FSA.[159]

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155. Ibid.

156. Ibid.

157. IRS Pub. 969, *Health Savings Accounts and Other Tax-Favored Health Plans.*

158. Prop. Treas. Reg. §1.125-5(h).

159. IRS Pub. 969, *Health Savings Accounts and Other Tax-Favored Health Plans.*

The FSA plan must establish a ceiling on contribution amounts. The ceiling is established by specifying either a maximum dollar amount or maximum percentage of pay that can be contributed.[160] For tax years beginning in 2017, the maximum amount that an employee can contribute to a health FSA is **$2,600.**[161]

To be excludable from the employee's income, distributions from a health FSA must be made only to reimburse the employee for **qualified medical expenses.** Qualified medical expenses are expenses that qualify for the medical and dental expense deduction. The employee must be able to obtain **at any time during the year** expense reimbursement up to the amount the employee elected to contribute during the year, regardless of the amount the employee has actually contributed. Accordingly, a health FSA is **"prefunded."**[162]

> **Example 27.** Ryan elects to participate in an FSA that his employer offers as part of a cafeteria plan. At the beginning of the plan year, which commences on January 1, 2017, he elects to contribute $2,400 through a salary reduction arrangement. His employer withholds $200 per month starting with Ryan's January paycheck.
>
> On May 31, 2017, Ryan has extensive dental surgery costing $2,400, which is a qualified medical expense. The FSA can reimburse Ryan for the full amount of the dental surgery at the end of May or any later time during 2017 even though Ryan has not yet contributed the full $2,400 for the year.

Note. Qualifying medical and dental expenses are discussed in IRS Pub. 502, *Medical and Dental Expenses.* Qualified dependent care expenses are discussed earlier in this chapter.

To substantiate the qualified expense for which reimbursement is appropriate, the employee must provide to the employer:[163]

- A written statement from a third party stating the nature and amount of the expense, and
- The employee's written statement indicating that they received no other reimbursement for the expense from another plan or other coverage.

Note. The FSA can only make distributions for qualified expenses actually incurred. It cannot make distributions in advance of the expense or to cover projected expenses.[164]

Expenses for nonprescription medications no longer qualify for FSA reimbursement. However, **nonprescription insulin** continues to constitute a qualified medical expense.[165]

Under the terms of an FSA, the employee must spend the amounts they contributed during the plan year or the employee forfeits the unused amount. The plan may offer up to a **2½-month grace period** after the plan year for the employee to use any remaining funds.[166] Alternatively, health FSA plans may allow up to $500 of unused amounts remaining at the end of the plan year to carry forward to the following plan year. The plan may specify a maximum carryover amount that is less than $500. Any unused amount in excess of the carryover amount is forfeited. A plan may allow **either** the grace period or a carryover, but not both.[167]

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160. Prop. Treas. Reg. §1.125-1(c)(1)(v)(A).

161. Rev. Proc. 2016-55, 2016-45 IRB 707.

162. IRS Pub. 503, *Child and Dependent Care Expenses.*

163. Ibid.

164. Ibid.

165. IRC §106(f).

166. Prop. Treas. Reg. §1.125-1(e).

167. IRS Pub. 969, *Health Savings Accounts and Other Tax-Favored Health Plans.*

The employer can retain the forfeited amounts. Alternatively, the forfeitures can be used in one or more of the following ways.[168]

- To reduce required salary reduction amounts for the next plan year on a reasonable and uniform basis
- Returned to the employees on a reasonable and uniform basis
- To defray the administrative costs of the plan

EMPLOYEE ACHIEVEMENT AWARDS

An employee achievement award is an item of tangible personal property that is given by an employer to an employee. The award must meet all the following requirements.[169]

1. It is transferred by an employer to an employee for a **length of service or safety achievement.**
2. It is awarded as part of a meaningful presentation.
3. It is awarded under conditions and circumstances that do not create significant likelihood of disguised compensation.

Amounts paid as employee achievement awards are deductible as a nonwage business expense and generally are not subject to payroll taxes.[170]

For awards given as part of an established written plan that does not favor highly compensated employees, the annual per-employee deduction limit is $1,600.[171] For awards that do not meet these tests, the annual per-employee deduction limit is $400.[172]

Length of Service Award

An award qualifies as a length of service award only if the employee receives the award after their first five years of employment and the employee did not receive a similar award during the same year or in any of the prior four years.[173]

Safety Achievement Award

An award qualifies as an excludable safety achievement award unless one of the following exceptions applies.

1. The award is given to a manager, administrator, clerical employee, or other professional employee.
2. During the tax year, more than 10% of applicable employees, have already received a safety achievement award (other than one of very small value). Eligible employees must have worked full-time for at least one year prior to the award.[174]

168. Prop. Treas. Reg. §1.125-5(o).
169. IRC §274(j)(3).
170. IRS Pub. 535, *Business Expenses.*
171. IRC §274(j)(2).
172. Ibid.
173. IRC §274(j)(4); IRS Pub. 5137, *Fringe Benefit Guide.*
174. Prop. Treas. Reg. §1.274-8(d)(3).

EMPLOYMENT TAX TREATMENT FOR FRINGE BENEFITS

Taxable fringe benefits are subject to employment taxes and must be reported on an employee's Form W-2. The following table can be used as a reference in determining how to classify fringe benefits as exempt or taxable.[175]

Table 2-1. Special Rules for Various Types of Fringe Benefits

Type of Fringe Benefit	Treatment Under Employment Taxes: Income Tax Withholding	Social Security and Medicare (including Additional Medicare Tax when wages are paid in excess of $200,000)	Federal Unemployment (FUTA)
Accident and health benefits	Exempt[1,2], except for long-term care benefits provided through a flexible spending or similar arrangement.	Exempt, except for certain payments to S corporation employees who are 2% shareholders.	Exempt
Achievement awards	Exempt[1] up to $1,600 for qualified plan awards ($400 for nonqualified awards).		
Adoption assistance	Exempt[1,3]	Taxable	Taxable
Athletic facilities	Exempt if substantially all use during the calendar year is by employees, their spouses, and their dependent children, and the facility is operated by the employer on premises owned or leased by the employer.		
De minimis (minimal) benefits	Exempt	Exempt	Exempt
Dependent care assistance	Exempt[3] up to certain limits, $5,000 ($2,500 for married employee filing separate return).		
Educational assistance	Exempt up to $5,250 of benefits each year. (See *Educational Assistance*, later in this section.)		
Employee discounts	Exempt[3] up to certain limits. (See *Employee Discounts*, later in this section.)		
Employee stock options	See *Employee Stock Options*, later in this section.		
Employer-provided cell phones	Exempt if provided primarily for noncompensatory business purposes.		
Group-term life insurance coverage	Exempt	Exempt[1,4,7] up to cost of $50,000 of coverage. (Special rules apply to former employees.)	Exempt
Health savings accounts (HSAs)	Exempt for qualified individuals up to the HSA contribution limits. (See *Health Savings Accounts*, later in this section.)		
Lodging on your business premises	Exempt[1] if furnished on your business premises, for your convenience, and as a condition of employment.		
Meals	Exempt[1] if furnished on your business premises for your convenience. Exempt if de minimis.		
Moving expense reimbursements	Exempt[1] if expenses would be deductible if the employee had paid them.		
No-additional-cost services	Exempt[3]	Exempt[3]	Exempt[3]
Retirement planning services	Exempt[5]	Exempt[5]	Exempt[5]
Transportation (commuting) benefits	Exempt[1] up to certain limits if for rides in a commuter highway vehicle and/or transit passes ($255), qualified parking ($255), or qualified bicycle commuting reimbursement[6] ($20). (See *Transportation (Commuting) Benefits*, later in this section.) Exempt if de minimis.		
Tuition reduction	Exempt[3] if for undergraduate education (or graduate education if the employee performs teaching or research activities).		
Working condition benefits	Exempt	Exempt	Exempt

[1] Exemption doesn't apply to S corporation employees who are 2% shareholders.
[2] Exemption doesn't apply to certain highly compensated employees under a self-insured plan that favors those employees.
[3] Exemption doesn't apply to certain highly compensated employees under a program that favors those employees.
[4] Exemption doesn't apply to certain key employees under a plan that favors those employees.
[5] Exemption doesn't apply to services for tax preparation, accounting, legal, or brokerage services.
[6] If the employee receives a qualified bicycle commuting reimbursement in a qualified bicycle commuting month, the employee can't receive commuter highway vehicle, transit pass, or qualified parking benefits in that same month.
[7] You must include in your employee's wages the cost of group-term life insurance beyond $50,000 worth of coverage, reduced by the amount the employee paid toward the insurance. Report it as wages in boxes 1, 3, and 5 of the employee's Form W-2. Also, show it in box 12 with code "C." The amount is subject to social security and Medicare taxes, and you may, at your option, withhold federal income tax.

175. IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits*.

STATUTORY EMPLOYEES AND NONEMPLOYEES

CORPORATE OFFICERS

For employment tax purposes, there is no distinction between classes of employees. Superintendents, managers, and other supervisory personnel are all employees. Within the definitions found in the Code, officers are specifically included for purposes of FICA, FUTA, and federal income tax withholding.[176] The common-law standard (discussed earlier) is not applicable because, by statute, an officer of a corporation is an employee of the corporation. However, an officer is not considered an employee of the corporation if:[177]

1. The officer does not perform any services or performs only minor services, **and**
2. The officer does not receive (and is not entitled to receive) remuneration.

The officer must meet both of these requirements to be considered a nonemployee. Determining whether services a corporate officer performs are considered minor or nominal depends on the character of the services, the frequency and duration of performance, and the actual or potential importance or necessity of the services in relation to the conduct of the corporation's business.[178]

An officer of a corporation is considered an employee for services they perform in their role as an officer. In Rev. Rul. 58-505, a mutual insurance company sought advice as to the employment status of officers who performed administrative duties for the company and also sold insurance policies for the company. In its response, the IRS stated that the treatment depended on whether the officers' services in the two capacities were interrelated. An officer whose selling and administrative roles are interrelated cannot claim to be acting in two separate and distinct activities. If the services are interrelated, the officer is considered an employee for all of their activities. If the services are separate and distinct and the wages and duties are not interrelated, then the status of each type of service must be considered separately.[179]

As described in a 1974 revenue ruling, three individuals were officers of a management corporation and five related brother-sister operating corporations. The management corporation paid the salaries of the individuals; consequently, the individuals were considered employees of the management corporation. For the operating corporations, the individuals performed only minor administrative functions entailing a few hours per year and received no remuneration. Because the officers satisfy the requirements for the exception from employee status (they perform only minor services for the corporations and received no remuneration), the officers were not employees of the **operating corporations.**[180]

In a 1971 revenue ruling,[181] the IRS held that a taxpayer who is the president and the sole shareholder of a closely held corporation is an employee of the corporation. The fact that the corporation is closely held and that the taxpayer is a sole proprietor and completely in charge of the corporation's activities is immaterial. The taxpayer's services are material to the operation of the corporation, and he is entitled to and receives remuneration for these services. Consequently, the taxpayer is an employee of the corporation.

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176. IRC §§3121(d)(1), 3306(i), and 3401(c).
177. Treas. Reg. §31.3121(d)-1(b).
178. Rev. Rul. 74-390, 1974-2 CB 331.
179. Rev. Rul. 58-505, 1958-2 CB 728.
180. Rev. Rul. 74-390, 1974-2 CB 331.
181. Rev. Rul. 71-86, 1971-1 CB 285.

STATUTORY EMPLOYEES

When a worker is not classified as a common-law employee, the worker can be classified as a statutory employee or statutory nonemployee. Statutory employees are workers identified by statute to be employees for purposes of FICA and FUTA tax under certain conditions.[182] Statutory employees do not have federal income tax withheld from their wages.[183]

By definition, a worker cannot be a statutory employee under IRC §3121(d)(3) if that worker is considered a common-law employee. IRC §3121(d)(3) lists workers in occupational groups, who under certain circumstances are considered employees for FICA tax purposes, and in some instances for FUTA tax purposes, but not for federal income tax withholding purposes. The following groups of workers are described as **statutory employees** because they are specifically listed in the Code.

1. An agent (or commission) driver who delivers food, beverages (other than milk), laundry, or dry cleaning for someone else
2. A full-time life insurance salesperson
3. A home worker who works on materials or goods a business supplies according to specifications the business sets, and who returns the finished work to the business
4. A full-time traveling or city salesperson who works on behalf of one firm and turns in orders to the firm from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments (The goods sold must be merchandise for resale or supplies for use in the buyer's business operation.)

Statutory employees **do not have federal income tax withheld** from their wages. They are subject to having **FICA taxes** withheld from their wages if they meet the following three conditions.[184]

1. The **service contract** contemplates that the worker **personally performs** substantially all of the work.
2. The worker does not have a **substantial investment** in facilities, other than transportation facilities used in performing the work.
3. The worker has a **continuing work relationship** with the business for which the worker performs services.

Service contract means an oral or written arrangement exists under which the worker performs particular services. **Personally perform** means the worker does substantially all the work. Therefore, if the arrangement permits the worker to delegate as much of the work as they desire, then the worker is not a statutory employee.[185]

The regulations do not define **substantial investment.** All of the facts for each situation must be considered to determine whether the facilities furnished by the worker are a substantial investment. Factors that may be considered include the following.[186]

1. What is the value of the worker's investment compared to the total investment?
2. Are the facilities furnished by the worker essential to perform the work or are they for the personal convenience of the worker?
3. Are the facilities furnished by the company being purchased or leased at fair market value or fair rental value by the worker?
4. Are the facilities furnished by the worker considerably more extensive than those usually furnished by workers performing comparable services?

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182. IRC §3121(d); Rev. Rul. 90-93, 1990-2 CB 33.

183. IRS Pub. 15-A, *Employer's Supplemental Tax Guide.*

184. Ibid.

185. Treas. Reg. §31.3121(d)-1(d)(4).

186. Social Security Program Operations Manual System RS 02101.300.

Continuing work relationship means the relationship is continuous and not in the nature of a single transaction.[187]

FUTA tax applies to workers who are agent or commission drivers, and to full-time traveling or city salespersons.[188] Home workers and full-time life insurance salespersons are not subject to FUTA tax.

Agent or Commission Drivers

The statute[189] defines agent or commission drivers as workers who distribute meat or meat products, vegetable or vegetable products, fruit or fruit products, bakery products, beverages (other than milk), or laundry or dry-cleaning services for a business.

The agent or commission drivers may sell at retail or wholesale. They may operate from their own trucks or use trucks belonging to the business for which they work. The drivers may serve customers designated by the business as well as those they solicit independently. Their compensation may be based on commission, or the difference between the price charged to the customer and the price paid by the driver to the business for the product or service.[190]

> **Example 28.** Bart is engaged on a continuing basis in distributing meat products to retail stores for the Beef Packing Company (Beef). Bart is not a common-law employee of Beef. The contract with Beef specifies that Bart personally performs substantially all of the services. Bart has no investment in facilities other than a delivery truck. He is paid on a commission basis. Bart is considered a statutory employee of Beef. However, if Bart expands the distribution business, hires other workers, and no longer personally performs the deliveries, he will no longer be Beef's statutory employee and will be an independent contractor.

Full-Time Life Insurance Salespersons[191]

An individual whose principal business activity is selling life insurance and/or annuity contracts for one life insurance company is generally considered a full-time life insurance salesperson. An individual is not considered a full-time life insurance salesperson if they are engaged in the **general insurance business** under a contract(s) of service that does not state that selling life insurance for one life insurance company is the principal business activity. For example, if the salesperson devotes substantial effort to selling applications for insurance contracts, other than life insurance and annuity contracts (for example, health and accident, fire, automobile, etc.), they are not considered a full-time life insurance salesperson.

Generally, the employment contract reflects the intent of the worker and the business in determining whether the worker is a full-time or part-time salesperson. **The actual time devoted to the work is not determinative.**[192]

Home Workers

The category of **home workers** encompasses workers who perform a wide range of duties. Traditionally, this includes workers who make clothing, needlecraft products, or similar items.[193] It can also include workers who provide typing or transcription services at home. The worker completes the work away from the company's place of business and the work is usually accomplished in the worker's own home, the home of another individual, or a home workshop.[194]

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187. Treas. Reg. §31.3121(d)-1(d)(4).

188. IRS Pub. 15-A, *Employer's Supplemental Tax Guide.*

189. IRC §3121(d)(3)(A); Treas. Reg. §31.3121(d)-1(d)(3)(i).

190. Treas. Reg. §31.3121(d)-1(d)(3)(i).

191. Treas. Reg. §31.3121(d)-1(d)(3)(ii).

192. Social Security Program Operations Manual System RS 02101.355.

193. Rev. Rul. 64-280, 1964-2 CB 384; Rev. Rul. 72-88, 1972-1 CB 319; Rev. Rul. 74-62, 1974-1 CB 291; Ltr. Rul. 9511001 (Nov. 21, 1994).

194. Treas. Reg. §31.3121(d)-1(d)(3)(iii).

In addition to the three general requirements previously listed, the following requirements must be met.[195]

1. The work must be done in accordance with the specifications given by the business (generally simple and consisting of such things as patterns or samples).
2. The business must furnish the material or goods on which the work is done.
3. The worker must return the finished product to the business or to another designated person. It is immaterial whether the business picks up the work or the worker delivers it.

IRC §3121(a)(10) provides that the pay that the home worker receives for such work is not subject to FICA tax unless the worker receives $100 or more of cash during any calendar year from one business. A home worker may be employed by several businesses.

Traveling or City Salesperson

This category includes workers who perform their jobs away from the business premises. Their full-time business activity is selling merchandise for a business. The test for full-time status relates to an exclusive principal business activity for a single business and not to the time spent on a job. Sideline sales activities for other businesses do not exclude salespersons from this statutory category of employees.[196]

These workers must meet the following requirements to be considered a statutory employee.[197]

1. Work full-time for one person or company except, possibly, for sideline sales activities on behalf of some other person
2. Sell on behalf of, and turns their orders over to, the person or company for which they work
3. Sell to wholesalers, retailers, contractors, or operators of hotels, restaurants, or similar establishments
4. Sell merchandise for resale or supplies for use in the customer's business
5. Agree to do substantially all of this work personally
6. Have no substantial investment in the facilities used to do the work, other than in facilities for transportation
7. Maintain a continuing relationship with the person or company for which they work
8. Are not employees under common-law rules

Example 29. Jaime performs sales services for a home-design catalog company. Jaime solicits orders for the company's catalogs exclusively from lumber dealers, who purchase them either for resale or for free distribution to their customers. The lumber dealers are wholesalers or retailers. The catalogs for resale constitute **merchandise for resale** and those purchased for free distribution constitute **supplies for use in the purchaser's business operation.** Jaime meets the statutory test and is an employee of the home-design catalog company. If Jaime only sold advertising space in the catalogs, the catalog company would not consider her an employee.

Worker Taxation Issues

Being categorized as a statutory employee can have a large impact on the tax liability of the worker. A statutory employee can claim their business expenses on Schedule C rather than being required to report the expenses as a miscellaneous itemized deduction subject to the 2%-of-AGI limitation.[198]

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195. Ibid.

196. Treas. Reg. §31.3121(d)-1(d)(3)(iv).

197. IRS Pub. 15-A, *Employer's Supplemental Tax Guide.*

198. *Lickiss v. Comm'r,* TC Memo 1994-103 (Mar. 15, 1994).

STATUTORY NONEMPLOYEES

By statute, there are **three occupations** in which the worker is **specifically not treated as an employee** and is referred to as a statutory nonemployee.[199] Statutory nonemployees are not treated as employees for FICA, FUTA, and federal income tax withholding purposes, provided they meet certain qualifications. The three occupations that comprise statutory nonemployees are the following.

1. Qualified real estate agents
2. Direct sellers
3. Companion sitters

Qualified Real Estate Agents

IRC §3508 provides that qualified real estate agents are statutory nonemployees. These workers must meet the following requirements.

1. The worker is a licensed real estate agent.
2. Substantially all the worker's remuneration for services performed as a real estate agent directly relates to sales or other output rather than the number of hours worked.
3. A written contract exists between the worker and the business that specifies that the worker will not be treated as an employee for federal tax purposes.

Services that include management of property are not considered when determining whether the real estate agent is "qualified."[200] Services that include appraisal activities for real estate sales are included if the agent earns income based on sales or other output.[201]

Direct Sellers

IRC §3508 provides that direct sellers are statutory nonemployees. The following requirements must be met to classify a worker as a direct seller.

1. The worker is engaged in the sale of consumer products in the home or in a place other than a permanent retail establishment or in the trade or business of delivering or distributing newspapers.
2. Substantially all of the worker's remuneration for services performed is directly related to sales or other output rather than the number of hours worked.
3. A written contract exists between the worker and the business for which the worker performs services that provides that the worker will not be treated as an employee for federal tax purposes.

Companion Sitters

Companion sitters are individuals who provide personal attendance, companionship, or household care services to children or to individuals who are elderly or disabled. A companion sitting placement service is a person or entity that places sitters with interested individuals.[202] IRC §3506 provides that qualifying companion sitters are statutory nonemployees. These workers are not companion sitting placement service employees if the placement service neither pays nor receives the salary or wages of the sitter.

The companion sitter is considered self-employed unless they are a statutory or common-law employee of the individual or business for which they perform services.

199. IRS Pub. 15-A, *Employer's Supplemental Tax Guide.*

200. Prop. Treas. Reg. §31.3508-1(b)(2).

201. IRS Pub. 15-A, *Employer's Supplemental Tax Guide.*

202. Treas. Reg. §31.3506-1(a).

HOUSEHOLD EMPLOYEES

Employment of a household employee (or "domestic worker") results in some special tax issues. The threshold question regarding a domestic worker is whether the worker is an employee or an independent contractor (discussed earlier). If the worker is a household employee (HE), the taxpayer who hired the HE is the employer, and an employer-employee relationship is deemed to exist.

Tax practitioners advising taxpayers who employ HEs must be aware of the following items, which are discussed in this section.

- The preliminary steps required in connection with hiring an HE
- The tax withholding obligations of the employer
- The identity of the employer
- The exemptions for family members and minors

PRELIMINARY STEPS

The tax practitioner advising a taxpayer who intends to employ an HE needs to be aware of several preliminary requirements, which include citizenship documentation and obtaining an employer identification number (EIN).

U.S. Citizenship and Immigration Requirements

As with any U.S. employer, the employer of an HE must ensure that the HE is legally permitted to work in the United States under laws enforced by the U.S. Citizenship and Immigration Services (USCIS). This is accomplished by completing USCIS Form I-9, *Employment Eligibility Verification*. To complete the form, the employer must examine documents of the employee that constitute sufficient proof of the employee's ability to work lawfully in the United States.

> **Note.** USCIS Form I-9 outlines a list of documents that the employer may accept as sufficient proof of the employee's ability to work lawfully in the United States. This form may be found at **uofi.tax/17a2x1** [www.uscis.gov/i-9]. Form I-9 is not filed with the USCIS but must be retained by the employer for the later of three years after the hiring date or for one year after the termination of the employee's services.

There may be substantial civil penalties for failure to complete Form I-9 or for hiring an unauthorized alien. The penalties for failure to comply with employment verification requirements range from $216 for the first violation to $2,156 for repeated violations. The penalties for hiring unauthorized aliens range from $539 for the first offense to $21,563 for repeated violations.[203] The USCIS may also impose criminal penalties, which include fines and up to six months in prison per violation.[204]

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[203] *Penalties.* Jan. 18, 2017. U.S. Citizenship and Immigration Services. [www.uscis.gov/i-9-central/penalties] Accessed on Feb. 3, 2017.

[204] Ibid.

Application for Employer Identification Number

Employment of an HE requires the employer to obtain an EIN from the IRS.[205] The employer must have an EIN to use in connection with the tax withholding obligations associated with the compensation paid to the employee (discussed in the next section). Employers may use either of the following two methods to obtain an EIN.

- Complete and file Form SS-4, *Application for Employer Identification Number*
- Use the online EIN application system provided by the IRS through its website at **uofi.tax/17a2x2** [https://sa1.www4.irs.gov/modiein/individual/index.jsp]

TAX OBLIGATIONS OF THE EMPLOYER

If an employer pays an HE cash wages of $2,000 or more in 2017, they must generally withhold social security tax at the rate of 6.2% and Medicare taxes at 1.45% from those wages. Employers are not required to withhold federal income tax. Federal income tax should only be withheld if the HE requests the employer to withhold the tax and the employer agrees. Employers who pay an HE more than $200,000 in a calendar year must also withhold 0.9% additional Medicare tax.[206]

Instead of withholding the HE's share of the tax, the employer may instead choose to pay the HE's share of social security and Medicare taxes from the employer's own funds. If the employer chooses to pay the HE's share of the social security and Medicare taxes, the employer must "gross up" the HE's income by the amount of the taxes paid on their behalf. In this situation, the social security and Medicare taxes paid by the employer for the employee are included in the employee's wages for income tax purposes. However, they are not included in social security and Medicare wages. The employer reports the social security and Medicare taxes in boxes 4 and 6 of the employee's Form W-2. In addition, the taxes are added to the employee's wages reported in box 1 of the Form W-2.[207]

Example 30. Michelle broke her hip falling off a ladder. She hired Derek to assist her over her long recovery period. Derek needed all his salary in order to make ends meet, so Michelle agreed to pay his share of social security and Medicare taxes. Derek's wages and deductions are calculated as follows.

Wages	$20,000 [a]
Social security and Medicare (7.65%)	1,530
Wages reported in Box 1 of W-2	$21,530

[a] Reported in Box 3 and Box 5 of the W-2.

Derek's Form W-2 follows.

205. *Do You Need an EIN?* Jul. 14, 2016. IRS. [www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Do-You-Need-an-EIN] Accessed on Nov. 23, 2016.

206. IRS Pub. 926, *Household Employer's Tax Guide.*

207. Ibid.

For Example 30

	a Employee's social security number 111-22-3333	OMB No. 1545-0008	Safe, accurate, FAST! Use — IRS e-file — Visit the IRS website at www.irs.gov/efile
b Employer identification number (EIN) 11-9996633		1 Wages, tips, other compensation 21530.00	2 Federal income tax withheld
c Employer's name, address, and ZIP code Michelle Marq 123 Main Street Urbana, IL 61801		3 Social security wages 20000.00	4 Social security tax withheld 1240.00
		5 Medicare wages and tips 20000.00	6 Medicare tax withheld 290.00
		7 Social security tips	8 Allocated tips
d Control number		9	10 Dependent care benefits
e Employee's first name and initial: Derek — Last name: Douglas — Suff. 124 Main Street Urbana, IL 61801		11 Nonqualified plans	12a See instructions for box 12 Code
		13 Statutory employee ☐ Retirement plan ☐ Third-party sick pay ☐	12b Code
		14 Other	12c Code
f Employee's address and ZIP code			12d 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
IL	11-9996633	21530.00				

Form **W-2** Wage and Tax Statement 2016 — 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.

The employer may report the social security and Medicare taxes on Schedule H, *Household Employment Taxes.* Generally, the employer attaches this form to their Form 1040, and the liability for the social security and Medicare taxes is included on the Form 1040 and paid with the return. However, if the employer is not required to file a Form 1040, the employer may sign and file Schedule H separately with an accompanying payment.[208]

> **Note.** The appropriate address to send Schedule H separately (when it does not accompany the employer's Form 1040) depends on the employer's state of residence and is found in the Schedule H instructions. The address is generally different from the Form 1040 filing address.

Alternate Procedure

The employer of an HE may have a business through which they withhold social security and Medicare taxes in connection with compensation paid to the employees of the business. Instead of using Schedule H, the employer may choose to report the HE's withholding amounts along with those of the business employees if the business files one of the following forms.[209]

- Form 941, *Employer's Quarterly Federal Tax Return*
- Form 943, *Employer's Annual Federal Tax Return for Agricultural Employees*
- Form 944, *Employer's Annual Federal Tax Return*

> **Note.** This procedure does not make the expenses for the HE tax deductible.

208. Instructions for Schedule H.

209. Ibid.

Federal Unemployment Tax Obligation

The employer of an HE is liable for paying FUTA if they pay compensation of $1,000 or more in any calendar quarter to HEs.[210] The FUTA rate for 2017 is 6% and is payable only on the first $7,000 of wages the employer pays to the HE. However, an employer may take a credit of up to 5.4% if the employer also pays state unemployment taxes, resulting in a net FUTA rate of 0.6%.[211]

Example 31. Geraldo is 81 years old and resides in Illinois. He requires assistance with preparing meals and household chores because of his health issues. He hires Larissa to provide the necessary assistance in his home each day. He pays Larissa $2,500 per month during 2016. Larissa does not request that Geraldo withhold income tax. Because Gerald pays Larissa more than $2,000 during 2016, he must withhold and pay social security and Medicare tax in connection with Larissa's compensation. However, because Larissa did not request income tax withholding, Geraldo is not obligated to withhold any income tax from her compensation.

Geraldo's tax preparer Ramona prepares the following Form W-2 for Larissa and the Schedule H that is attached to Geraldo's 2016 tax return.

	a Employee's social security number: 945-45-4545	OMB No. 1545-0008	Safe, accurate, FAST! Use IRS e-file — Visit the IRS website at www.irs.gov/efile
b Employer identification number (EIN): 38-1234567		1 Wages, tips, other compensation: 30000.00	2 Federal income tax withheld:
c Employer's name, address, and ZIP code: Geraldo Lazzarro, 125 Maple Road, Chicago, IL 63303		3 Social security wages: 30000.00	4 Social security tax withheld: 1860.00
		5 Medicare wages and tips: 30000.00	6 Medicare tax withheld: 435.00
		7 Social security tips:	8 Allocated tips:
d Control number:		9:	10 Dependent care benefits:
e Employee's first name and initial: Larissa M. / Last name: Edwards / Suff.: 5656 West Boulevard, Chicago, IL 63303		11 Nonqualified plans:	12a See instructions for box 12 Code:
		13 Statutory employee ☐ Retirement plan ☐ Third-party sick pay ☐	12b Code:
		14 Other:	12c Code:
			12d Code:
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
IL	38-1234567	30000.00				

Form **W-2** Wage and Tax Statement 2016 — 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.

210. IRS Pub. 926, *Household Employer's Tax Guide.*

211. IRS Pub. 15, *(Circular E), Employer's Tax Guide.*

For Example 31

SCHEDULE H (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Household Employment Taxes

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

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

▶ **Information about Schedule H and its separate instructions is at *www.irs.gov/scheduleh.***

OMB No. 1545-1971

2016

Attachment Sequence No. **44**

Name of employer

Geraldo Lazzarro

Social security number
945-45-4545

Employer identification number
38-1234567

Calendar year taxpayers having no household employees in 2016 don't have to complete this form for 2016.

A Did you pay **any one** household employee cash wages of $2,000 or more in 2016? (If any household employee was your spouse, your child under age 21, your parent, or anyone under age 18, see the line A instructions 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 2016 for any household employee?

☐ **Yes.** Skip line C and go to line 7.
☐ **No.** Go to line C.

C Did you pay **total** cash wages of $1,000 or more in **any** calendar **quarter** of 2015 or 2016 to **all** household employees? (**Don't** count cash wages paid in 2015 or 2016 to your spouse, your child under age 21, or your parent.)

☐ **No. Stop.** Don't file this schedule.
☐ **Yes.** Skip lines 1–9 and go to line 10.

Part I Social Security, Medicare, and Federal Income Taxes

1	Total cash wages subject to social security tax	1	30,000	
2	Social security tax. Multiply line 1 by 12.4% (0.124)		2	3,720
3	Total cash wages subject to Medicare tax	3	30,000	
4	Medicare tax. Multiply line 3 by 2.9% (0.029)		4	870
5	Total cash wages subject to Additional Medicare Tax withholding	5		
6	Additional Medicare Tax withholding. Multiply line 5 by 0.9% (0.009)		6	
7	Federal income tax withheld, if any		7	
8	**Total social security, Medicare, and federal income taxes.** Add lines 2, 4, 6, and 7		8	4,590

9 Did you pay **total** cash wages of $1,000 or more in **any** calendar **quarter** of 2015 or 2016 to **all** household employees? (**Don't** count cash wages paid in 2015 or 2016 to your spouse, your child under age 21, or your parent.)

☐ **No. Stop.** Include the amount from line 8 above on Form 1040, line 60a. If you're not required to file Form 1040, see the line 9 instructions.

☒ **Yes.** Go to line 10.

For Privacy Act and Paperwork Reduction Act Notice, see the instructions. Cat. No. 12187K **Schedule H (Form 1040) 2016**

For Example 31

Schedule H (Form 1040) 2016 Page 2

Part II Federal Unemployment (FUTA) Tax

			Yes	No
10	Did you pay unemployment contributions to only one state? If you paid contributions to a credit reduction state, see instructions and check **"No."**	10	×	
11	Did you pay all state unemployment contributions for 2016 by April 18, 2017? Fiscal year filers see instructions	11	×	
12	Were all wages that are taxable for FUTA tax also taxable for your state's unemployment tax?	12	×	

Next: If you checked the **"Yes"** box on **all** the lines above, complete Section A.
If you checked the **"No"** box on **any** of the lines above, skip Section A and complete Section B.

Section A

13	Name of the state where you paid unemployment contributions ▶ IL			
14	Contributions paid to your state unemployment fund	14	697	
15	Total cash wages subject to FUTA tax	15	7,000	
16	**FUTA tax.** Multiply line 15 by 0.6% (0.006). Enter the result here, skip Section B, and go to line 25	16	42	

Section B

17 Complete all columns below that apply (if you need more space, see instructions):

(a) Name of state	(b) Taxable wages (as defined in state act)	(c) State experience rate period From	(c) To	(d) State experience rate	(e) Multiply col. (b) by 0.054	(f) Multiply col. (b) by col. (d)	(g) Subtract col. (f) from col. (e). If zero or less, enter -0-.	(h) Contributions paid to state unemployment fund

18	Totals	18		
19	Add columns (g) and (h) of line 18	19		
20	Total cash wages subject to FUTA tax (see the line 15 instructions)		20	
21	Multiply line 20 by 6.0% (0.060)		21	
22	Multiply line 20 by 5.4% (0.054)	22		
23	Enter the **smaller** of line 19 or line 22 (Employers in a credit reduction state must use the worksheet on page H-7 and check here) ☐		23	
24	**FUTA tax.** Subtract line 23 from line 21. Enter the result here and go to line 25		24	

Part III Total Household Employment Taxes

25	Enter the amount from line 8. If you checked the **"Yes"** box on line C of page 1, enter -0-	25	4,590	
26	Add line 16 (or line 24) and line 25	26	4,632	

27 Are you required to file Form 1040?

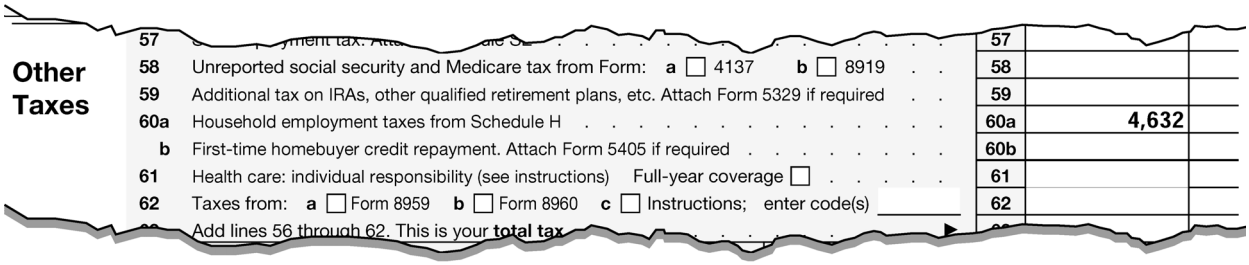
☒ **Yes. Stop.** Include the amount from line 26 above on Form 1040, line 60a. **Don't** complete Part IV below.

☐ **No.** You may have to complete Part IV. See instructions for details.

Address and Signature — Complete this part only if required. See the line 27 instructions

Note. The unemployment rules and contribution rates vary between the states, and the tax practitioner should consult these rules for the state in which the HE is employed. Some states are "credit reduction states," in which only a partial credit for state unemployment contributions is allowed against FUTA, resulting in an effective rate higher than 0.6%. For further details, see the instructions to Form 940.

After completing the Schedule H to accompany Geraldo's return, Ramona ensures that Geraldo's social security, Medicare, and FUTA tax liability of $4,632 is properly shown on Geraldo's Form 1040, as follows.



Other Taxes	57	[illegible]	57	
	58	Unreported social security and Medicare tax from Form: a ☐ 4137 b ☐ 8919	58	
	59	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	59	
	60a	Household employment taxes from Schedule H	60a	4,632
	b	First-time homebuyer credit repayment. Attach Form 5405 if required	60b	
	61	Health care: individual responsibility (see instructions) Full-year coverage ☐	61	
	62	Taxes from: a ☐ Form 8959 b ☐ Form 8960 c ☐ Instructions; enter code(s)	62	
		Add lines 56 through 62. This is your **total tax** ▶		

Note. The employer must also take into account any state income tax and unemployment tax obligations. For example, in Illinois, the employer must generally withhold state income tax in addition to federal income tax.[212] Employers may pay the tax with the Illinois state income tax return. Further details on the Illinois tax withholding and filing requirements can be found in Illinois Department of Revenue Pub. 121, *Illinois Income Tax Withholding for Household Employees.*

IDENTITY OF THE EMPLOYER

Generally, the employer is the person for whom the HE performs household services, regardless of the nature of the services provided.[213] Typically, the person who has the right of control over the HE under the right-of-control test (discussed earlier) is the employer, even if that person does not actually exercise control over the HE.[214] The right to discharge the HE is also an important factor in determining the identity of the employer.[215] However, if the person for whom the HE provides services does not control the payment of compensation to the HE, then the employer is the person who **does** control compensation.[216] When it is unclear who the employer is, an examination of the facts and circumstances may be necessary to determine the employer's identity.[217]

Observation. Particularly in family situations, it is essential for the tax practitioner to clearly identify who the employer is, because it is the employer who has reporting and withholding obligations for the HE's employment.[218] Issuing a hiring letter that makes the employer's identity clear and making compensation payments consistently from an appropriate account belonging to the employer helps eliminate issues that could arise because of a lack of clarity regarding the employer's identity.

Example 32. Use the same facts as **Example 31,** except Geraldo's daughter, Norina, pays Larissa from her own checking account. Norina stops by Geraldo's house each month to meet with her father and Larissa and to give Larissa her monthly paycheck. Even if Geraldo supervises Larissa and instructs her daily on how to complete the household chores, Norina is the employer because she controls the payment of compensation to Larissa. Norina, as the employer, is the person with the tax withholding and reporting obligations. Accordingly, a Schedule H must accompany Norina's tax return.

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212. *Withholding Income Tax for Household Employees.* Illinois Department of Revenue. [tax.illinois.gov/Individuals/SpecialFilingRequirements/householdemployer.htm] Accessed on Nov. 28, 2016.

213. IRC §3401(d).

214. Treas. Reg. §31.3401(c)-1(b).

215. Ibid.

216. IRC §3401(d)(1); and Treas. Reg. §31.3401(d)-1(f).

217. Treas. Reg. §31.3401(c)-1(d).

218. Treas. Reg. §31.3401(d)-1(h).

Example 33. Use the same facts as **Example 32,** except Norina pays Larissa by issuing a check from Geraldo's account. She can sign the checks because she has Geraldo's power of attorney. However, Geraldo could sign checks himself if necessary. It is likely that Geraldo will be considered the employer because he not only has the right of control over Larissa's employment duties, but he also has the legal authority to pay her. Accordingly, as the employer, Geraldo has the reporting and tax obligations associated with Larissa's employment.

EXEMPTIONS FOR FAMILY MEMBERS AND MINORS

Most types of employment are subject to social security and Medicare taxation, and the employer is obligated to withhold and pay these amounts based on the employee's compensation.[219] However, there is an exception for any HE who is the employer's:[220]

- Spouse,
- Child under the age of 21,
- Parent, or
- Employee who was under the age of 18 at any time during the year.

However, a parent's wages are subject to social security and Medicare taxation if both of the following conditions apply.[221]

- The son or daughter employing the parent has a child living in the home who is under age 18 or had a mental or physical condition that required the personal care or the supervision of an adult for at least four continuous weeks during the calendar quarter in which the parent provides employment services.
- The son or daughter employing the parent is a widow or widower, or is divorced and has not remarried, or has a mentally or physically impaired spouse living in the home who is incapable of caring for the child living in the home during a continuous 4-week period during the calendar quarter.

In addition, if the employer's HE is related to that employer in one of the following ways, the HE's compensation is exempt from FUTA taxation.[222]

- Spouse
- Parent
- Child under the age of 21

Amounts subject to the preceding exceptions are not included in the sections of Schedule H relating to social security and Medicare taxes or FUTA tax.

> **Note.** Although the preceding federal exceptions are available for employees who are family members and minors, the tax practitioner must consult state rules to determine whether any exemptions exist for state tax withholding or state unemployment contributions. Federal and state rules frequently differ in this area, and the rules vary from state to state.

219. IRC §3121.

220. IRC §3121(b)(3).

221. IRC §3121(b)(3)(B); Instructions for Schedule H.

222. IRC §3306(c)(5).

EMPLOYER RESPONSIBILITIES ASSOCIATED WITH FOREIGN WORKERS

The Immigration Reform and Control Act of 1986 (IRCA)[223] makes the employer a front-line enforcement agent with respect to certain immigration laws. The IRCA imposes specific duties on employers who hire new workers.

VERIFICATION OF IDENTITY AND ELIGIBILITY[224]

Under the IRCA, employers and employment agencies are required to verify the identity and employment eligibility of anyone hired. To accomplish this, the employer is required to complete Form I-9 (discussed previously) for every employee. Form I-9 requires the employer to attest that it examined documents from the employee to verify identity and employment eligibility. The employer must keep the Form I-9 on file for the longer of three years after the date of hire or one year after the employee's employment ends.

ANTIDISCRIMINATION PROVISIONS[225]

The Immigration and Nationality Act has specific antidiscrimination provisions that employers must adhere to in the process of verifying employee identity and eligibility. Employers with four or more employees cannot make adverse employment decisions based upon real or perceived citizenship or immigration status. Employers with four or more employees also cannot engage in document discrimination. Document discrimination occurs when the employer requests that the applicant produce a specific document or documents other than those required by law. Rejecting documents that appear genuine on their face also constitutes document discrimination. IRCA contains a prohibition against national origin discrimination for employers with four to 14 employees.

ENFORCEMENT AND PENALTIES[226]

There are civil penalties for failure to comply with employee verification requirements or for knowingly hiring or continuing to employ ineligible workers. For knowingly hiring or continuing to employ an undocumented worker, the penalties for **each** undocumented worker are:[227]

- $539 to $4,313 for a first offense,
- $4,313 to $10,781 for a second offense, and
- $6,469 to $21,563 for subsequent offenses.

These penalties also apply for violation of certain antidiscrimination provisions of the Immigration and Nationality Act. Criminal penalties and/or prison terms may also apply.

Additionally, employers must be aware of any state laws in connection with hiring undocumented workers. The Supreme Court recently held that the State of Arizona can sanction businesses that hire undocumented workers.[228] Federal regulation does not preempt state regulation in this area.

> **Note.** Laws in this area are currently receiving increased enforcement efforts. Employers should observe their obligations very closely and document their compliance.

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223. The Immigration Reform and Control Act of 1986 is codified at 8 USC §1324a.

224. *Handbook for Employers.* U.S. Citizenship and Immigration Services. [www.uscis.gov/sites/default/files/files/form/m-274.pdf] Accessed on Jan. 22, 2017.

225. Ibid.

226. Ibid.

227. *Penalties.* Jan. 18, 2017. U.S. Citizenship and Immigration Services. [www.uscis.gov/i-9-central/penalties] Accessed on Mar. 9, 2017.

228. *Chamber of Commerce v. Whiting,* 563 U.S. 582 (2011).