Taxable and Nontaxable Compensation

Section 3 – Part 2

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Introduction

Welcome to Section 3 of the CPP study group. Section 3 – Taxable and Nontaxable Compensation - covers content that is at the heart of payroll and consequently covers the biggest consolidated content for the CPP exam. Section 3 will build the foundation for future chapters when you will be calculating tax withholdings and net pay.

Throughout this document you'll be given highlighted content to supplement *The Payroll Source*. While this content will not cover everything you need for the exam, it is a good tool to help facilitate studying. Different icons will point out special items

 Example

 Form to know

 Legislation to know

 Number to know

 Test your knowledge

Topics from Content Outline

Principles of Paycheck Calculations

Compensation/Benefits

Knowledge, Skills and Abilities

Employee Benefits

- Knowledge of impact of taxable benefits
- Knowledge of impact of non-taxable benefits
- Knowledge of a qualified plan (i.e. retirement plans, sec. 125, awards, moving)
- Knowledge of a non-qualified plan (i.e. retirement plans, sec. 125, awards, moving)
- Knowledge of imputing fringe benefits

Regulatory

- Knowledge of IRS regulations impacting payroll
- Knowledge of IRS sec 129 (components of exclusion and limitations)
- Knowledge of IRS sec 132 (components of exclusion from income)
- Knowledge of accountable and non-accountable plans (e.g. business expense)
- Knowledge of federal tax requirements for stock awards and purchases
- Knowledge of taxation of wages paid to deceased employees
- Knowledge of taxationof imputed income (e.g. GTL, moving expense, etc.)
- Knowledge of allocated tips
- Knowledge of adoption assistance
- Knowledge of repayment of employer provided loans
- Knowledge of supplemental wages

Reporting

- Knowledge of Form 4070 requirements

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Knowledge of Form 8027 requirements

Knowledge of employee tip reporting

Compensation/Benefits

Ability to calculate gross pay

Ability to calculate gross pay for tipped employees

Knowledge of impact of stock awards

Knowledge of impact of stock purchases

Knowledge of special accounting rule

Knowledge of federal standard mileage rates

Knowledge of educational assistance income inclusion

Knowledge of educational assistance income exclusion

Knowledge of awards and prizes income inclusion

Knowledge of awards and prizes income exclusion

Knowledge of transit/parking/commuting taxation/limits

Ability to calculate employer paid taxes (gross-up)

Ability to calculate imputed income (e.g. GTL, personal use of company car, mileage)

Knowledge of taxable income (e.g., fringe benefits, personal use of company car, mileage, relocation, awards and prizes)

Knowledge of non-taxable income (e.g., fringe benefits, personal use of company car, mileage, relocation, awards and prizes)

Ability to calculate federal taxable wages (fit, social security, Medicare)

Ability to calculate supplemental income

Ability to calculate hours worked (e.g. regular, overtime)

Net, Disposable, Take Home Pay

Ability to calculate net pay

Ability to calculate disposable earnings

Ability to calculate take home pay

Ability to calculate total payroll (gross pay, voluntary/involuntary deductions, employer cost)

Part 2: Other Fringe Benefits under the IRC

Educational Assistance

Job related education – Excludable if:

- Excludable as a working condition fringe benefit
- Truly "job related"
- Not qualifying the ee for a promotion
- Not required to meet the job's minimum requirements
- Generally graduate level not excludable

Non Job Related Education



IRC Section 127

- Excluded from taxable wages if:
  - Non discriminatory
  - No more than $5,250.00/year

- Provided via an Educational Assistance Program

- American Taxpayer Relief Act of 2012
  - Permanently extended this income exclusion
  - Graduate level classes also excluded

Business Expenses

- Exempt from reporting/withholding if:
  - Accountable plan
  - Temporary
    - Less than 1 year
  - Substantiated
  - Excess returned
- Business Travel
  - Exempt from reporting/withholding if:
  - Away from home or
  - Temporary &
  - Business need &
  - Employee could deduct as business under IRC 162

Exempt if reimbursed via an accountable Plan

- Accountable Plan
  - Business connection
  - Substantiation
    - With receipts for items >$75
    - Electronic/web based plans ok
  - Excess amounts returned to employer
  - All criteria must be met or plan is not accountable and all reimbursements are taxable
  - Taxable if reimbursed via a nonaccountable plan or if excess is not returned

- Frequent Flyer Miles (received from business travel)
  - 2002 IRS noted:
    - Will not assert FFM as taxable income
    - Does not apply to other incentive/promotional programs converted to cash
    - Or compensation paid in the form of travel

- Per Diem Allowance
  - Substantiation not required if
  - Employee records time, place and business purpose of expense
  - No more than IRS federal Per Diem amounts for area of travel
  - IRS Pub 1542: Per Diem Rates

Business use of a personal car

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- Can reimburse up to $0.575 cents per mile for 2015
  - Must be substantiated
  - Cash car allowance without substantiation is fully taxable

Business Meals

Generally *not* taxable if

- Provided during working hours for convenience
- Di Minimis (doughnuts/coffee, etc.)
- Occasional
- For business reasons

Can be taxable if

- Reimbursed during relocation
- Provided in cash

Other Payments

Adoption Assistance

- Excluded from federal taxable wages
  - IRC 137
  - up to $13,400.00 (2015)
    - Over all years related to the adoption
    - Not subject to Federal income tax withholding
      - even amts in excess of limit
    - Is subject to Social Security/Medicare/FUTA
- W-2 Box 12, code "T"
  - Report total reimbursed, even amts in excess of limit
  - Employee must complete form 8839, Qualified Adoption Expenses & file with personal tax return
    - Determines taxable vs non taxable amounts to employee

Advances & Overpayments

- Taxable wages & subject to all withholding *when paid*
  - Adjust current year wages/tax withholding if repaid in same year
- If repaid in *subsequent* year
  - Fed taxable wages (W2c box 1 and 2) *not* reduced if repaid in subsequent year
    - EE may file for deduction/credit on personal tax return
  - W2c Social Security & Medicare wages adjusted/tax refunded; regardless of when repaid

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Non-cash Achievement Awards

Exempt from tax/reporting if for safety or length of service

- Length of service must be at least 5 years
- Tangible personal property
- Meaningful presentation
  - 💰 Max of $1,600.00 under qualified plan
  - 💰 Max of $400.00 absent of a qualified plan
- Never cash or cash equiv

Back Pay

- Awarded as result of litigation
- Generally subject to Fed/FICA & W-2 tax reporting/withholding when paid
  - Many court cases & some exceptions
    - Punitive damages reported on 1099, box 3
- Back pay under a statute requires separate Social Security notification for credit to SSA wages for year earned

Bonuses/Commissions

- Fully taxable/reportable
- Fed & FICA
  - Medicare withholding increases to 2.35% (1.45% + 0.9%) for wages exceeding $200,000 YTD
- Supplemental withholding rates apply
- Supplemental wages over $1 million
  - 39.6% withholding rate

Commission Exceptions

- Noncash incentives to retail sales employees paid solely on commission and
- Commissions to life insurance sales people
  - W2 reportable Box 1, 3 & 5
  - Subject to FICA withholding

Not subject to Federal income tax *withholding*

Dependent Care Assistance

💰 Up to $5,000.00 excluded from

- Federal
- FICA & FUTA
- Total Amount valued W-2, Box 10
  - Include all, even amounts over $5000
    - Flex spending dependent care
    - Back up dependent care
- Excess above $5,000.00 – fully taxable

Disaster Relief Payments -

IRC Section 139

- Victims of Terrorism Tax Relief Act
- Publication 3920, Tax Relief for Victims of Terrorist Attacks
- Qualified disaster payments received are not includable in taxable wages
- Qualified disaster payments are made for:
  - Personal, family, living or funeral expenses
  - Repairs for rehabilitation of personal residence and contents

Gross-up – Employer-paid taxes

Gross up = Employer paid taxes

Employer-paid taxes are also taxable

Gross = net/(100% - total tax %)

📖 Gen R. Ous Corp promised Sally Jones a $2,000.00 bonus and agreed to pay for all withholding taxes. Sally has YTD wages of $55,000.00 and works in TX where there is no state income tax. Using the federal supplemental withholding rate, what will be the gross amount of her net $2,000.00 payment?

25% Fed
6.2% SS
1.45% Medicare
32.65% Total Withholding Tax
100% - 32.65% = 67.35%
Gross = $2,000.00/67.35% = $2969.56

Proof:

Gross		$2,969.56
FITW	25%	($742.39)
SS	6.2%	($184.11)
Med	1.45%	($43.06)
Net		$2,000.00

Gross Up Considering Social Security Max

Special considerations if employee has reached social security base for the year or if the amount to be grossed up will take the employee above social security wage base

- If the employee has reached the social security wage base, omit the social security tax rate from the formula
- If the amount of the gross up will take the employee above the social security wage base, omit the social security tax rate from the formula; the amount to be grossed up and the remaining social security tax needs to be divided by the tax rate factor

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Gross = (net + *SS w/h to max*) *divided by* {100% - total tax % (*excluding SS%*)}

📖 Bob Vagabond's employer agrees to pay the taxes associated with a $6,000 cash/non substantiated relocation bonus. The payment is subject to 3.5% state tax and Bob's YTD Social Security taxable wages are $116,239.00. How much will be added to Bob's W-2 as federal taxable wages for this payment?

Step 1

$ 118,500. 2015 Social Security Max
$ 116,239. YTD Social Security Wages
$ 2,261 Wages to reach max
$2,261 x 6.2% = $ 140.18 SS w/h to max

Step 2

25.00% Fed
00.00% Social Security (will add flat $ later)
1.45% Medicare
3.50% State
29.95% Total Withholding Tax

Step 3

Gross = ($6,000 + $140.18)/(100% - 29.95%)
Gross = $6,140.18/70.05%
Gross = $8,765.42

Proof

Gross		$8,765.42
FITW	25%	(2,191.36)
SS	to max	(140.18)
Med	1.45%	(127.10)
State	3.5%	(306.79)
Net		$6,000.00

Other Gross Up Calcs:

- See Source examples beginning 3-78:
  - Medicare
    - When YTD wages exceed $200,000
      - Additional 0.9%
  - Federal Income Tax
    - When YTD supplemental wages exceed $1,000,000
      - 39.6%
  - If 401k deferrals are to be applied

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Equipment Allowance

- For use of employee's own tools/equipment can be exempt
  - Allowance must be kept separate from wages
  - Substantiation needed to connect the allowance to the work performed
  - Allowance cannot reduce regular wages
  - Amounts should not be standard across all employees, but related to individual use

Golden Parachute

- Paid to an executive after a change in ownership or control
- At least 3 times the employee's average wage during the most resent five years
- Fully taxable
- Subject to withholding

Excess Parachute

- Portion of Golden Parachute which exceeds 5 year average annual compensation
- Subject to extra 20% excise tax withholding
- Excise tax withheld reported on W-2 box 12, code "K"

Leave Sharing Plans

- Not wages to the "donor" of the leave time
- Taxable wages/withholding to recipient when used/paid
- Value of leave surrendered to a charity as a donation, generally taxable to donor, unless IRS notes exceptions as with
  - Hurricane Katrina
  - Hurricane Sandy
  - 2014 Ebola victims

Loans to employees

If loan is below federal market interest rates and if combined loan balances >$10,000.00, the difference between interest charged & federal rate is reportable on W-2

- Subject to Social Security
- Subject to Medicare

If the loan is forgiven, it is subject to all statutory tax reporting and withholding in year forgiven for federal, social security, and Medicare.

Advances/Draws against Commission

- Generally fully reportable/taxable *unless*
- Meets qualifications of loan *and*
- Employee signs agreement to repay

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Differential Military Pay

 Heroes Earnings Assistance and Relief Tax Act

- Differential wage payments
  - All or portion of pay to employee while on military duty
  - Are supplemental wages for FITW (W-2, Box 1 & 2)
    - If *temp* assignment wages are subject to FICA / FUTA
      - i.e. National Guard or Reserves
    - Active service or indefinite assignments are not FICA taxable

Severance

- Subject to all statutory reporting/tax withholding
- Taxable when paid
- Supplemental Wages

Company Stock

Stock given to employees as compensation

- Fully taxable when transferred to employee without restriction (i.e. vesting)
- Subject to all statutory tax withholding

Stock Options

- Option to purchase stock at a fixed price for length of time
  - Incentive Stock Option
  - Nonqualified (non statutory) Stock Option
  - Employee Stock Purchase Plan

Incentive Stock Options

- Favorable tax treatment if restrictions are met (Source pg 3-90)
  - If stock "held" until 2 years after grant and 1 year after exercise => capital gain, not W2
  - If stock sold prior to above =>disqualifying disposition
- When stock is sold information statement to employee is required

Employee Stock Purchase Plans

- Opportunity to purchase stock at a discount
- Maximum discount is 15%
- Same "holding" rules as Incentive Stock Options
- When stock is sold information statement to employee is required

Disqualifying Disposition

- If ISO or discounted ESPP stock is sold within 2 years of grant or within 1 year of exercise = "disqualifying disposition"
- Difference between value & purchase price is then income
- Reportable for federal only, but not subject to withholding

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Non-qualified stock option exercises

- Value - Purchase Price = Taxable Value
- Fully reportable/withholding
- W-2 box 12, code "V"

NQ Stock Options & Divorce

- Options transferred to non employee spouse; when exercised:
  - Social Security, Medicare and FUTA reportable to employee (W-2)
  - Federal taxable *and* subject to withholding for non employee ex spouse (1099, box 3)
    - Fed taxable 1099 box 3
    - FITW (use supplemental rates) 1099, box 4
      - And form 945

Supplemental Unemployment Benefits

- Paid in addition to state unemployment benefits for laid off workers
- Subject to FITW
- Excluded from Social Security/Medicare only if certain criteria met
- 2014 IRS confirmed Severance is not SUB pay & therefore is FICA taxable

Employee Tips

- Employee must report to employer tips >$20 per month
  - Form 4070 (Employee Report of Tips to Employer) or employer's own form
    - Due by 10th of month following month in which tips were received
    - Electronic tip reporting – okay
    - is subject to all statutory tax withholding
  - Tips less than $20/mo are still taxable income to employee
    - Employee must report on personal tax return

Wages after death

- In same year as death
  - W-2 Social Security and Medicare only
  - *and* 1099, box 3 to beneficiary
- In years after death
  - Only 1099, box 3 to beneficiary
  - no withholding

An employee of GEM Corporation dies on December 1, 2015. The employee is due wages of $400 for the last days worked. This payment is processed for pay date December 21, 2015. What amount of tax withholding, if any, should be withheld from the pay check?

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Federal	$0
Soc Sec at 6.2%	$24.80
Medicare at 1.45%	$5.80

The $400 Should be reported
On the employee's (estate of) W2, boxes 3 & 5
In box 3 of form 1099-MISC issued to the beneficiary

📖 In January 2016, Payroll is advised that the same deceased employee is owed $500 for unused vacation. What tax should be withheld? How should the payment be reported?

Since the payment will be made in the year after death, the $500 payment is only reported on the 1099 MISC to the beneficiary, not at all on a W-2. No income tax is withheld

Reporting & Withholding Taxes on Taxable *Non Cash* Benefits

- I.e. Personal Auto Use, Value of Trips Awarded, etc.
- Must be reported at least annually
- Withholding
  - Add to regular wages & tax entire amount over regular pay frequency *or*
  - Withhold at supplemental wage rates
    - Federal: 25% (or 39.6% as ap)

Special accounting rule

- Allowed for non cash fringe benefits
- November & December values reported in subsequent year
- 2015 Reporting period
  - November 1, 2014 - October 30, 2015
- Not for use with GTL, moving expenses or property, i.e. stock

Exception for Personal Auto Use

- Employer may choose not to withhold federal income tax on personal auto use
- Must advise employee in writing
  - By Jan 31 or
  - Within 30 days of receipt of vehicle
- Box 1 reporting and FICA reporting/withholding still required

Validate Your Progress

Employee Benefits

- ☐ Knowledge of impact of taxable benefits
- ☐ Knowledge of impact of non-taxable benefits
- ☐ Knowledge of a qualified plan (i.e. retirement plans, sec. 125, awards, moving)

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- ☐ Knowledge of a non-qualified plan (i.e. retirement plans, sec. 125, awards, moving)
- ☐ Knowledge of imputing fringe benefits

Regulatory

- ☐ Knowledge of IRS regulations impacting payroll
- ☐ Knowledge of IRS sec 129 (components of exclusion and limitations)
- ☐ Knowledge of IRS sec 132 (components of exclusion from income)
  Knowledge of accountable and non-accountable plans (e.g. business expense)
- ☐ Knowledge of federal tax requirements for stock awards and purchases
- ☐ Knowledge of taxation of wages paid to deceased employees
- ☐ Knowledge of taxation of imputed income (e.g. GTL, moving expense, etc.)
- ☐ Knowledge of allocated tips
- ☐ Knowledge of adoption assistance
- ☐ Knowledge of repayment of employer provided loans
- ☐ Knowledge of supplemental wages

Reporting

- ☐ Knowledge of Form 4070 requirements
- ☐ Knowledge of Form 8027 requirements
- ☐ Knowledge of employee tip reporting

Compensation/Benefits

- ☐ Ability to calculate gross pay
- ☐ Ability to calculate gross pay for tipped employees
- ☐ Knowledge of impact of stock awards
- ☐ Knowledge of impact of stock purchases
- ☐ Knowledge of special accounting rule
- ☐ Knowledge of federal standard mileage rates
- ☐ Knowledge of educational assistance income inclusion
- ☐ Knowledge of educational assistance income exclusion
- ☐ Knowledge of awards and prizes income inclusion
- ☐ Knowledge of awards and prizes income exclusion
- ☐ Knowledge of transit/parking/commuting taxation/limits
- ☐ Ability to calculate employer paid taxes (gross-up)
- ☐ Ability to calculate imputed income (e.g. GTL, personal use of company car, mileage)
- ☐ Knowledge of taxable income (e.g., fringe benefits, personal use of company car, mileage, relocation, awards and prizes)
- ☐ Knowledge of non-taxable income (e.g., fringe benefits, personal use of company car, mileage, relocation, awards and prizes)
- ☐ Ability to calculate federal taxable wages (fit, social security, Medicare)
- ☐ Ability to calculate supplemental income
- ☐ Ability to calculate hours worked (e.g. regular, overtime)

Net, Disposable, Take Home Pay

- ☐ Ability to calculate net pay
- ☐ Ability to calculate disposable earnings
- ☐ Ability to calculate take home pay
- ☐ Ability to calculate total payroll (gross pay, voluntary/involuntary deductions, employer cost)

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