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# Employment Taxes

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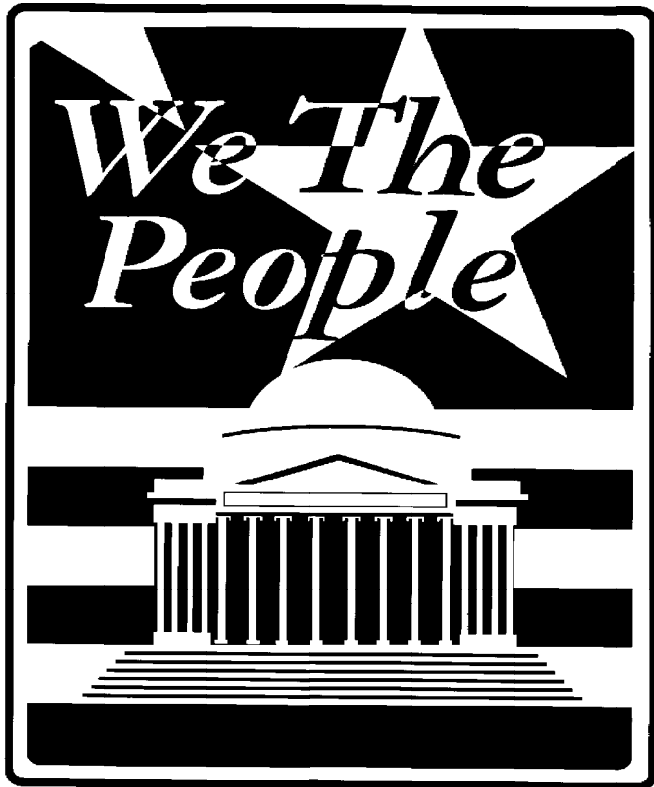
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## Important Changes for 1994

**Tax rates and maximum wages.** The social security tax and Medicare tax rates remain the same for 1994 and 1995. The social security tax is 6.2% for both the employer and the employee (12.4% total). The Medicare tax is 1.45% for both the employer and the employee (2.9% total). The wage base for social security for 1994 is \$60,600. For 1995, the wage base for social security is \$61,200. For 1994 and 1995, there is no wage base limitation for Medicare tax; all covered wages are subject to Medicare tax.

**Household employees.** Beginning in 1994, social security and Medicare taxes apply to household employees with wages from household employment of \$1,000 or more per year. Do not use Form 942, *Employer's Quarterly Tax Return for Household Employers*, for wages paid after 1994. Beginning in 1995, employers who have only household employees will report annually on their individual income tax returns. See Publication 926, *Employment Taxes for Household Employers*, for more information.

**Federal unemployment (FUTA) tax rate.** The gross FUTA rate remains 6.2% through 1995.



**Electronic deposit of taxes.** Generally, taxpayers whose total deposits of withheld income, social security, and Medicare taxes during calendar year 1993 exceeded \$78 million are required to deposit these taxes through an electronic funds transfer (EFT) system, called TAXLINK, beginning in 1995.

Employers not required to make deposits by EFT may enroll in the system, which will allow tax deposits without coupons, paper checks, or visits to an authorized depository. For more information, call 1-800-829-5469, or write to:

Internal Revenue Service  
Cash Management Site Office  
Atlanta Service Center  
P.O. Box 47669, Stop 295  
Doraville, GA 30362

## Important Reminders

**Educational assistance plans.** The exclusion from social security, Medicare, federal unemployment taxes, and income tax withholding for qualified educational assistance plans has been extended through December 31, 1994. The extension is retroactive to June 30, 1992. See *Withholding and Reporting Payments Other Than Wages* under *Income Tax Withholding*.

**New Form 945.** Beginning in 1994, nonpayroll withholding, such as backup withholding and withholding on pensions, annuities, and gambling winnings, is no longer reported on Form 941. It is reported separately on Form 945, *Annual Return of Withheld Income Tax*. Separate deposits are also required. See Circular E for more information.

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## Introduction

This publication is mainly intended for small businesses. This includes self-employed persons such as sole proprietors, independent contractors, and members of a partnership.

**Ordering publications and forms.** To order free publications and forms, call our toll-free telephone number 1-800-TAX-FORM (1-800-829-3676). You may also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address.

**Telephone help.** You can call the IRS with your tax question Monday through Friday during regular business hours. Check your telephone book for the local number or you can call toll-free 1-800-829-1040.

**Telephone help for hearing-impaired persons.** If you have access to TDD equipment, you can call 1-800-829-4059 with your tax question or to order forms and publications. See your tax package for the hours of operation.

## Useful Items

You may want to see:

### Publication

- 15** Circular E, Employer's Tax Guide
- 51** Circular A, Agricultural Employer's Tax Guide
- 535** Business Expenses
- 583** Taxpayers Starting a Business
- 1635** Understanding Your EIN

### Form (and Instructions)

- W-2** Wage and Tax Statement
- W-4** Employee's Withholding Allowance Certificate
- 940 (or 940-EZ)** Employer's Annual Federal Unemployment (FUTA) Tax Return
- 941** Employer's Quarterly Federal Tax Return
- 943** Agricultural Employer's Annual Federal Tax Return
- 945** Annual Return of Withheld Income Tax
- 1099-MISC** Miscellaneous Income

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## Employment Taxes

If you have any employees, you generally are required to withhold federal income tax from their wages. You may also have to withhold and pay social security and Medicare taxes. You are subject to penalties if you fail to comply with these laws. If you do not withhold these taxes, or withhold the taxes but do not deposit them, you may be subject to a penalty equal to the amount of the tax. See *Penalties* under *Deposits*, later.

This publication discusses an employer's responsibility for these taxes. It also discusses income tax withholding on payments other than wages, the federal unemployment (FUTA) tax, the rules for advance payment of the earned income credit, and the rules for tip reporting and allocation. Information useful for 1995 is also included.

If you need information on railroad taxes, see the instructions for Form CT-1, *Employer's Annual Railroad Retirement Tax Return*, and Form CT-2, *Employee Representative's Quarterly Railroad Tax Return*. Railroad retirement and railroad unemployment repayment taxes are explained in the *Instructions for Form CT-1*.

**Note:** After your employees file their 1994 income tax returns, you can help them correct any mistakes they may have made in figuring their income tax withholding for 1995 by making new 1995 Forms W-4 available. You should encourage them to check their income tax withholding situation if they owed a large amount of tax or received a large refund for 1994, and to give you a new Form W-4 for 1995 if necessary. An employee is more likely

to have too little tax withheld if both the employee and his or her spouse work. See *Form W-4 Withholding Allowances*, under *Income Tax Withholding*, later.

After you receive completed Forms W-4 from your employees, you can help them determine whether they will have the right amount of income tax withheld in 1995 by giving them Publication 919, *Is My Withholding Correct for 1995?* This publication will help your employees compare the amount of tax they expect to show on their 1995 tax returns with the amount of tax to be withheld from their pay during 1995.

**Employee's social security number.** If one of your employees does not have a social security number and has not applied for one, you should tell the employee to submit an application on Form SS-5, *Application for a Social Security Card*, to the nearest Social Security office. Form SS-5 can be obtained from any Social Security office or by calling 1-800-772-1213.

The employee without a social security number must furnish evidence of age, identity, and U.S. citizenship along with the Form SS-5. An employee who is 18 years old or older must appear in person with this evidence at a Social Security office.

Also, if an employee has changed his or her name, he or she should ask the Social Security Administration (SSA) for a corrected social security card.

**New employees.** You must ask each new employee to complete the employee part of Immigration and Naturalization Service (INS) Form I-9, *Employment Eligibility Verification*. You must then complete the employer part of the form to verify the employee's identity and eligibility to work. You can get M-274, *Handbook for Employers*, which contains Forms I-9 and instructions, from INS regional and district offices.

**Employer identification number.** If you do not have an employer identification number (EIN), you must get one. To request an EIN, file Form SS-4, *Application for Employer Identification Number*, with the IRS Service Center for your area listed in the *Instructions for Form SS-4*. If you prefer, you can ask for an EIN immediately by calling the tele-TIN phone number for your state's IRS Service Center listed in the *Instructions for Form SS-4*. You can request Form SS-4 and the *Instructions for Form SS-4* at IRS or SSA offices.

## Who Are Employees?

Before you can know how to treat payments you make for services rendered to you, you must first know the business relationship that exists between you and the person performing those services. The person performing the services may be:

- 1) An independent contractor;
- 2) A common-law employee;
- 3) A statutory employee; or
- 4) A statutory nonemployee.

This discussion explains these four categories. A later discussion, *Employee or Independent Contractor?*, points out the differences between an independent contractor and an employee and gives examples from various types of occupations. If an individual who works for you is not an employee under the common-law rules (see *Employee or Independent Contractor?*, later), you generally do not have to withhold federal income tax from that individual's pay. However, in some cases you may be required to backup withhold on these payments. See *Backup Withholding*, later.

## Independent Contractors

People such as lawyers, contractors, subcontractors, public stenographers, auctioneers, etc., who follow an independent trade, business, or profession in which they offer their services to the general public are generally not employees. However, whether such people are employees or independent contractors depends on the facts in each case. The general rule is that an individual is an independent contractor if you, the payer, have the right to control or direct only the result of the work and not the means and methods of accomplishing the result.

## Common-Law Employees

Under common-law rules, every individual who performs services subject to the will and control of a payer, as to both **what** must be done and **how** it must be done, is an employee. It does not matter that the employer allows the employee discretion and freedom of action, as long as the employer has the **legal right** to control both the method and the result of the services. For a discussion of the factors that indicate whether sufficient control is present to establish an employer-employee relationship, see *Employee or Independent Contractor?*, later.

Two usual characteristics of an employer-employee relationship are that the employer has the right to discharge the employee and the employer supplies the employee with tools and a place to work.

If you have an employer-employee relationship, it makes no difference how it is described. It does not matter if the employee is called an employee, partner, co-adventurer, agent, or independent contractor. It does not matter how the payments are measured, how they are made, or what they are called. Nor does it matter whether the individual is employed full time or part time.

For employment tax purposes, no distinction is made between classes of employees. Superintendents, managers, and other supervisory personnel are all employees. An **officer of a corporation** is generally an employee, but a director is not. An officer who performs no services or only minor services, and neither receives nor is entitled to receive any pay, is not considered an employee.

You generally have to withhold and pay income, social security, and Medicare taxes on wages you pay to common-law employees. However, the wages of certain employees may be exempt from one or more of these

taxes. See *Family Members, Employees of Exempt Organizations, and Religious Exemptions*, later.

## Statutory Employees

The following four categories of workers are called statutory employees:

- 1) A driver who distributes meat products, vegetable products, fruit products, bakery products, or beverages (other than milk) or picks up and delivers laundry or dry cleaning, if the driver is your agent or is paid on commission.
- 2) A full-time life insurance sales agent whose principal business activity is selling life insurance or annuity contracts, or both, primarily for one life insurance company.
- 3) An individual who works at home on materials or goods that you supply and that must be returned to you or to a person you name, if you also furnish specifications for the work to be done.
- 4) A full-time traveling or city salesperson who works on your behalf and turns in orders to you 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. The work performed for you must be the salesperson's principal business activity. See *Salespersons under Employee or Independent Contractor?*, later.

**Social security and Medicare taxes.** Individuals within any of the above four categories are employees whose wages are subject to withholding of social security and Medicare taxes if:

- The service contract states or implies that almost all of the services are to be performed personally by them;
- The individual has little or no investment in the equipment and property used to perform the services (other than an investment in transportation facilities); and
- The services are performed on a continuing basis for the same payer.

**Federal unemployment tax.** For federal unemployment tax, the term **employee** means the same as it does for social security and Medicare taxes, except that it does not include categories (2) and (3), above. Thus, any individual who is an employee under categories (1) or (4) is also an employee for federal unemployment tax purposes and subject to FUTA.

**Income tax.** Do not withhold income tax from the wages of statutory employees.

**Reporting payments to statutory employees.** Furnish a Form W-2 to a statutory employee, and check *Statutory employee* in box 15. Show your payments to the employee as other compensation in box 1. Also, show social security tax withheld in box 4, social security

wages in box 3, Medicare wages in box 5, and Medicare tax withheld in box 6. The statutory employee can deduct his or her trade or business expenses from the payments shown on Form W-2. He or she reports earnings as a statutory employee on line 1 of Schedule C. (A statutory employee's business expenses are not subject to the reduction by 2% of his or her adjusted gross income that applies to common-law employees.)

## Statutory Nonemployees

Two categories of statutory nonemployees have been established: **direct sellers** and **licensed real estate agents**. They are treated as self-employed for federal income tax and employment tax purposes if:

- 1) Substantially all payments for their services as direct sellers or real estate agents are directly related to sales or other output, rather than to the number of hours worked; and
- 2) Their services are performed under a written contract providing that they will not be treated as employees for federal tax purposes.

**Direct sellers.** Direct sellers are persons:

- 1) Engaged in selling (or soliciting the sale of) consumer products in the home or at a place of business other than in a permanent retail establishment; or
- 2) Engaged in selling (or soliciting the sale of) consumer products to any buyer on a buy-sell basis, a deposit-commission basis, or any similar basis prescribed by regulations, for resale in the home or at a place of business other than in a permanent retail establishment.

Direct selling includes activities of individuals who attempt to increase direct sales activities of their direct sellers and who earn income based on the productivity of their direct sellers. Such activities include providing motivation and encouragement, imparting skills, knowledge, or experience, and recruiting.

For more information on direct sellers, see Publication 911, *Tax Information for Direct Sellers*.

**Licensed real estate agents.** This category includes individuals engaged in appraisal activities for real estate sales if they earn income based on sales or other output.

## General Rules for Withholding

You may find it helpful to remember the following general rules for withholding:

- 1) **Independent contractors.** You do not have to withhold income tax or social security and Medicare taxes from amounts you pay an independent contractor. But, if you pay an independent contractor \$600 or more during the year in the course of your trade or business, you generally must issue and file a Form 1099-MISC.
- 2) **Common-law employees.** You generally must withhold income tax, social security

tax, and Medicare tax from the wages you pay common-law employees. You may also have to pay federal unemployment tax and your share of social security and Medicare taxes on these wages.

- 3) **Statutory employees.** You do not withhold income tax from the wages of statutory employees. But you must withhold and pay social security and Medicare taxes. Unless they are full-time life insurance sales agents or work at home, you must also pay federal unemployment tax on their wages.
- 4) **Statutory nonemployees.** You do not withhold or pay taxes on payments to statutory nonemployees.

**Penalty for treating an employee as an independent contractor.** If you classify an employee as an independent contractor and you had no reasonable basis for doing so, you can be held liable for employment taxes for that worker (the relief provisions, discussed below, will not apply). Further, if you do not withhold income, social security, and Medicare taxes from his or her wages, you may be held personally liable for a penalty equal to taxes that should have been paid if you are the person responsible for the collection and payment of withholding taxes. See *Penalties* under *Deposits*, later.

**Relief provisions.** If you have a reasonable basis for not treating a worker as an employee, you may be relieved from having to pay employment taxes for that worker. To get this relief, you must file all required federal tax returns, including information returns, on a basis consistent with your treatment of the worker. You (or your predecessor) must not have treated any worker holding a substantially similar position as an employee for any periods beginning after 1977. For further information, see Revenue Procedure 85-18, in Internal Revenue Cumulative Bulletin 1985-1, page 518.

**Technical service specialists.** This relief provision does not apply to a worker who provides services to another business (the client) as a technical specialist under an arrangement between the business providing the worker, such as a technical services firm, and the client. A technical service specialist is an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work. This rule does not automatically convert technical service specialists to employees for employment tax purposes. The common-law standards control whether the specialist is treated as an employee or an independent contractor. However, if you directly contract with a technical service specialist to provide services for your business rather than for another business, you may still be entitled to the relief provision. See *Employee or Independent Contractor?*, below.

**Leased employees.** Under certain circumstances, a corporation furnishing workers to various professional people and firms is the

employer of those workers for employment tax purposes. For example, a professional service corporation may provide the services of secretaries, nurses, and other similarly trained workers to its subscribers. The service corporation enters into contracts with the subscribers under which the subscribers specify the services to be provided and the fee to be paid to the service corporation for each individual furnished. The contracts provide that the service corporation has the right to control and direct the worker's services for the subscriber including the right to discharge or reassign the worker. The service corporation hires the workers, pays their wages, provides them with unemployment insurance and other benefits, and is the employer for employment tax purposes. For information on employee leasing as it relates to pension plan qualification requirements, see *Employee leasing* in Publication 560, *Self-Employed Retirement Plans*.

**Nonbusiness (personal) services by employees.** Noncash payments by an employer for personal services by employees, not in the course of the employer's business, are not subject to employment taxes.

Cash payments by an employer, however, for personal services by employees not in the course of the employer's business, such as making repairs on the employer's home, are subject to the following rules:

- 1) Payments are subject to income tax withholding and federal unemployment taxes if the employee earns \$50 or more in cash in a calendar quarter performing personal services for the employer, and works 24 or more days in that quarter or in the preceding quarter performing services not in the course of the employer's business.
- 2) Payments are subject to social security and Medicare taxes if the employee receives \$100 or more in cash in a calendar year from the employer for personal services.

These rules do not apply to corporate employees. They also do not apply to household and farm workers.

**Additional information.** For more information about the treatment of special types of employment, the treatment of special types of payments, and similar subjects, get a free copy of Circular E or Circular A (for agricultural employers) from the IRS.

## Employee or Independent Contractor?

An employer must generally withhold income taxes, withhold and pay social security and Medicare taxes, and pay unemployment taxes on wages paid to an employee. An employer does not generally have to withhold or pay any taxes on payments to independent contractors.

**Common-law rules.** To help you determine whether an individual is an employee under

the common-law rules, the IRS has identified 20 factors that are used as guidelines to determine whether sufficient control is present to establish an employer-employee relationship.

These factors should be considered guidelines. Not every factor is applicable in every situation, and the degree of importance of each factor varies depending on the type of work and individual circumstances. However, all relevant factors are considered in making a determination, and no one factor is decisive.

It does not matter that a written agreement may take a position with regard to any factors or state that certain factors do not apply, if the facts indicate otherwise. If an employer treats an employee as an independent contractor and the relief provisions discussed earlier do not apply, the person responsible for the collection and payment of withholding taxes may be held personally liable for an amount equal to the taxes that should have been withheld.

The 20 factors indicating whether an individual is an employee or an independent contractor are:

- 1) **Instructions.** An employee must comply with instructions about when, where, and how to work. Even if no instructions are given, the control factor is present if the employer has the right to control how the work results are achieved.
- 2) **Training.** An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods and receive no training from the purchasers of their services.
- 3) **Integration.** An employee's services are usually integrated into the business operations because the services are important to the success or continuation of the business. This shows that the employee is subject to direction and control.
- 4) **Services rendered personally.** An employee renders services personally. This shows that the employer is interested in the methods as well as the results.
- 5) **Hiring assistants.** An employee works for an employer who hires, supervises, and pays workers. An independent contractor can hire, supervise, and pay assistants under a contract that requires him or her to provide materials and labor and to be responsible only for the result.
- 6) **Continuing relationship.** An employee generally has a continuing relationship with an employer. A continuing relationship may exist even if work is performed at recurring although irregular intervals.
- 7) **Set hours of work.** An employee usually has set hours of work established by an employer. An independent contractor generally can set his or her own work hours.
- 8) **Full-time required.** An employee may be required to work or be available full-time. This indicates control by the employer. An independent contractor can work when and for whom he or she chooses.

- 9) **Work done on premises.** An employee usually works on the premises of an employer, or works on a route or at a location designated by an employer.
- 10) **Order or sequence set.** An employee may be required to perform services in the order or sequence set by an employer. This shows that the employee is subject to direction and control.
- 11) **Reports.** An employee may be required to submit reports to an employer. This shows that the employer maintains a degree of control.
- 12) **Payments.** An employee is generally paid by the hour, week, or month. An independent contractor is usually paid by the job or on a straight commission.
- 13) **Expenses.** An employee's business and travel expenses are generally paid by an employer. This shows that the employee is subject to regulation and control.
- 14) **Tools and materials.** An employee is normally furnished significant tools, materials, and other equipment by an employer.
- 15) **Investment.** An independent contractor has a significant investment in the facilities he or she uses in performing services for someone else.
- 16) **Profit or loss.** An independent contractor can make a profit or suffer a loss.
- 17) **Works for more than one person or firm.** An independent contractor is generally free to provide his or her services to two or more unrelated persons or firms at the same time.
- 18) **Offers services to general public.** An independent contractor makes his or her services available to the general public.
- 19) **Right to fire.** An employee can be fired by an employer. An independent contractor cannot be fired so long as he or she produces a result that meets the specifications of the contract.
- 20) **Right to quit.** An employee can quit his or her job at any time without incurring liability. An independent contractor usually agrees to complete a specific job and is responsible for its satisfactory completion, or is legally obligated to make good for failure to complete it.

**IRS help to make determination.** If you are unable to determine from the preceding guidelines whether a worker is your employee, you can file a Form SS-8, discussed next.

**Form SS-8.** In doubtful cases, the facts will determine whether or not there is an actual employer-employee relationship. If you want the IRS to determine whether a worker is an employee, file Form SS-8, *Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding*, with the District Director.

The following examples may help you to properly classify your workers:

## Building and Construction Industry

**Example 1.** John Brown has an oral agreement with Ace Building Co. to do carpentry work on any house designated by the Ace Building Co. He supplies his own hand tools. The Ace Building Co. supplies the material for each job. He has to do the work himself and he works on a full-time basis for the company. For some work he is paid on a piecework basis and for some on an hourly basis. He has no assistants, does not have an office, and does not advertise in newspapers or otherwise hold himself out to the public as being in the carpentry business. The Ace Building Co. can discharge him any time before he finishes a job without contractual liability. John is an employee of the Ace Building Co.

**Example 2.** Ron Smith, a mason, has an oral agreement with Jiffy, Inc., a contractor, to face a building with brick. Jiffy supplies all material for the job. He supplies only his hand tools. He has to do the work himself and is paid on an hourly basis. Jiffy employs two other masons on the job, who are supervised by Ron. Detailed supervision over him is neither necessary nor warranted because of his skill in the work. He can quit the job at any time, or Jiffy can discharge him at any time. He has no investment or proprietary interest in a business that offers the general public services similar to those he does for Jiffy. Ron is an employee of Jiffy, Inc.

**Example 3.** Tom Green is a painting subcontractor who has contracted to paint 264 houses. He hired 40 painters to do the work for him, although only about 15 are on the job at any one time. He supplies all the paint, brushes, and ladders. He designates the house to be painted and either pays the painters per house or by the hour. Detailed instructions about the work are not necessary because of the painters' skill in their trade. He inspects the work and requires them to repaint any unsatisfactory work. The painters cannot engage helpers without his consent. He can discharge them for any reason, and they are free to resign at any time. The painters are under no legal obligation to complete the painting of the houses. They assume no business risks and have no capital investment. None of them has an established business. The painters are employees of Tom Green.

**Example 4.** Jerry Jones has an agreement with Wilma White to supervise the remodeling of her house. She did not advance funds to help him carry on the work. She makes direct payments to the suppliers for all necessary materials. She carries liability and workers' compensation insurance covering Jerry and others he engaged to assist him. She pays them an hourly rate, and exercises almost constant supervision over the work. Jerry is not free to transfer his assistants to other jobs. He may not work on other jobs while working for Wilma. He assumes no responsibility to complete the work and will incur no contractual liability if he fails to do so. He and his assistants perform personal services for hourly wages. They are employees of Wilma White.

**Example 5.** Milton Manning, an experienced tilesetter, orally agreed with a corporation to perform full-time services at construction sites. He uses his own tools and performs services in the order designated by the corporation and according to its specifications. The corporation supplies all materials, makes frequent inspections of his work, pays him on a piecework basis, and carries workers' compensation insurance on him. He does not have a place of business or hold himself out to perform similar services for others. Either party can end the services at any time. Milton Manning is an employee of the corporation.

**Example 6.** Wallace Black agreed with the Sawdust Co. to supply the construction labor for a group of houses. The company agreed to pay all construction costs. However, he supplies all the tools and equipment. He performs personal services as a carpenter and mechanic for an hourly wage. He also acts as superintendent and foreman, and engages other individuals to assist him. The company has the right to select, approve, or discharge any helper. A company representative makes frequent inspections of the construction site. When a house is finished, Wallace is paid a certain percentage of its costs. He is not responsible for faults, defects of construction, or wasteful operation. At the end of each week, he presents the company with a statement of the amount he has spent, including the payroll. The company gives him a check for that amount from which he pays the assistants, although he is not personally liable for their wages. Wallace Black and his assistants are employees of the Sawdust Co.

**Example 7.** A local plumbers' union and a contractors' association agreed to set up an apprenticeship program. The program is financed by the contractors and is administered by a joint apprenticeship committee. Trainees are enrolled first in a preapprenticeship program, in which they attend vocational school full time 5 days a week for 6 to 8 weeks. During this period, they are paid an hourly rate and are furnished with all materials and supplies used in school.

After completion of the preapprenticeship program, the trainees are assigned to work for local contractors as apprentice plumbers. The apprentices must attend training classes related to the trade one day a week for two years. The apprenticeship program pays them for the time spent in attending classes at the same hourly rate they earn working for their contractor-employers.

While in the preapprenticeship program, the trainees are not employees. Their payments from the program are not subject to income tax withholding or social security, and Medicare taxes. The contractors and the administrators of the preapprenticeship program are not liable for federal unemployment tax. However, the apprentices assigned to contractors as apprentice plumbers are considered employees, even when attending classes under the apprenticeship program. Their payments from the program are subject to income tax withholding, social security and Medicare taxes, and federal unemployment tax.

**Example 8.** Bill Plum contracted with Elm Corporation to complete the roofing on a housing complex. A signed contract established a flat amount for the services rendered by Bill Plum. Bill is a licensed roofer and carries workers' compensation and liability insurance under the business name, Plum Roofing. He hires his own roofers who are treated as employees for federal employment tax purposes. If there is a problem with the roofing work, Plum Roofing is responsible for paying for any repairs. Bill Plum, doing business as Plum Roofing, is an independent contractor.

**Example 9.** Vince Elm, an electrician, submitted to a housing complex a job estimate for electrical work at \$12 per hour for 400 hours. He is to receive \$960 every two weeks for the next 10 weeks. This is not considered payment by the hour. Even if he works more or less than 400 hours to complete the work, Vince Elm will receive \$4,800. He also performs additional electrical installations under contracts with other companies, which he obtained through advertisements. Vince is an independent contractor.

## Trucking Industry

**Example 1.** Drivers for Rover Trucking Co. often engage laborers to unload their trucks with the express consent of the company. The drivers pay the unloaders from funds provided by the company. The unloaders are company employees. This also would be true if the drivers had only the implied consent of the company.

**Example 2.** A company engages Phil Blue to haul products to its customers. The company has legal ownership and control of the trucking equipment. Phil can be required, on an hour's notice, to make deliveries at times and places specified by the company. Refusal can jeopardize his relationship with the company. He has to operate and maintain the equipment and provide the necessary operators and helpers. He is not allowed to use the company's equipment to haul for others. He is paid on a tonnage basis and is not guaranteed a minimum amount of compensation. He has to pay the operators and helpers out of his tonnage receipts as well as pay for all insurance coverage required by the company. Phil and any operators or helpers engaged to assist him are employees of the company.

**Example 3.** Rose Trucking contracts to deliver material for Forest Inc. at \$140 per ton. Rose Trucking is not paid for any articles that are not delivered. At times, Jim Rose, who operates as Rose Trucking, may also lease another truck and engage a driver to complete the contract. All operating expenses, including insurance coverage, are paid by Jim Rose. All equipment is owned or rented by Jim and he is responsible for all maintenance. None of the drivers are provided by Forest Inc. Jim Rose, operating as Rose Trucking, is an independent contractor.

## Fishing Industry

**Example 1.** Harry Rose is the captain of one of the Pan Fishing Company's schooners. He engages a crew of 15 to operate the schooner. He offers to pay each crew member on the *lay* (sharing of the profit) basis. He and the crew members (except the engineer, who is paid a straight fee) are jointly liable for any losses resulting from a voyage.

The schooner is an American vessel of more than 10 net tons. He and the Pan Fishing Company entered into a contract of service within the United States.

After the voyage, Captain Rose sells the catch through a fish exchange, which deducts its fees from the proceeds. After deducting certain specified expenses (such as fuel, oil, etc.), he turns one-fourth of the proceeds over to Pan Fishing Co., less 5%, which he keeps as his commission. From the remaining three-fourths, the expenses of food, bait, etc., are deducted. The remainder is then equally divided among the members of the crew, including himself.

Because the crew is normally made up of 10 or more individuals, the members of a crew engaged under these circumstances are employees of either the captain (if he is not an agent of the vessel owner) or of the vessel owner. Their lays are in the nature of wages, and the agreements under which the crews are engaged in these circumstances are contracts of hire.

In this example, Captain Rose is acting as an agent of Pan Fishing Co. Therefore, the company is the employer. As an employer of a crew working on an American vessel under a contract entered into in the U.S., the company must withhold income tax and social security and Medicare taxes from the entire crew's wages, including the wages of Captain Rose and the engineer. The company must also pay the employer's portion of social security and Medicare taxes.

Because the schooner is a vessel of more than 10 net tons with a crew of more than nine members, the company must also pay federal unemployment tax on these wages.

The value of *meals and lodging furnished to the crew* is not subject to income tax withholding, social security and Medicare taxes, and federal unemployment tax because the company must furnish meals and lodging on board the vessel so that the crew can do its work.

**Federal unemployment tax.** The work of catching fish is exempt from federal unemployment tax *except* for:

- 1) Work related to catching salmon or halibut for commercial purposes; or
- 2) Work performed on a vessel of more than 10 net tons.

However, work that is not exempt under this rule may qualify as exempt if the four conditions under *Certain crew members considered self-employed*, discussed next, are met.

**Certain crew members considered self-employed.** Wages paid to the members of a crew

on a fishing boat are not subject to federal income tax withholding, social security and Medicare taxes, or the federal unemployment tax if all the following conditions are met:

- 1) The members neither get nor are entitled to any money for their work (other than as provided in condition (2), below);
- 2) The members get shares of the catch or of the proceeds from the sale of the catch;
- 3) Each member's share depends on the size of the catch; and
- 4) The operating crew of the boat (or each boat from which a member gets a share for a fishing operation involving more than one boat) is normally fewer than 10 persons.

Each member of the crew who meets these conditions is considered self-employed. The earnings of these crew members are considered trade or business income and therefore subject to self-employment tax. See Publication 533, *Self-Employment Tax*.

**Example 2.** Mike Jones, an owner of a fishing boat of more than 10 net tons, employs a captain and eight others to work as crew members. The proceeds from the sale of the catch offset boat operating expenses, such as fuel, bait, and ice. 60% of the balance is divided among the captain and the crew members, and 40% between Mike and the captain. Between voyages the crew members do not receive any additional compensation, but they must do certain work, such as repairing nets, splicing cable, and transporting the catch. However, the mate, the engineer, and the cook receive an additional payment of \$100 each. This payment does not depend on the boat's catch. Since the mate, the engineer, and the cook receive payment other than a share of the catch, they are not considered self-employed. The \$100 payment and their share of the proceeds from the catch are subject to federal income tax withholding, social security and Medicare taxes, and the federal unemployment tax.

The other six crew members, including the captain, are considered self-employed because they do not receive any additional pay and are members of an operating crew of fewer than 10 members. Mike does not have to withhold federal income tax or social security and Medicare taxes from their pay. They must pay self-employment tax on their earnings. Also, because the boat has a crew of fewer than 10 members and meets the other conditions mentioned above under *Certain crew members considered self-employed*, Mike does not have to pay the federal unemployment tax for the other six crew members, even though the boat was more than 10 tons.

**Example 3.** Assume the same facts as in Example 2, except that, in addition to receiving a share of the catch, the captain and the other crew members are entitled to receive \$10 per hour for repairing nets, constructing new nets, splicing cable, and other incidental work while in port. Since the crew members are entitled to receive payment other than a share of the catch, they are not considered self-employed.

The \$10 per hour payment and their share of the proceeds from the catch are subject to federal income tax withholding, social security and Medicare taxes, and the federal unemployment tax.

**Reporting requirements.** The operator of a boat must file with the IRS a completed Form 1099-MISC, *Miscellaneous Income*, if any of the crew members work as self-employed individuals. It must be filed with the IRS by February 28 of the year following the calendar year in which the crew member was paid. All amounts must be reported. The \$600 or more rule does not apply.

**Statement to crew member.** Each operator who is required to file Form 1099-MISC must also furnish a statement to each crew member. You may use Copy B of Form 1099-MISC for this purpose. This statement must be furnished to all crew members by January 31 of the year following the calendar year in which the crew member was paid.

## Shrimp Processing

**Example.** The Capital Shrimp Processing Co. hired Shirley Gray to devein shrimp. She works on a seasonal, part-time basis on the company's premises. The company pays her on a piecework basis. She or the company may end her services at any time. The percentage of her time spent in working for the Capital Shrimp Processing Co. varies. She also deveins shrimp under similar conditions for other processing firms. Shirley Gray is an employee of the Capital Shrimp Processing Co.

## Automobile Industry

**Example 1.** Donna Lee is a salesperson employed on a full-time basis by Bob Blue, an auto dealer. She works 6 days a week and is on duty in Bob's showroom on certain assigned days and times. She appraises trade-ins, but her appraisals are subject to the sales manager's approval. Lists of prospective customers belong to the dealer. She has to develop leads and report results to the sales manager. Because of her experience, she requires only minimal assistance in closing and financing sales and in other phases of her work. She is paid a commission and is eligible for prizes and bonuses offered by Bob. Donna is an employee of Bob Blue.

**Example 2.** Sam Sparks performs automobile repair services in the repair department of an automobile sales company. He works regular hours and is paid on a percentage basis. He has no investment in the repair department. The sales company supplies all facilities, repair parts, and supplies; issues instructions on the amounts to be charged, parts to be used, and the time for completion of each job; and checks all estimates and repair orders. Sam is an employee of the sales company.

**Example 3.** An auto sales agency furnishes space for Helen Smith to perform automobile repair services. She provides her own tools, equipment, and supplies. She seeks out business from insurance adjusters and other

individuals and does all the body and paint work that comes to the agency. She hires and discharges her own helpers, determines her own and her helpers' working hours, quotes prices for repair work, makes all necessary adjustments, assumes all losses from uncollectible accounts, and receives, as compensation for her services, a large percentage of the gross collections from the auto repair shop. Helen is self-employed and the helpers are her employees.

## Attorney

**Example.** Donna Yuma is an attorney who is engaged in the private practice of law. She received a \$10,000 annual retainer from Wilson Corporation starting in 1993. In return for the fee, Donna must defend the corporation against any suit brought against it. In 1993, Donna represented the corporation in two suits. In 1994, she was not called upon to perform any services for the retainer she received for 1994. During 1993, Wilson Corporation provided Donna with an office on the premises in order to efficiently prosecute the suits. Donna Yuma is engaged in her own trade or business and is an independent contractor with regard to the services she performs for Wilson Corporation.

## Taxicab Driver

**Example.** Tom Spruce rents a cab from Taft Cab Co. for \$150 per day. He pays for all maintenance and gas on the cab. Tom keeps all fares. Although he has use of the two-way radio communication, dispatcher, and advertising media provided by Taft Cab Co., these items are equally important to the interests of both Taft Cab Co. and Tom Spruce. They enhance their profits by promoting more cab rental business and efficiency. Tom Spruce is an independent contractor.

## Salespersons

To determine whether salespersons are employees under the usual common-law rules, you must evaluate each individual case. If a salesperson who works for you does not meet the tests for a common-law employee, discussed earlier, you do not have to withhold federal income tax from his or her pay (see *Statutory Employees*, earlier). However, even if a salesperson is not an employee under the usual common-law rules, his or her pay may still be subject to social security and Medicare taxes and federal unemployment (FUTA) taxes. To determine whether a salesperson is an employee for social security, Medicare, and federal unemployment purposes, you must apply the statutory employee tests. A salesperson is an employee for social security, Medicare, and federal unemployment purposes if he or she:

- 1) Works full time for one person or company except, possibly, for sideline sales activities on behalf of some other person;
- 2) Sells on behalf of, and turns his or her orders over to, the person or company he or she works for;

- 3) Sells to wholesalers, retailers, contractors, or operators of hotels, restaurants, or similar establishments;
- 4) Sells merchandise for resale, or supplies for use in the customer's business;
- 5) Agrees to do most of this work personally;
- 6) Has no substantial investment in the facilities used to do the work, other than in facilities for transportation; and
- 7) Maintains a continuing relationship with the person or company he or she works for.

## Household Employees

Household employees are persons you hire to perform services at your private home. If you file Form 941, for business employees, you can report wages you pay your household employees with wages you pay your other employees. Otherwise, for years after 1994, report these wages with your individual income tax return. If your home is on a farm operated for a profit, also see the instructions for Form 943. See Publication 926.

## Companion Sitting Services

A person in the trade or business of referring sitters to individuals who need their services is not considered the employer of the sitters if:

- 1) He or she does not pay or receive the salary or wages of the sitters; and
- 2) He or she is paid a fee by the sitter or the persons who employ the sitter.

A sitter is any individual who furnishes personal attendance, companionship, or household care services to children or to individuals who are elderly or disabled.

**Example.** Mr. Jones operates a placement service for companion sitters. He put Sharon Silver in touch with Mrs. Smith, an elderly woman who needed a person to furnish personal attendance, companionship, and household care. Sharon receives her salary directly from Mrs. Smith. Mr. Jones charged Mrs. Smith a fee of \$40 for locating a sitter. Sharon is not an employee of Mr. Jones.

## Part-Time Workers

For income tax withholding, social security, Medicare, and federal unemployment purposes, there are no differences between full-time employees, part-time employees, and employees hired for short periods. It does not matter whether the worker has another job or has the maximum amount of social security and Medicare taxes withheld by another employer. Income tax withholding may be figured the same way as for full-time workers. Or it may be figured by the part-year employment method, explained in Publication 493, *Alternative Tax Withholding Methods and Tables*.

## Family Members

**Child employed by parents.** Payments for the services of a child under the age of 18 who works for his or her parent (or a partnership in which each partner is a parent of the child) in a trade or business are not subject to social security and Medicare taxes. If these services are for work other than in a trade or business, such as domestic work in the parent's private home, they are not subject to social security and Medicare taxes until the child reaches 21.

Payments for the services of a child under the age of 21 who works for his or her parent whether or not in a trade or business are not subject to federal unemployment taxes.

The above rules apply even if the child is paid regular wages. The wages for these services are not subject to social security, Medicare, and federal unemployment taxes. But they may still be subject to income tax withholding.

**One spouse employed by another.** The wages for the services of an individual who works for his or her spouse in a trade or business are subject to income tax withholding and social security and Medicare taxes, but not to federal unemployment taxes. However, the services of one spouse employed by another in other than a trade or business, such as domestic service in a private home, are not subject to social security, Medicare, and federal unemployment taxes.

**Covered services of a child or spouse.** The wages for the services of a child or spouse are subject to income tax withholding as well as social security, Medicare, and federal unemployment taxes if he or she works for:

- 1) A corporation, even if it is controlled by the child's parent or the individual's spouse;
- 2) A partnership, even if the child's parent is a partner, unless each partner is a parent of the child;
- 3) A partnership, even if the individual's spouse is a partner; or
- 4) An estate, even if it is the estate of a deceased parent.

**Parent employed by child.** The wages for the services of a parent employed by a son or daughter in a trade or business are subject to income tax withholding and social security and Medicare taxes. Social security and Medicare taxes do not apply to wages paid to a parent for services not in a trade or business, but they do apply to domestic services if:

- 1) The parent cares for a child who lives with a son or daughter and is under 18, or requires adult supervision for at least 4 continuous weeks in a calendar quarter due to a mental or physical condition, and
- 2) The son or daughter is a widow or widower, divorced, or married to a person

who, because of a physical or mental condition, cannot care for the child during such period.

## Employees of Exempt Organizations

Many **nonprofit organizations** are exempt from income tax. Although they do not have to pay income tax themselves, they must still withhold income tax from the pay of their employees. However, there are special social security, Medicare, and federal unemployment tax rules that apply to the wages they pay their employees.

**Section 501(c)(3) organizations.** Nonprofit organizations described in section 501(c)(3) of the Internal Revenue Code include any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals. These organizations are usually corporations and are exempt from income tax under section 501(a).

**Social security and Medicare taxes.** Wages paid to employees of section 501(c)(3) organizations are subject to social security and Medicare taxes unless one of the following situations applies:

- 1) A 501(c)(3) organization pays an employee wages of less than \$100 in a calendar year.
- 2) A 501(c)(3) organization is wholly owned by a state or its political subdivision. Such an organization should contact the appropriate state official for information about reporting and getting social security and Medicare coverage for its employees. However, see *State and local government employees*, later.
- 3) A church or church-controlled organization that is opposed to the payment of social security and Medicare taxes for religious reasons has filed Form 8274, *Certification by Churches and Qualified Church-Controlled Organizations Electing Exemption from Employer Social Security and Medicare Taxes*, to elect exemption from social security and Medicare taxes. The organization must have filed for exemption before the first date on which a quarterly employment tax return would otherwise be due. An employee of a church or church-controlled organization that is exempt from social security and Medicare taxes must pay the self-employment tax if the employee is paid \$108.28 or more in a year. However, an employee who is a member of a qualified religious sect can apply for an exemption from the self-employment tax by filing Form 4029. See *Members of recognized religious sects opposed to insurance*, under *Religious Exemptions*, below.

**Federal unemployment tax.** An organization described in section 501(c)(3) of the Internal Revenue Code that is exempt from income tax is also exempt from the federal unemployment tax. This exemption cannot be waived.

**Other than section 501(c)(3) organizations.** Nonprofit organizations that are not section 501(c)(3) organizations may also be exempt from paying income tax under section 501(a) or 521. These organizations are not exempt from withholding income, social security, or Medicare tax from their employees' pay, or from paying federal unemployment tax. However, two special rules for social security, Medicare, and federal unemployment taxes apply to them:

- 1) If an employee is paid less than \$100 during a calendar year, his or her wages are not subject to social security and Medicare taxes.
- 2) If an employee is paid less than \$50 in a calendar quarter, his or her wages are not subject to federal unemployment tax for the quarter.

The above rules do not apply to employees who work for pension plans and other similar organizations described in section 401(a).

## Religious Exemptions

Special rules apply to the treatment of ministers for social security purposes. An exemption from social security is available for ministers and certain other religious workers and members of certain recognized religious sects. For more information on getting an exemption, or revoking an exemption, see Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*.

**Ministers.** Ministers are individuals who are duly ordained, commissioned, or licensed by a religious body constituting a church or church denomination. They are given the authority to conduct religious worship, perform sacerdotal functions, and administer ordinances and sacraments according to the prescribed tenets and practices of that religious organization.

A minister who performs services for you subject to your will and control is your employee. The common-law rules discussed earlier under *Common-Law Employees* should be applied to determine whether a minister is your employee or is self-employed. The earnings of a minister are not subject to social security and Medicare tax withholding. They are subject to self-employment tax. You do not withhold these taxes from wages earned by a minister. However, you may agree with the minister to voluntarily withhold tax to cover the minister's liability for self-employment tax and income tax. See *Form W-2*, later, for information on reporting the wages of a minister.

**Exemptions for ministers and others.** Certain ordained ministers, Christian Science practitioners, and members of religious orders who have not taken a vow of poverty, who are



subject to self-employment tax (to pay contributions for social security and Medicare), can apply to exempt their earnings from the tax on religious grounds. The application must be based on conscientious opposition to public insurance because of personal religious considerations. Self-employed individuals and their employees who are members of certain recognized religious sects opposed to insurance can also apply for an exemption from the tax. The exemption applies only to qualified services performed for the religious organization.

To apply for the exemption, the employee should file Form 4361, *Application for Exemption From Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners*. See Publication 517 for more information about Form 4361.

**Members of recognized religious sects opposed to insurance.** If you belong to a recognized religious sect or a division of such sect that is opposed to insurance, you may qualify for an exemption from the self-employment tax. To qualify, you must be conscientiously opposed to accepting the benefits of any public or private insurance that makes payments because of death, disability, old age, or retirement, or makes payments toward the cost of, or provides services for, medical care (including social security and Medicare benefits). If you buy a retirement annuity from an insurance company, you will not be eligible for this exemption. Religious opposition based upon the teachings of the sect is the only legal basis for the exemption. In addition, your religious sect (or division) must have existed since December 31, 1950.

**Self-employed.** If you are self-employed, you can apply for exemption by filing an application, Form 4029, *Application for Exemption From Social Security and Medicare Taxes and Waiver of Benefits*, and waive all social security benefits.

**Employees.** The social security and Medicare tax exemption available to the self-employed who are members of a recognized religious sect opposed to insurance is also available to their employees who are members of such a sect. This applies to partnerships only if each partner is a member of the sect. This exemption for employees applies only if both the employee and the employer are members of such a sect, and the employer has an exemption. To get the exemption, the employee must file Form 4029.

An employee of a church or church-controlled organization that is exempt from social security and Medicare taxes can also apply for an exemption on Form 4029.

See Revenue Procedure 91-20 for guidelines used to determine whether an organization is a religious order or whether an individual is a member of a religious order.

## Income Tax Withholding

You generally must withhold income tax from wages you pay employees if their wages for any payroll period exceed the dollar value of their withholding allowances for that period.

The amount to be withheld is figured separately for each payroll period.

A **payroll period** is the period of time for which you usually make a payment of wages to an employee. **Regular** payroll periods can be daily, weekly, biweekly, semimonthly, monthly, quarterly, semiannual, or annual. A **miscellaneous** payroll period is any other period. Sundays and holidays are included in computing the number of days in a miscellaneous payroll period.

You should not withhold tax from the wages of employees who claim exemption from withholding on **Form W-4**. Only employees who did not have to pay income tax last year and do not expect to pay any this year may claim exemption from withholding. Employees who claim exempt status on Form W-4 must renew their status by filing a new Form W-4 with you by February 15 of each year.

In addition to wages, other payments or benefits you give to your employees may or may not be subject to withholding, as discussed next.

## Withholding and Reporting Payments Other Than Wages

**Employee benefits.** Certain employee benefits, including vacation leave, sick leave, compensatory time, severance pay, disability pay, and death benefit plans, are not includible in income until paid to the employee. The benefits are not subject to social security and Medicare taxes, federal unemployment tax, and income tax withholding until paid to the employee.

**Contributions to a simplified employee pension (SEP) plan.** An employer's SEP contributions to an employee's individual retirement arrangement (IRA) are excluded from the employee's gross income. These excluded amounts are not subject to social security, Medicare, and federal unemployment taxes, or income tax withholding. However, any employer SEP contributions paid under a salary reduction agreement are included in wages for purposes of social security and Medicare taxes and the federal unemployment tax.

See Publication 590, *Individual Retirement Arrangements*, for more information about SEP plans.

**Supplemental unemployment benefits.** If you pay, under a plan, supplemental unemployment benefits to a former employee, all or part of the payments may be taxable, depending on how the plan is funded. Amounts that represent a return to the employee of amounts previously subject to tax are not taxable and are not subject to withholding. You should withhold income tax on the taxable part of the payments made, under a plan, to an employee who is involuntarily separated because of a reduction in force, discontinuance of a plant or operation, or other similar condition. It does not matter whether the separation is temporary or permanent.

Withholding on taxable supplemental unemployment benefits must be based on the withholding certificate the employee gave you.

See Publication 525, *Taxable and Nontaxable Income*, for more information about the taxability of supplemental unemployment benefits.

**Annuity or pension payments.** Pension and annuity payments are generally subject to federal income tax withholding unless the recipient elects not to have tax withheld. The withholding rules apply to the **taxable** part of payments from an employer pension, annuity, profit-sharing, stock bonus, or other **deferred compensation plan**. The rules also apply to payments from an individual retirement arrangement, and an annuity, endowment, or life insurance contract issued by a life insurance company. There is no withholding on any part of a distribution that is not expected to be includible in the recipient's gross income.

Recipients of payments described above can choose not to have withholding apply to their pensions or annuities. The election remains in effect until the recipient revokes it. The payer must notify the recipient that this election is available.

For purposes of withholding income tax on periodic payments, a pension or annuity is treated as wages. The recipient of a pension or annuity should give the payer a completed withholding allowance certificate, **Form W-4P**, *Withholding Certificate for Pension or Annuity Payments*, or other form provided by the payer. If the recipient does not give the payer a certificate, the payer must withhold as if the recipient were married and claimed three withholding allowances.

On a nonperiodic payment that qualifies as an eligible rollover distribution, you must withhold tax at a rate of 20%, unless the payment is directly transferred from the distributing plan to a new plan. You must withhold tax on other nonperiodic payments at a flat 10% rate. See Circular E for more information.

You must furnish the recipients and the IRS with Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*

**Sick pay paid by third party.** Employees can request that federal income tax be withheld from sick pay paid by third parties, such as insurance companies. An employee who wants income tax withheld from sick pay must file **Form W-4S**, *Request for Federal Income Tax Withholding from Sick Pay*, with the third-party payer.

For more information about sick pay paid by third parties, see Publication 952, *Sick Pay Reporting*.

**Leave sharing plans.** If you establish a leave sharing plan for your employees that allows them to donate leave to other employees for medical emergencies, the amounts paid to the recipients of the leave are considered wages. These amounts are includible in the gross income of the recipients and are subject to social security, Medicare, and federal unemployment

taxes, and income tax withholding. Do not include these amounts in the income of the donors.

**Bonuses and awards.** If you pay bonuses, make taxable awards, or pay other supplemental wages to an employee, you must withhold income tax from the payment. If you add the payment to the employee's regular wages, you can figure the income tax to be withheld as if the total of the supplemental and regular wages were a single wage payment for the regular payroll period. However, if you withhold tax on the regular wage portion at the appropriate rate and specifically indicate on your payroll records the amount of each payment, you can withhold on the supplemental portion using a flat 28% rate without considering withholding allowances or the amount of regular wages.

If supplemental wages are paid separately, you can figure the tax to withhold by adding the supplemental wages to the regular wages for either the current payroll period or the last preceding payroll period within the same calendar year. If you have already withheld tax from the regular wages, you can figure the tax to withhold by using a 28% rate without considering withholding allowances and without referring to a regular wage payment.

You become liable for withholding income, social security, and Medicare taxes, and for paying federal unemployment tax, when you **actually pay** bonuses and vacation pay to your employees. This is true even though the employees earned the right to these payments at an earlier date and the vacation plan is unfunded.

**Employee achievement awards.** Do not withhold on the fair market value of an employee achievement award if it is excludable from your employee's gross income. To be excludable from your employee's gross income, the award must be tangible personal property (not cash or securities) given to an employee for length of service or safety achievement, awarded as part of a meaningful presentation, and awarded under circumstances that do not indicate that the payment is disguised compensation. Amounts excluded for employee achievement awards are not subject to social security, Medicare, and federal unemployment taxes, or income tax withholding.

**Limits.** The most you can exclude for the cost of all employee achievement awards to the same employee for the year is \$400. A higher limit of \$1,600 applies to qualified plan awards. These awards are employee achievement awards under a written plan that does not discriminate in favor of highly compensated employees. An award cannot be treated as a qualified plan award if the average cost per recipient of all awards under all your qualified plans is more than \$400.

If during the year an employee receives awards not made under a qualified plan and also receives awards under a qualified plan, the exclusion for the total cost of all awards to that employee cannot be more than \$1,600. The \$400 and \$1,600 limits cannot be added together to exclude more than \$1,600 for the

cost of awards to any one employee during the year.

**Wages not paid in money.** If in the course of your trade or business you pay your employees in some medium that is neither cash nor a readily negotiable instrument, such as a check, you are said to pay them "in kind." Payments in kind may be in the form of goods, lodging, food, clothing, or services. The fair market value of such payments at the time they are provided is generally subject to income tax withholding. However, for household work, agricultural labor, and service not in the employer's trade or business, income tax withholding is not required for noncash payments. Withhold on these payments only if you and the employee agree to do so.

**Meals and lodging.** The value of meals is not subject to income tax withholding if the meals are furnished for the employer's convenience and on the employer's premises. The value of lodging is not subject to withholding if the lodging is furnished for the employer's convenience, on the employer's premises, and as a condition of employment.

"For the convenience of the employer" means that you have a substantial business reason for providing the meals and lodging other than to provide additional compensation to the employee. For example, meals provided at the place of work so that an employee can be available for emergencies during his or her lunch period would generally be considered for the convenience of the employer.

However, whether meals or lodging are provided for the convenience of the employer depends on all the facts and circumstances. A written statement that the meals or lodging are for your convenience is not sufficient.

For more information, see Chapter 3 in Publication 535.

**Dependent care assistance programs.** The maximum amount you can exclude from your employee's gross income for dependent care assistance is \$5,000 (\$2,500 for married taxpayers filing separate returns). The excluded amount is not subject to social security, Medicare, and federal unemployment taxes, or income tax withholding. If the dependent is cared for in a facility at your place of business, the amount to exclude from the employee's income is based on his or her use of the facility and the value of the services provided. For more information, see chapter 5 in Publication 535.

**Dependent care providers.** If you were the provider of dependent care or pay the provider directly, your employee may ask you for help in obtaining a completed **Form W-10, Dependent Care Provider's Identification and Certification**. The dependent care credit and the exclusion for employer-provided dependent care assistance benefits cannot be claimed by your employee unless the dependent care provider is identified by name, address, and (if not an exempt organization) taxpayer identification number. The dependent care provider is required to furnish this information on Form W-10.

**Health insurance plans.** If you pay the cost of an accident or health insurance plan for your employees, your payments are not wages and are not subject to social security and federal unemployment taxes, or income tax withholding.

**Medical care reimbursements.** Medical care reimbursements paid for an employee under an employer's self-insured medical reimbursement plan are not wages and are not subject to income tax withholding.

**Educational assistance programs.** For tax years beginning before January 1, 1995, the amount you paid for the cost of tuition, fees, course supplies, and similar items for your employees under a qualified educational assistance program, up to \$5,250 for each employee per year, is not includable in the gross income of your employees and is not subject to social security, Medicare, and federal unemployment taxes, or income tax withholding. Educational assistance includes any payments for graduate level courses that could lead to a law, business, medical, or other advanced academic or professional degree.

You generally do not have to include in wages or withhold on the value of payments made for job-related training for your employees. For more information, see Chapter 5 in Publication 535.

**Scholarship and fellowship payments.** Only amounts you pay as a qualified scholarship to a candidate for a degree may be excluded from the recipient's gross income. A qualified scholarship is any amount granted as a scholarship or fellowship that is used for tuition, fees, books, supplies, and equipment. Any amounts you pay for room and board, and any amounts you pay for teaching, research, or other services required as a condition of receiving the scholarship, are not excludable from the recipient's gross income. A qualified scholarship is not subject to social security, Medicare, and federal unemployment taxes, or income tax withholding. For more information, see Publication 520, *Scholarships and Fellowships*.

**Outplacement services.** If you provide outplacement services to your employees to help them find new employment (such as career counseling, resume assistance, skills assessment, etc.) the value of these benefits may be income to them subject to all withholding taxes. However, the value of these services will not be subject to any employment taxes if:

- 1) You derive a substantial business benefit from providing the services (such as improved employee morale or business image) separate from the benefit you would receive from the mere payment of additional compensation, and
- 2) The employee would be able to deduct the cost of the services as employee business expenses if he or she had paid for them.

However, if you receive no additional benefit from providing the services, or if the services are not provided on the basis of employee need, then the value of the services is treated as wages and is subject to income tax, social security, and Medicare withholding. Similarly, if an employee receives the outplacement services in exchange for reduced severance pay (or other taxable compensation), then the amount the severance pay is reduced is treated as wages for employment tax purposes.

**Withholding for idle time.** Payments made under a voluntary guarantee to employees for *idle time* (any time during which an employee performs no services) are wages for the purposes of social security, Medicare, and federal unemployment taxes, and the withholding of income tax.

Payments for *lost time* to an employee who was reinstated following a determination that he or she was dismissed without cause are also subject to income tax withholding.

**Reimbursement and other expense allowance arrangements.** A reimbursement or allowance arrangement is a system by which you substantiate and pay the advances, reimbursements, and charges for your employees' business expenses. How you report a reimbursement or allowance amount depends on whether it is an accountable or a nonaccountable plan. If a single payment includes both wages and an expense reimbursement, you must specify the amount of the reimbursement.

**Accountable plan.** To be an accountable plan, your reimbursement or allowance arrangement must require your employees to meet all three of the following rules:

- 1) They must have paid or incurred deductible expenses while performing services as your employees,
- 2) They must adequately account to you for these expenses within a reasonable period of time, and
- 3) They must return any excess reimbursement or allowance within a reasonable period of time.

Amounts paid under an accountable plan are not wages and are not subject to income tax withholding and payment of social security, Medicare, and federal unemployment taxes.

If the expenses covered by this arrangement are not substantiated or excess reimbursement is not returned within a reasonable period of time, the amount is treated as paid under a nonaccountable plan. This amount is subject to income tax withholding and payment of social security, Medicare, and federal unemployment taxes for the first payroll period following the end of the reasonable period.

A reasonable period of time depends on the facts and circumstances. Generally, it is considered reasonable if your employees receive the reimbursement within 30 days of the time they incur the expense, adequately account for the expenses within 60 days after

they were paid or incurred, and return any excess reimbursement within 120 days after the expense was paid or incurred. Also, it is considered reasonable if you give your employees a periodic statement (at least quarterly) that asks them to either return or adequately account for outstanding amounts and they do so within 120 days.

**Nonaccountable plan.** A nonaccountable plan is an arrangement that does not meet the requirements for an accountable plan. All amounts paid under a nonaccountable plan are wages and are subject to income tax withholding and payment of social security, Medicare, and federal unemployment taxes when paid.

**Per diem or other fixed allowance.** You may reimburse your employees by travel days, or miles, or some other fixed allowance. In these cases, your employee is considered to have accounted to you if the payments do not exceed rates established by the federal government. The **standard mileage rate** is 29 cents per mile for auto expenses. However, see Revenue Procedure 93-51, for information on using a fixed and variable rate (FAVR) allowance. The government per diem rates for meals and lodging in the continental United States are listed in Publication 1542, *Per Diem Rates*. Other than the amount of these expenses, your employee's business expenses (for example, the business purpose of the travel or the number of business miles driven) must be substantiated.

If the per diem or allowance paid exceeds the amounts specified, you must report the amount in excess of the specified amount as wages. This excess amount is subject to income tax withholding and payment of social security, Medicare, and federal unemployment taxes. The amount equal to the specified amount is shown in box 13 of Form W-2, using code "L."

For more information, see Chapter 16 in Publication 535.

**Excessive termination payments (golden parachutes).** A golden parachute is a contract entered into by a corporation and key personnel under which the corporation agrees to pay certain amounts to the key personnel in the event of a change in ownership or control of the corporation. Payments under golden parachute contracts, like any termination pay, are subject to social security, Medicare, and federal unemployment taxes, and income tax withholding.

Beginning with payments under contracts entered into, significantly amended, or renewed after June 14, 1984, no deduction is allowed to the corporation for excess parachute payments. The employee is subject to a 20% nondeductible excise tax to be withheld by the corporation on all excess payments. The payment is generally considered an excess parachute payment if it equals or exceeds three times the average compensation of the recipient over the previous 5-year period. The amount over the average is the excess parachute payment.

**Example.** An officer of a corporation receives a golden parachute payment of

\$400,000. This is more than three times greater than his or her average compensation of \$100,000 over the previous 5-year period. The excess parachute payment is \$300,000 (\$400,000 minus \$100,000). The corporation cannot deduct the \$300,000, and must withhold the excise tax of \$60,000 (20% of \$300,000). Get Circular E for information on reporting golden parachute payments.

**Exempt payments.** Most small business corporations are exempt from the golden parachute rules. See IRC section 280G for more information.

**Interest-free and below-market interest rate loans.** If an employer lends an employee (or an independent contractor) more than \$10,000 at less than the applicable federal interest rate, the employer is considered to have paid additional compensation to the employee equal to the difference between the applicable federal interest rate and the interest rate charged. This rule applies to any such loan, regardless of amount, if one of its principal purposes is the avoidance of federal tax.

This additional compensation to the employee is subject to social security, Medicare, and federal unemployment taxes, but not to income tax withholding. Include it in compensation on Form W-2 (or Form 1099-MISC for an independent contractor). For more information, see Chapter 8 in Publication 535.

**Cafeteria plans.** Cafeteria plans, including flexible spending arrangements, are benefit plans under which all participants are employees who can choose from among cash and certain qualified benefits. If the employee elects qualified benefits, employer contributions are excluded from his or her wages if the benefits are excludable from gross income under a specific section of the Internal Revenue Code (other than scholarship and fellowship grants under section 117, educational assistance programs under section 127, and employee fringe benefits under section 132). The cost of group term life insurance that is includible in income only because the insurance exceeds \$50,000 of coverage or is on the life of the employee's spouse or children is considered a qualified benefit under a special rule.

Qualified benefits under a cafeteria plan are not subject to social security, Medicare, and federal unemployment taxes, or income tax withholding. If an employee elects to receive cash instead of any qualified benefit, it is treated as wages subject to all employment taxes. For more information, see Chapter 5 in Publication 535.

**Employee fringe benefits.** The following fringe benefits that an employer provides to an employee are excluded from the employee's gross income. They are not subject to social security, Medicare, and federal unemployment taxes, or income tax withholding.

- 1) A no-additional cost service, which is a service offered for sale to customers in the course of the employer's line of business in which the employee works. It is provided at no substantial additional cost, including lost revenue, to the employer.

Examples include airline, bus, and train tickets and telephone services provided free or at reduced rates by an employer in the line of business in which the employee works.

- 2) A qualified employee discount that, if offered for property, is not more than the employer's gross profit percentage. If offered for services, the discount is not more than 20% of the price for services offered to customers.
- 3) A working condition benefit, which is property or a service the employee could deduct as a business expense if he or she had paid for it. Examples include a company car for business use and subscriptions to business magazines. Under special rules, all of the use of a demonstrator car by an auto salesperson is excluded if there are substantial restrictions on personal use.
- 4) A de minimis benefit, which is a service or an item of such small value (after taking into account how frequently similar benefits are provided to employees) as to make accounting for the benefit unreasonable or administratively impracticable. Examples include typing of a personal letter by a company secretary, occasional personal use of a company copying machine, occasional parties or picnics for employees, occasional supper money and taxi fare for employees working overtime, holiday gifts with a low fair market value, occasional tickets for entertainment events, and coffee and doughnuts furnished to employees. Also include meals at an eating facility operated by the employer for the employees' benefit on or near the employer's business premises if the income from the facility equals or exceeds the direct operating costs of the facility.
- 5) A qualified transportation benefit, which includes transit passes, transportation in a commuter highway vehicle to and from work, and qualified parking at or near the place of work. The combined exclusion for the transit passes and transportation cannot exceed \$60 per month. The exclusion for parking cannot exceed \$155 per month for 1994 (\$160 per month for 1995). For more information, on this transportation fringe benefit, see Chapter 4 in Publication 535.
- 6) A qualified moving expense reimbursement, which includes any amount received, directly or indirectly, by an employee from an employer as a payment for, or reimbursement of, expenses that would be deductible as moving expenses, if paid or incurred by the employee. For more information on expenses that qualify for a deduction, see Publication 521, *Moving Expenses*.
- 7) An on-premises gym or other athletic facility provided and operated by the employer if substantially all the use is by employees, their spouses, and their dependent children.

- 8) A qualified tuition reduction, which an educational organization provides its employees for education, generally below the graduate level. For more information on a qualified tuition reduction, see Publication 520.

#### **Special fringe benefit rules for airlines and their affiliates.**

Employees of a qualified affiliate of an airline (a member of a group in which another member operates the airline) who are directly engaged in providing airline-related services may exclude from their income as a no-additional-cost service the fair market value of air transportation provided by the other member. Airline-related services means providing any of the following services in connection with air transportation: catering; baggage handling; ticketing and reservations; flight planning and weather analysis; service at restaurants and gift shops located at an airport; and similar services.

Any use of air transportation provided by an airline to parents of the airline's employees is also treated as use by the employees. The employees are entitled to exclude the fair market value of such transportation from their income as a no-additional-cost service.

**Note.** In order to be excluded from the income of highly compensated employees, all of the above items except a working condition benefit or a de minimis benefit (other than eating facilities) must be offered to employees on a nondiscriminatory basis.

**More information.** For more detailed information on fringe benefits, see Chapter 4 in Publication 535.

#### **Withholding and Reporting Taxable Noncash Fringe Benefits**

Use the following guidelines for reporting and withholding tax on taxable noncash fringe benefits.

**Choice of period for withholding, depositing, and reporting.** For employment tax and withholding purposes, you can treat fringe benefits (including personal use of employer-provided highway motor vehicles) as paid on a pay period, quarter period, semiannual period, annual period, or other basis. But the benefits must be treated as paid no less frequently than annually. You do not have to choose the same period for all employees. You can withhold more frequently for some employees than for others.

You can change the period as often as you like as long as you treat all the benefits provided in a calendar year as paid no later than December 31 of the calendar year.

You can also treat the value of a single fringe benefit as paid on one or more dates in the same calendar year, even if the employee receives the entire benefit at one time. For example, if your employee receives a fringe benefit valued at \$1,000 in one pay period during 1994, you can treat it as made in four payments of \$250, each in a different pay period of

1994. You do not have to notify the IRS of the use of the periods discussed above.

**Transfer of property.** The above choice for reporting and withholding does not apply to a fringe benefit that is a transfer of tangible or intangible personal property of a kind normally held for investment, or a transfer of real property. For this kind of fringe benefit, you must use the actual date provided.

**Withholding and depositing taxes.** You can add the value of fringe benefits to regular wages for a payroll period and figure income tax withholding on the total. Or you can withhold federal income tax on the value of fringe benefits at the flat 28% rate applicable to supplemental wages.

You must withhold the applicable income, social security, and Medicare taxes on the date or dates you chose to treat the benefits as paid. Deposit the amounts withheld as discussed under *Deposits*, later.

**Amount of deposit.** To estimate the amount of income and employment taxes and to deposit them on time, make a reasonable estimate of the value of the fringe benefits provided on the date or dates you chose to treat the benefits as paid. Determine the estimated deposit by figuring the amount you would have had to deposit if you had paid cash wages equal to the estimated value of the fringe benefits and withheld taxes from those cash wages. Even if you do not know which employee will receive the fringe benefit on the date the deposit is due, you should follow this procedure.

If you underestimate the value of the fringe benefits and deposit less than the amount you would have had to deposit if the applicable taxes had been withheld, you may be subject to a penalty.

If you overestimate the value of the fringe benefit and overdeposit, you can either claim a refund or have the overpayment applied to the next employment tax return.

If you paid the required amount of taxes to the IRS but withheld a lesser amount from the employee, you can recover from the employee the social security, Medicare, or income taxes you paid on the employee's behalf, and included on the employee's Form W-2. However, you must recover the income taxes before April 1 of the following year.

#### **Election not to withhold—special rule for highway motor vehicles.**

You can choose not to withhold income tax on the value of an employee's personal use of a highway motor vehicle you provided. You do not have to make this choice for all employees. You can withhold income tax from the wages of some employees but not others. You must, however, withhold the applicable social security and Medicare taxes on such benefits.

You can choose not to withhold income tax by:

- 1) Notifying the employee as described below that you choose not to withhold; and
- 2) Including the value of the benefits in boxes 1, 3, and 5 on Form W-2 furnished on time.

The notice must be in writing and must be provided to the employee by January 31 of the election year or within 30 days after a vehicle is first provided to the employee, whichever is later. This notice must be provided in a manner reasonably expected to come to the attention of the affected employee. For example, the notice may be mailed to the employee, included with a paycheck, or posted where the employee could reasonably be expected to see it. You can also change your election not to withhold at any time by notifying the employee in the same manner.

**Special accounting rule for valuation.** Under the general income tax and reporting rule, you must determine the value of fringe benefits provided in a calendar year by January 31 of the following calendar year. If the benefit is the personal use of a highway motor vehicle, you can either determine the value for the calendar year, or determine the value as if the entire use of the vehicle for the year by the employee is personal and include 100% in the employee's income.

Instead of using the general rule, you can use the special accounting rule explained in the following paragraphs. The special accounting rule cannot be used, however, for a fringe benefit that is a transfer of tangible or intangible personal property of a kind normally held for investment, or a transfer of real property.

**Special accounting period.** You can treat the value of benefits provided during the last 2 months of the calendar year or any shorter period as paid in the next year. Thus, the value of benefits actually provided in the last 2 months of 1994 would be treated as provided in 1995 together with the value of benefits provided in the first 10 months of 1995. This does not mean that all benefits treated as paid during the last 2 months of a calendar year can be deferred until the next year. Only the value of benefits actually provided during the last 2 months of the calendar year can be treated as paid in the next calendar year.

**Conformity rules.** Use of the special accounting rule is optional. You can use the rule for some fringe benefits but not others. The period of use need not be the same for each fringe benefit. However, if you use the rule for a particular fringe benefit, you must use it for all employees who receive that benefit.

If you use the special accounting rule, your employee must use it and for the same period as you use it. But your employee cannot use the special accounting rule unless you do.

You do not have to notify the IRS if you use the special accounting rule. You can also, for appropriate reasons, change the period for which you use the rule without notifying the IRS. But you must report the income and deposit the withheld taxes as required, for the changed period.

**Amount to report on Forms 941 and W-2.** The actual value of fringe benefits provided during a calendar year (or other period as explained under *Special accounting rule for valuation*, earlier) must be determined by January 31 of the following year. You must report the

actual value on Form W-2 and also on Form 941 for the 4th quarter of the prior year and pay any tax due. If you choose, you can use a separate Form W-2 for fringe benefits and any other benefit information.

For 1994, include the value in box 1 of Form W-2. Also include it in boxes 3 and 5 if applicable. Show the total value of the fringe benefits provided in the calendar year or other period in box 12 of Form W-2. If you provided your employee with the use of a highway motor vehicle and included 100% of the value of the vehicle in the employee's income, you must also report it separately in box 12. If there is not enough space on the Form W-2, you must report it to the employee on a separate schedule so that the employee can compute the value of any business use of the vehicle.

If you use the special accounting rule, you must notify the affected employees of the period in which you used it. You must give the notice at or near the date you give the Form W-2 but not earlier than with the employee's last paycheck of the calendar year.

### Form W-4 Withholding Allowances

In general, an employee can claim withholding allowances equal to the number of exemptions the employee will be entitled to in figuring income tax on his or her annual return. An employee may also be able to claim a special withholding allowance and allowances for estimated deductions and credits. See *Special withholding allowance* and *Additional withholding allowances*, later.

You should ask each new employee to give you a **Form W-4** on or before his or her first day of work. This certificate is effective for the first payment of wages and will last until the employee files another one unless the employee claims exemption from withholding. The certificate must include the employee's social security number.

If an employee does not give you a Form W-4, you must withhold tax as if the employee were a single person who has claimed no withholding allowances. Married employees (and widows and widowers qualified to file their income tax returns as married persons) who have not indicated on Form W-4 that they are married will be treated as single persons for withholding purposes.

#### Changes in allowances or marital status.

An employee who wants to change the number of allowances claimed or show a change in marital status should file a new Form W-4. Near the end of each year, you should ask each of your employees to file a new Form W-4 for the following year if there has been a change in allowances or marital status since the last Form W-4 was filed. If the employee has a change in name because of a changed marital status, advise the employee to report this to the Social Security Administration. This will ensure that wage reports showing the new name will be correctly credited to the employee's social security records.

**Effective date of Form W-4.** You must put a new Form W-4 into effect no later than

the start of the first payroll period ending on or after the 30th day from the date you receive it. If you pay wages without regard to a payroll period, you must put the new Form W-4 into effect no later than the first payment of wages on or after the 30th day from the date you receive it.

**Repayment or reimbursement.** If an employee gives you a new Form W-4 claiming additional withholding allowances, you cannot reimburse the employee for income taxes collected during the year before the effective date of the new W-4. But you can reimburse the employee for income taxes you overcollected on or after the effective date if you did not take the new certificate into account.

**Note:** A Form W-4 that makes a change for the next calendar year will not take effect in the current calendar year.

**Two jobs.** An employee who holds two jobs at the same time and claims all withholding allowances on the Form W-4 filed with one employer, must claim zero allowances on the Form W-4 filed with the second employer.

**Married employees.** You should inform your married employees that, if a husband and wife both work, they can divide their allowances any way they like. But one spouse may not claim an allowance claimed by the other.

**Exempt employees.** An employee can claim an exemption from income tax withholding on Form W-4 if he or she had a right to a refund of all federal income tax withheld last year because of no income tax liability, and expects the same situation to exist this year. An employee who can be claimed as a dependent by someone else usually cannot claim this exemption if he or she has nonwage income, and he or she expects income plus wages to be more than \$600. A student is not automatically exempt from income tax withholding. An employee who has claimed exemption from withholding and later discovers he or she will incur tax liability must give you a new Form W-4 within 10 days.

An employee who wants to continue claiming exemption from withholding must file a new Form W-4 by February 15 each year. If the employee does not do so, withhold tax as if the employee is single with zero withholding allowances.

**Special withholding allowance.** An employee can claim a special withholding allowance if the employee is single and works for only one employer, or is married and works for only one employer and the employee's spouse is not employed. The employee can also claim this allowance if the total wages the employee or the employee's spouse (or both) earned on other jobs is \$1,000 or less.

**Additional withholding allowances.** An employee can claim additional withholding allowances on Form W-4 for estimated deductions, adjustments to income, or tax credits. For more information, see the instructions for

Form W-4. If an employee has estimated tax credits that are not covered in the Form W-4 instructions, he or she can use the method described in Publication 505, *Tax Withholding and Estimated Tax*, to figure withholding allowances.

An employee should complete the *Deductions and Adjustments Worksheet* on page 2 of Form W-4 to figure the number of additional allowances. The additional allowances remain in effect until the employee files a new Form W-4 with you. If the number of allowances he or she is entitled to claim decreases to less than the number the employee is now claiming, the employee must file a new form within 10 days.

**Additional withholding.** If an employee determines that his or her income tax liability for the year will be more than the total amount to be withheld, the employee can have an additional amount withheld by showing the amount on line 6 of Form W-4.

A married employee may also have tax withheld at the higher "single" rate by checking the appropriate box on Form W-4.

**Invalid withholding certificate.** Any alteration of, or unauthorized addition to, a withholding certificate makes it invalid. If an employee indicates to you, either orally or in writing, that the information on the withholding certificate is false, the certificate will be invalid even if it is not yet in effect. If you realize the certificate is invalid, then you must ask your employee to furnish a new one. If the employee does not comply, you must withhold from the employee the same amount you would withhold from a single person claiming no exemptions. However, if a prior certificate is still in effect, you should withhold according to that certificate.

**Filing Form W-4 with the Internal Revenue Service.** You must send the IRS a copy of any Form W-4 received from an employee who is still employed by you at the end of the quarter if:

- 1) The employee filing it claims 11 or more withholding allowances; or
- 2) The employee filing it claims exemption from income tax withholding, but the employee's wages are more than \$200 a week.

Copies of the Forms W-4 that must be submitted because of either of the above conditions should be sent along with your quarterly employment tax return, Form 941. You can send them more often if you like. If you do, please include a statement giving your name, address, employer identification number, and the number of forms you are sending. If you would like to report this material on magnetic tape, see Publication 1245, *Specifications for Filing Form W-4, Employee's Withholding Allowance Certificate, on Magnetic Tape, and 5/8- and 3/4-Inch Magnetic Diskettes*.

## Figuring Withholding

You should figure withholding on gross wages before any deductions for social security and Medicare taxes, pension, union dues, insurance, etc., are made. You can figure the withholding by any of several methods, the most common of which are the **percentage method** and the **wage bracket method**.

Circular E contains the applicable tables and more detailed instructions for using both of these withholding methods.

**Percentage method.** Under the percentage method, figure the income tax to withhold as follows:

- 1) Multiply the dollar amount of one withholding allowance for a payroll period (see Circular E) by the number of allowances claimed on Form W-4 by the employee;
- 2) Subtract that amount from the employee's wages; and
- 3) Figure the amount to be withheld according to the employee's wage level and marital status as listed in the *Tables for Percentage Method of Withholding* in Circular E.

The amount of one withholding allowance for payroll periods of varying lengths and the rates to apply to the taxable wages are given in Circular E.

You can also figure withholding using your employee's yearly wages. To do so, find in the percentage tables the income tax to be withheld from the employee's wages (less withholding allowances) for the year. Then divide this amount by the number of payroll periods in the year. The result is the withholding for each payroll period.

**Wage bracket method.** Under the wage bracket method, use tables based on wage ranges to figure the income tax to be withheld. These tables are reproduced in Circular E. Tables are for weekly, biweekly, semimonthly, monthly, and daily or miscellaneous payroll periods, for both married and unmarried employees.

To figure the income tax to withhold under this method, determine the employee's correct payroll period, marital status, total wage payment, and the number of withholding allowances claimed on Form W-4. Then use the table for the correct payroll period and marital status, and find the amount of tax you must withhold.

**Other methods.** Three alternative methods that usually produce the same result are the **average estimated wages, annualized wages, and cumulative wages methods**. Any alternative method must provide acceptable results over the full range of salary and exemption situations. You cannot use a method that consistently deducts amounts less than those required under the percentage method.

Any method can be used if it produces substantially the same result as the percentage method or the wage bracket method or a result

that falls between these two methods. A result within \$10 of the amount that would be withheld annually under either the percentage or wage bracket method is considered substantially the same.

For more information on alternative methods of figuring income tax withholding, see Circular E and Publication 493.

## Social Security and Medicare Taxes

The Federal Insurance Contributions Act (FICA) provides for a federal system of old-age, survivors, disability, and hospital insurance. The old-age, survivors, and disability insurance part is financed by the social security tax. The hospital insurance part is financed by the Medicare tax. Each of these taxes is reported separately.

Social security and Medicare taxes are levied on both you and your employees (unless you or your employees are not subject to these taxes; see *Family Members, Employees of Exempt Organizations, and Religious Exemptions*, earlier). You, as an employer, must collect and pay the employee's part of the taxes and you must pay a matching amount.

**Tax rates and wage bases.** These taxes have different tax rates and wage bases. The wage base is the maximum wage that is subject to the tax for the year. You can multiply each payment by the tax rate or you can use the tables provided in Circular E. There are no withholding allowances for social security and Medicare taxes.

The tax rate for social security is 6.2% each for employers and employees (12.4% total) and the wage base for 1994 is \$60,600. For 1995, the wage base is \$61,200.

The tax rate for Medicare is 1.45% each for employers and employees (2.9% total). For 1994 and 1995, there is no wage base limit for Medicare tax; all covered wages are subject to Medicare tax.

**Meals and lodging.** Meals, lodging, clothing, services, and other payments in kind are generally subject to the same social security and Medicare taxes as wages paid in cash. However, the value of meals that are exempt from income tax withholding because they are furnished for the employer's convenience and on the employer's premises are also exempt from social security and Medicare taxes. Similarly, lodging that is exempt from income tax withholding because it is furnished for the employer's convenience, on the employer's premises, and as a condition of employment, is also exempt from these taxes. See *Meals and Lodging under Withholding and Reporting Payments Other Than Wages*, earlier, for more information.

**Successor employer.** If you acquire substantially all of the business property of another employer, or a unit of that employer's business, you are considered a successor employer. You can, in determining the wage bases for each of your new employees who worked for the other employer, include the

wages the other employer paid to the employee.

**Example.** Early in 1994, you bought all the assets of a plumbing business from Mr. Martin. Mr. Brown, who had been employed by Mr. Martin and received \$2,000 in wages before the date of purchase, continued to work for you. You and Mr. Brown are subject to social security taxes on the first \$58,600 (\$60,600 less \$2,000) and Medicare taxes on all wages you pay him during the rest of the calendar year.

**Employee's portion of taxes paid by employer.** If you are not a household or agricultural employer and you pay your employee's liability for social security and Medicare taxes without deducting them from the employee's pay, you must include the amount of the payments in the employee's wages for social security, Medicare, and federal unemployment taxes, and income tax withholding. This increase in the employee's wage payment for your payment of the employee's social security and Medicare taxes is also subject to employee social security and Medicare taxes. This again increases the amount of the additional taxes you must pay.

To figure the employee's increased wages in this situation, you divide the stated pay (the amount the employer pays without taking into account the employer's payment of employee social security and Medicare taxes) by a factor for that year. This factor is determined by subtracting the combined employee social security and Medicare tax rate for the year the wages are paid from 1. For 1994, the factor is .9235 (1 — .0765). If the wages are more than \$55,964.10, follow the procedure described under *Stated pay of more than \$55,964.10 in 1994*, later.

**Stated pay of \$55,964.10 or less in 1994.**

For an employee with wages of \$55,964.10 or less in 1994, figure the correct wages (wages plus employer-paid employee taxes) and withholding to report by dividing the wages by .9235. This will give you the social security and Medicare wages to report in boxes 3 and 5 of Form W-2. Also include this amount in box 1.

To figure the correct social security tax to enter in box 4 and Medicare tax to enter in box 6, multiply the amounts in boxes 3 and 5 by the withholding rates for those taxes and enter the results in boxes 4 and 6.

**Example.** Donald Devon hires Lydia Lone for only one week during 1994. He pays her \$200 for that week. Donald agrees to pay Lydia's part of the social security and Medicare taxes. To figure her reportable wages, he divides \$200 by .9235. The result, \$216.57, is the amount reported as wages in boxes 1, 3, and 5 of Form W-2. To figure the amount to report as social security tax, Donald multiplies \$216.57 by the social security tax rate of 6.2% (.062). The result, \$13.43, is entered in box 4 of Form W-2. To figure the amount to report as Medicare tax, Donald multiplies \$216.57 by the Medicare tax rate of 1.45% (.0145). The result, \$3.14, is entered in box 6 of Form W-2. Although he did not actually withhold these amounts from Lydia, he will report these amounts as taxes withheld on Form 941 and is

responsible for matching these amounts as the employer share of these taxes.

For FUTA and income tax withholding, Lydia's weekly wages are \$216.57.

**Stated pay of more than \$55,964.10 in 1994.** For an employee with stated pay of more than \$55,964.10 in 1994, the correct social security wage amount is \$60,600 (the first \$55,964.10 of wages + .9235). The stated wages in excess of \$55,964.10 are not subject to social security tax because the tax only applies to the first \$60,600 of wages (stated pay plus employer-paid employee taxes). Enter \$60,600 in box 3 of Form W-2.

To figure the correct Medicare wages to enter in box 5 of Form W-2, subtract \$55,964.10 from the stated pay. Divide this amount by .9855 and add \$60,600. For example, if stated pay is \$100,000, the correct Medicare wages are figured as follows:

$$\$100,000 - \$55,964.10 = \$44,035.90$$

$$\$44,035.90 \div .9855 = \$44,683.82$$

$$\$44,683.82 + \$60,600 = \$105,283.82$$

The Medicare wages are \$105,283.82. Enter this amount in box 5. The social security tax to enter in box 4 is \$3,757.20 (\$60,600 × .062). The Medicare tax to enter in box 6 is \$1,526.62 (\$105,283.82 × .0145).

Although these employment tax amounts are not actually withheld, the employer reports them as withheld on Form 941, and is responsible for paying equal amounts as the employer's share of the social security and Medicare taxes. If the wages for income tax purposes in the preceding example are the same as for social security and Medicare purposes, the correct wage amount for income tax withholding is \$105,283.82 (\$100,000 + \$3,757.20 + \$1,526.62), which is included in box 1 of Form W-2.

**Household and agricultural employers.**

If you are a household employer in a private home or an agricultural employer, you do not use this procedure. Any employee social security and Medicare tax you pay for an employee is additional income to the employee for income tax purposes. But it is not considered wages for social security, Medicare, and federal unemployment taxes.

**Supplemental unemployment payments.**

Employer provided supplemental unemployment payments are not subject to social security and Medicare taxes if the payments are linked to state unemployment payments. A lump sum payment is not considered linked to state unemployment payments because the amount is not linked to the period of unemployment.

**Back pay under a statute.** Generally, you treat back pay as wages paid in the year actually received. However, if back pay was awarded by a court or government agency to enforce a worker's protection law, special rules apply for filing Forms W-2 with SSA for these payments. See Publication 957, *Reporting Back Pay to the Social Security Administration*, for more information.

**Federal employees.** Federal employees are subject to Medicare taxes. Covered federal employment can be used in determining eligibility for Medicare benefits. Federal employees hired after 1983 are also subject to the social security tax. This coverage counts for figuring social security benefits on the same basis as other covered employment. Certain services performed by penal inmates, medical interns, student nurses, and temporary emergency employment are not covered under either of these provisions.

**Uniformed services.** The pay for services of a member of a uniformed service on active duty or on inactive duty training (generally weekend training and drills) is subject to social security and Medicare taxes.

**State and local government employees.**

State and local government employees can be covered by social security and Medicare under a section 218 agreement (voluntary agreement) entered into by the state and the Secretary of Health and Human Services. The state decides which employees are covered by the voluntary agreement. The wages of an employee covered by the agreement are subject to social security and Medicare taxes.

The wages of **an employee hired after March 31, 1986**, who is not covered under a voluntary agreement are subject to Medicare tax. This does not apply to:

- 1) Individuals hired to relieve unemployment;
- 2) Patients or inmates working in hospitals, homes, or other institutions;
- 3) Temporary workers hired for snow, flood, or similar emergencies;
- 4) Certain student employees of hospitals of the District of Columbia;
- 5) Election officials or workers receiving less than \$100 (\$1,000 after 1994) in a calendar year for such service; and
- 6) Individuals paid on a fee basis who are subject to self-employment tax.

**Wages for services performed after July 1, 1991**, by an employee who is not covered under a voluntary agreement and who is not a member of the retirement system of the state or local government are subject to social security and Medicare taxes. The same exceptions discussed in the previous paragraph apply to these wages.

An employee is considered a member of the retirement system only if that employee actually participates in the program. Therefore, if participation in a retirement system is elective and an employee elects not to participate, that employee's wages are subject to social security and Medicare taxes.

**Group-term life insurance.** Include in wages for income tax, social security, and Medicare purposes, the cost of group-term life insurance you provided to an employee for coverage over \$50,000, or for coverage that discriminated in favor of the employee. This amount is subject to withholding for social security and

Medicare, but not income tax. This taxable insurance cost can be treated as paid by the pay period, by the quarter, or on any basis as long as the cost is treated as paid at least once a year.

**Monthly cost.** You determine the monthly cost of group term life insurance by multiplying the number of thousands of dollars of insurance coverage (figured to the nearest 10th) by the appropriate cost per thousand per month. You determine age on the last day of the tax year. If you provide group term life insurance for a period of coverage of less than one month, you prorate the monthly cost over that period. The monthly cost of each \$1,000 of group-term life insurance protection is as follows:

Age	Cost
Under 30	\$ .08
30 through 34	\$ .09
35 through 39	\$ .11
40 through 44	\$ .17
45 through 49	\$ .29
50 through 54	\$ .48
55 through 59	\$ .75
60 through 64	\$1.17
65 through 69	\$2.10
70 and over	\$3.76

**Plan requirements.** For you to exclude the cost of life insurance benefits from the income of your employees, your plan must meet certain eligibility and nondiscrimination requirements. For more information, see Chapter 5 in Publication 535.

**Former employees.** For coverage of taxable group-term life insurance provided to former employees (including retirees), the former employees must pay the employee's share of social security and Medicare taxes with their income tax returns. The employer must separately include on the Form W-2 the portion of wages that consists of payments for group-term life insurance and the amount of social security and Medicare taxes owed by the former employee for coverage provided after separation from service.

**Sick pay.** Employers and third-party payers, such as insurance companies, must withhold employee social security and Medicare taxes and pay employer social security and Medicare taxes on most sick pay payments. In general, sick pay is any amount paid by an employer to an employee because of the employee's sickness or injury.

Third-party sick pay is any amount paid by a third party to an employee in place of wages for any period the employee is absent due to sickness or injury. Liability for paying the employer portion of social security and Medicare taxes, however, shifts from the third party to the employer for whom the employee normally works if the third party notifies the employer, within the time required for a tax deposit, of the amount of the sick pay payment. For more information, see Publication 952.

The following kinds of payments are not subject to social security and Medicare taxes:

- 1) Payments made more than 6 months after the last calendar month the employee worked.
- 2) Payments received under workers' compensation law.
- 3) Payments, or parts of payments, attributable to the employee's contribution to a sick pay plan.
- 4) Payments made for medical care.
- 5) Payments (generally for injury) not related to absence from work.
- 6) Most payments made to a state or local government employee. The third-party payer should contact the state or local government employer for instructions.

**Deferred compensation arrangements.**

Employer contributions to a cash or deferred compensation arrangement that is part of a qualified profit-sharing or stock bonus plan are included in social security and Medicare wages even though they may not be included in the gross incomes of the employees.

An amount deferred under a nonqualified deferred compensation plan is treated as social security and Medicare wages when the services are performed or when the employee no longer has any substantial risk of forfeiting the right to the deferred compensation, whichever is later.

**Tax sheltered annuities.** Employer payments made by an educational institution or a tax-exempt organization to purchase a tax-sheltered annuity for an employee are included in the employee's social security and Medicare wages if the payments are made because of a salary reduction agreement.

**Common paymaster.** If two or more related corporations employ the same individual at the same time and pay this individual through a common paymaster, which is one of the corporations, the corporations are considered a single employer. They have to pay, in total, no more in social security and Medicare taxes than a single employer would.

Each corporation must pay its own part of the employment taxes and may deduct only its own part of the wages. The deductions will not be allowed unless the corporation reimburses the common paymaster for the wage and tax payments.

**International social security agreements.**

The United States has social security agreements with many countries to eliminate dual taxation and coverage under two social security systems. Under these agreements, you must generally pay social security taxes only to the country you live in. Employees and employers who are subject only to foreign social security taxes under these agreements are exempt from U.S. social security taxes including the Medicare portion.

The United States now has social security agreements with the following countries: Austria, Belgium, Canada, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden,

Switzerland, and the United Kingdom. Additional agreements are expected in the future. For more information, contact:

Social Security Administration  
Office of International Policy  
P.O. Box 17741  
Baltimore, MD 21235

**Paying Social Security, Medicare, and Withheld Income Taxes**

Social security and Medicare taxes and withheld income tax are reported and paid together. The following sections discuss some rules that apply equally to both types of taxes.

**Liability for Tax Withheld**

You are required by law to deduct and withhold income, social security, and Medicare taxes from the salaries and wages of your employees. You are liable for the payment of these taxes to the federal government whether or not you collect them from your employees. If, for example, you deduct less than the correct tax from your employees' wages, you are still liable for the full amount.

**Liability of third parties.** Any lender, surety, or other third party who pays wages directly to the employees of an employer, or to the employee's agent, is responsible for any required withholding on those wages. This includes the withholding of income, social security, Medicare, and railroad retirement taxes. The third party is also liable for any interest and penalties accruing on these accounts.

If a third party supplies funds to an employer so that the employer can pay the employees' wages, and if the third party knows that the employer will not pay or deposit the taxes that are required to be withheld when due, then the third party must pay the taxes withheld from the employee's wages but not paid by the employer. However, the third party does not have to pay more than 25% of the amount that is specifically supplied for paying wages. The third party supplier must also pay interest on the taxes if they are paid after the due date of the employer's return.

Third parties are liable only for payment of the employees' part of payroll taxes. They are not liable for the employer's part. The employer must file an employment tax return for wages that he or she or a third party pays and must furnish statements to employees of wages paid and taxes withheld. The employer also remains liable for any withholding taxes not paid by the third party.

**Liability of trustee in bankruptcy.** A trustee in bankruptcy must withhold, report, and pay income, social security, and Medicare taxes from the payment of priority claims for employee's wages earned prior to, but unpaid at the time of, an employer's bankruptcy.

**How to pay withheld tax.** Third parties who pay employment taxes must file two copies of Form 4219, *Statement of Liability of Lender,*



*Surety, or Other Person for Withholding Taxes.* A separate set of forms must be filed for each employer and calendar quarter.

Form 4219 must be filed with the IRS Service Center where the employer for whom wages were paid, or funds were supplied, files federal employment tax returns.

Each Form 4219 should be accompanied by a check or money order made out to the Internal Revenue Service. To avoid interest, full payment should be made on or before the due date of the employer's federal employment tax return.

## Tax Returns

Generally, social security and Medicare taxes and withheld income tax are reported together on **Form 941**. However, there are two exceptions:

- 1) If your employees are agricultural workers, use **Form 943**.
- 2) If your employees work in your home rather than in your business—for example, to do child care, housekeeping, or gardening work—after 1994, combine these taxes with your personal income tax you report on **Form 1040**.

**When to file returns.** Form 943 is an annual return due one month after the calendar year ends. The other forms are quarterly returns due one month after the end of each calendar quarter. The periods covered by these forms are the same whether you use a fiscal year or the calendar year as your tax year. The due dates are given below:

<u>Return and Period</u>	<u>Due Date</u>
Form 943: Calendar year	January 31
Form 941:	
1st quarter: January–February–March	April 30
2nd quarter: April–May–June	July 31
3rd quarter: July–August–September	October 31
4th quarter: October–November–December	January 31

However, if you must deposit the tax (see the following discussion) and you deposit it on time and in full, you have an extra 10 days to file the return:

<u>Return and Period</u>	<u>Due Date</u>
Form 943: Calendar year	February 10
Form 941:	
1st quarter: January–February–March	May 10
2nd quarter: April–May–June	August 10
3rd quarter: July–August–September	November 10
4th quarter: October–November–December	February 10

If a due date falls on a Saturday, Sunday, or legal holiday, it is postponed until the next day that is not a Saturday, Sunday, or legal holiday. A statewide legal holiday delays a due

date only if the IRS office where you are required to file is located in that state. A return postmarked by the U.S. Post Office by the due date is considered filed on time.

**Seasonal or intermittent employers.** If you are a seasonal or intermittent employer, you do not have to file Form 941 when you have paid no wages during a quarter. However, you must check the seasonal filer box on each return you file so the IRS will not expect a return each quarter.

**Paying the tax.** When you pay social security, Medicare, and withheld income taxes—whether through deposits or with your return—you should write the following information on your check or money order:

- 1) Your employer identification number;
- 2) The type of tax you are paying; and
- 3) The period covered by the payment.

## Deposits

You will generally have to make deposits of social security and Medicare taxes and withheld income taxes before the return is due. You must deposit both your part and your employees' part of social security and Medicare taxes.

**Figuring deposits.** Each return period is divided into a number of shorter deposit periods. Whether or not you must make a deposit depends on whether, based on your lookback period, discussed next, you are a monthly or semiweekly depositor, and on your tax liability at the end of the deposit period. Voluntary early deposits during a deposit period do not affect the determination of the tax liability for that period.

To determine if a deposit is required and the amount of the deposit, reduce your tax liability by the amount of any advance earned income credit payments (discussed later) you made to your employees.

**Deposit rules.** You must use these rules for wages paid after December 31, 1993. If you file Form 943, see Circular A.

Under the deposit rules, if your accumulated undeposited Form 941 taxes do not exceed \$100,000 on any day during the year, you will know from your tax liability in your *lookback period*, discussed below, what your deposit dates will be for the entire year.

**Lookback period.** To find your deposit requirements for a calendar year, you look back to your Form 941 tax liabilities during a lookback period, which is the 12-month period ending the preceding June 30. Adjustments made on a supplemental tax return are included only in the quarter the adjustments are reported. The lookback period for 1995 is the period July 1, 1993, to June 30, 1994. If you are a new employer, you are treated as having no tax liabilities during the quarters you had no employees.

Under the deposit rules, you are either a monthly depositor or a semiweekly depositor. The IRS will send you a notice each November to confirm, based on your lookback period,

whether you are a monthly depositor or a semiweekly depositor.

In addition to the rules based on the lookback period, there is a one-day rule for accumulated taxes of \$100,000 or more and a *de minimis* rule for accumulated taxes of less than \$500.

### • **Monthly depositor.**

You are a monthly depositor for a calendar year if the total amount of reported taxes for the lookback period is not more than \$50,000. Deposit the taxes accumulated on paydays during each month of a quarter by the 15th day of the following month.

### • **Semiweekly depositor.**

You are a semiweekly depositor for a calendar year if the total amount of accumulated taxes for the lookback period is more than \$50,000.

Deposit taxes accumulated for Wednesday, Thursday, and/or Friday paydays during each week of a quarter by the following Wednesday, and

Deposit taxes accumulated for Saturday, Sunday, Monday, and/or Tuesday paydays during each week of a quarter by the following Friday.

### • **One-day rule.**

If the amount of your accumulated Form 941 taxes is \$100,000 or more on any day during a deposit period, either monthly or semiweekly, deposit the taxes on the next banking day. If you are a monthly depositor, you become a semiweekly depositor for the remainder of the calendar year and the following calendar year.

### • **De minimis rule.**

If the amount of your accumulated taxes for the quarter is less than \$500, you may deposit the taxes by the due date of the return or pay them with your timely filed Form 941. If the amount for the quarter will be \$500 or more (or you are unsure that it will be less than \$500), you must follow the regular deposit rules (semiweekly or monthly) that apply to you.

**Semiweekly period in two calendar quarters.** If a calendar quarter ends on a day other than a Tuesday or Friday, taxes you accumulated during the days covered by the two calendar quarters must be deposited with two deposit coupons.

For example, if you are a semiweekly depositor and accumulate taxes on Saturday, September 30, 1995, and on Tuesday, October 3, 1995, you will need to make two separate deposits, even though they are part of the same semiweekly deposit period.

**Special rule for semiweekly depositors.** If there are fewer than three banking days to make a deposit, a minimum of three days are allowed to make the deposit if you are not subject to the \$100,000 one-day rule.

**New employer.** If you are a new employer, you will be treated as a monthly depositor until you have a liability of more than \$50,000 for a July 1–June 30 lookback period,

or you fall under the *One-day rule*, discussed earlier.

**Safe harbors.** You will meet the deposit requirements if any deposit shortfall does not exceed the greater of (1) \$100, or (2) 2% of the amount of taxes otherwise required to be deposited, and you deposit the shortfall as follows.

- **Monthly depositor.**  
Deposit the shortfall by the due date of Form 941 or mail it with the return.
- **Semiweekly or one-day depositor.**  
Deposit the shortfall by the earlier of the Form 941 due date covering that deposit, or the first Wednesday or Friday, whichever is earlier, on or after the 15th day of the month following the month the deposit was required to be made.

**Penalty.** If this safe-harbor rule is not satisfied, a failure-to-deposit penalty may apply. See *Penalties*, later.

**Tax calendar.** If you would like a calendar that lists the various due dates on which employers must file returns and make deposits, see Publication 509, *Tax Calendars for 1995*.

**How to make deposits.** Make your deposit by mailing or delivering a single check or money order covering social security, Medicare, and withheld income taxes to an authorized financial institution or a Federal Reserve bank. Each deposit must be accompanied by a federal tax deposit (FTD) coupon. The federal unemployment tax, explained later, must be paid separately. To ensure that your deposit is properly credited to your account, write your employer identification number, the tax return number, and the tax period the deposit applies to on your check or money order. You can get the names of authorized institutions from a Federal Reserve bank. To be on time, mailed deposits must arrive at the depository by the due date. It is very important to clearly mark the correct type of tax and tax period on each deposit coupon. This information is used by the IRS to credit your account.

A Federal Tax Deposit Coupon Book containing a supply of **Form 8109, Federal Tax Deposit Coupon**, and instructions will automatically be sent to you after you apply for an employer identification number.

You will continue to receive coupon books automatically and generally will not need to reorder.

To change your mailing address for the FTD coupons, use **Form 8109C, FTD Address Change**. This will not change your address for other account matters with the IRS. You may continue to use the old coupons until you receive a book with the new address.

If you need to make a deposit and do not have a coupon, contact your local IRS office and provide the following information:

- Business name,
- Address where you want the coupon books sent,
- Number of coupon books, and
- Employer identification number.

If you have not received your employer identification number and must make a deposit, mail your payment with an explanation to the IRS Service Center where you file your return. Make your check payable to the Internal Revenue Service and show on it your name, address, kind of tax, period covered, and the date you applied for your employer identification number.

If you have an EIN but have not yet received your supply of preprinted coupons, you can use Form 8109-B to make a deposit. This form is available from most IRS offices. Do not use Form 8109-B if you have preprinted Form 8109 available.

**Note.** Do not use a Federal Tax Deposit Coupon to deposit delinquent taxes you have been assessed by the IRS. These payments should be mailed to the IRS Service Center that assessed the taxes together with copies of any related notices. Also, do not mail estimated tax payments for your own income tax return with social security, Medicare, and withheld income taxes.

**Timeliness of deposits.** The timeliness of a deposit depends on the date the authorized financial institution or Federal Reserve bank receives it. A deposit received after the due date will be considered timely if you can establish that it was mailed at least two days before the due date. However, deposits of \$20,000 or more by an employer required to deposit tax more than once a month must be received by the due date to be timely.

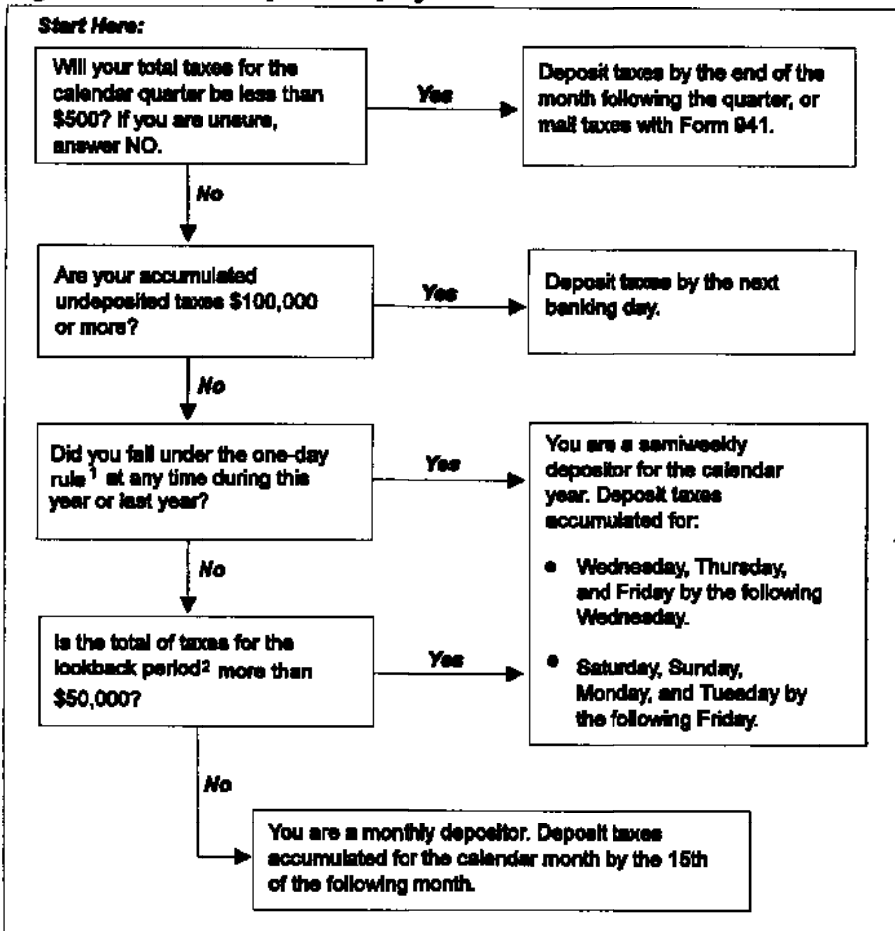
**Penalties.** If you do not deposit social security, Medicare, and withheld income taxes on time with an authorized financial institution or a Federal Reserve bank, you may have to pay a penalty. In addition, the IRS can require you to file monthly returns for these taxes on Form 941-M, *Employer's Monthly Federal Tax Return*.

The penalty will not apply if the failure to meet the deposit requirements was due to reasonable cause and not to willful neglect.

**Federal tax deposit penalties.** The penalty for a late tax deposit is based on the length of time the deposit is late. The following penalties apply for late deposits:

- 1) If the deposit is not more than 5 days late, the penalty is 2% of the underpayment.

**Figure A. When to Deposit Employment Taxes**



<sup>1</sup> You fall under the one-day rule if your accumulated undeposited "Form 941" taxes are \$100,000 or more on any day during the semiweekly or monthly deposit period.

<sup>2</sup> See the discussion under *Lookback period*.

- 2) If the deposit is more than 5 days late but not more than 15 days late, the penalty is 5% of the underpayment.
- 3) If the deposit is more than 15 days late, the penalty is 10% of the underpayment.
- 4) If the deposit is not made within 10 days after the IRS issues the first notice demanding payment or by the day that notice and demand for immediate payment is given, the penalty is 15% of the underpayment.

**Trust fund recovery penalty.** If you are a person responsible for withholding, accounting for, or depositing or paying withholding taxes and willfully fail to do so, you can be held liable for a penalty equal to the tax not paid, plus interest. A responsible person can be an officer of a corporation, a partner, a sole proprietor, or an employee of any form of business. A trustee or agent with authority over the funds of the business can also be held responsible for the penalty.

“Willfully” in this case means voluntarily, consciously, and intentionally. Paying other expenses of the business instead of the taxes due is considered to be acting willfully. If you are the person responsible for the collection and payment of withholding taxes, you can be subject to this penalty even if you are an officer or employee of a corporation or a member or employee of a partnership.

**Criminal penalties.** Be sure to follow all the tax laws that apply to you. In addition to civil penalties, criminal penalties may be imposed for intentionally not paying taxes, not filing returns, or filing false returns.

## Other Forms

**Form W-2.** You must furnish copies of Form W-2 to each employee from whom income, social security, or Medicare taxes have been withheld. (Sole proprietors do not report their own income on Forms 941 and W-2.) You must also furnish it to employees from whom income tax would have been withheld if the employee had claimed no more than one withholding allowance or had not claimed exemption from withholding on Form W-4. The Form W-2 must show the total wages and other compensation paid (whether or not subject to withholding), total wages subject to social security taxes, total wages subject to Medicare taxes, the amounts deducted for income, social security, and Medicare taxes, and any other information required on the statement. For information on preparing Form W-2, see the *Instructions for Forms W-2*.

Show any reportable employment-related payments to employees on Form W-2. This includes payments such as wages, bonuses, allowances, noncash payments, and taxable fringe benefits. Do **not** report any compensation to employees on Form 1099-MISC or any other information return. For information on how to report other payments, see *Information Returns*, later.

Form W-2 is a six-part combined federal-state form designed for use by employers in states where both federal and state taxes must

be withheld. This form may also be used where city or other subdivision taxes are withheld. It is printed in sets of six copies so that copies are available for filing and for the employee's records.

Furnish Form W-2 to employees as soon after December 31 as possible, so they may file their income tax returns early. In any event, you **must** furnish the employee Form W-2 no later than January 31 of the following year. However, when an employee who leaves your employment gives you a written request for the form earlier, you must give it to him or her within 30 days after you receive the request or, if later, 30 days after the final wage payment, if the 30-day period ends before January 31. You should keep any undeliverable employee copies (copies B and C) of Form W-2 as a part of your records for a period of 4 years.

**Ministers.** If your employee is an ordained minister, report all taxable compensation as wages on Form W-2. Include in this amount expense allowances or reimbursements paid under a nonaccountable plan, discussed under *Nonaccountable plan*, earlier. Do not include a parsonage allowance (excludable housing allowance) in this amount. You may report a parsonage allowance (housing allowance), including any allowances for utilities and the rental value of housing provided, in a separate statement or as “Other” in box 14 on Form W-2. Do not show any amount as social security or Medicare wages, or any withholding for social security or Medicare. If you withheld tax from the minister under a voluntary agreement, this amount should be shown as income tax withholding. For more information on ministers, see Publication 517.

**Form W-3.** Employers must file Form W-3, *Transmittal of Income and Tax Statements*, annually by the last day of February to transmit Copy A of Forms W-2 to the SSA. Form W-2 will be processed by the SSA, which will then furnish the IRS with the income tax data that it needs from these forms. You must file 1994 Forms W-2 on magnetic media if you file 250 or more forms. The 250 requirement applies separately to each type of form.

**Additional forms.** Forms W-2 and W-3 are available from the IRS.

**Extensions.** If you are unable to file Forms W-2 with the IRS on either paper forms or magnetic media by the due date, get **Form 8809, Request for Extension of Time To File Information Returns**. You must, however, furnish the required statements to recipients by the due date.

**Reconciliation of Forms 941 and W-3.** Amounts reported for the current calendar year on the 4 quarterly Forms 941 must agree with the totals reported on Form W-3. The amounts that must agree are: social security wages, social security tips, Medicare wages and tips, and the advance earned income credit.

**Correcting Forms 941 and W-2.** Use **Form 941c, Statement To Correct Information**, to

correct income, social security, and Medicare tax information reported on Form 941 (or Form 943). Attach Form 941c to the tax return making the adjustment. Social security and Medicare tax information can be corrected for prior years, but income tax information can be corrected only for earlier periods of the current calendar year.

Because Form W-2 is used by the Social Security Administration to post the employee's social security and Medicare wages and tips to his or her earnings record, you must file **Form W-2c, Statement of Corrected Income and Tax Amounts**, with SSA and give copies to the employee for any social security or Medicare correction made after you have filed Form W-2 with SSA. Send Form W-2c to SSA with **Form W-3c, Transmittal of Corrected Income and Tax Statements**. If you are correcting only the employees' names and social security numbers, Form W-3c is not needed.

**Change of address.** If you move or change your mailing address, be sure to notify the IRS by using **Form 8822, Change of Address**. Mail it to the Internal Revenue Service Center for your old address.

## Federal Unemployment Tax

The **Federal Unemployment Tax Act (FUTA)**, along with the state systems, provides unemployment payments to workers who have lost their jobs. This tax applies to all wages you pay to your employees, unless an exemption applies. Most employers pay both a state and federal unemployment tax. However, even if you are exempt from state tax, you may still have to pay the federal tax. See *Payments Subject to FUTA*, later.

**Note:** This publication discusses only the federal unemployment tax. For information on state unemployment tax, contact your state unemployment tax office.

Use the following three tests to determine whether you must pay federal unemployment (FUTA) tax. Each test applies to a different category of employee, and each is independent of the others. It is possible to be liable for the tax in one category, but not in another. If a test describes your situation, you are subject to federal unemployment tax on the wages you pay to employees in that category during the current calendar year.

- 1) **In general.** You are subject to federal unemployment tax on the wages you pay employees who are not farm workers or household workers if in the current or preceding calendar year:
  - a) The wages you paid to employees in this category totaled \$1,500 or more in any calendar quarter, or
  - b) In each of 20 different calendar weeks, there was at least a part of a day in which you had an employee in this category. The 20 weeks do not have to be consecutive. Nor does it have to be the same employee each week. Individuals

on sick leave or vacations are counted as employees.

- 2) **Household workers.** You are subject to federal unemployment tax on the cash wages you pay to household workers if the wages you paid to employees in this category totaled \$1,000 or more in any calendar quarter of the current or preceding year. A household worker is an employee who performs domestic services in a private home, local college club, or local fraternity or sorority chapter.
- 3) **Farm workers.** You are subject to federal unemployment tax on the wages you pay to farm workers if in the current or preceding calendar year:
  - a) The cash wages you paid for the farm labor totaled \$20,000 or more in any calendar quarter, or
  - b) In each of 20 different calendar weeks in the current or preceding calendar year, there was at least one day in which you had 10 or more farm worker employees. The 20 weeks do not have to be consecutive. Nor does it have to be the same 10 employees each week. Nor do all 10 employees have to work a full day or the same part of the day. Individuals on sick leave or vacation are counted as employees.

## Payments Subject to FUTA

**Tips.** All tip income (including credit card tips) reported by the employee to the employer for social security and Medicare tax purposes is considered wages for federal unemployment tax purposes.

**Wages not paid in money.** If in the course of your trade or business you pay your employees in some medium that is neither cash nor a readily negotiable instrument (such as a check), you are said to pay them "in kind." Payments in kind may be in the form of goods, lodging, food, clothing, or services. Generally, wages paid in kind are treated as wages paid in money. The value of a wage payment in kind is the fair market value it would have on the day it is made. The value of **meals and lodging** you provide to employees is not subject to federal unemployment tax if the meals and lodging meet the tests for exemption from income tax withholding. See *Meals and lodging, under Withholding and Reporting Payments Other Than Wages*, earlier.

Payments in kind for farm labor are not considered wages. Do not count them either to figure whether you are subject to federal unemployment tax under test (3) above or to figure how much tax you owe. Also do not count payments in kind to household workers when figuring whether you are subject to federal unemployment tax under test (2) above.

**Employee liability for taxes paid by employer.** Generally, if you pay an employee's liability for any state unemployment taxes or social security or Medicare taxes (without

deduction from the employee's pay), include the payments in the employee's wages for purposes of the federal unemployment tax. This rule does not apply to payments for domestic service in your home or for agricultural labor. See *Employee's portion of taxes paid by employer, under Social Security and Medicare Taxes*, earlier.

### Supplemental unemployment payments.

The federal unemployment tax does not apply to employer provided supplemental unemployment payments if the payments are linked to state unemployment payments and are not made in a lump sum.

**Wages of foreign workers.** The federal unemployment tax does not apply to the wages of a worker admitted to the United States under contract to perform farm labor for you before 1995 and who returns to his or her own country when the contract is completed. However, count the wages you pay to an alien worker in figuring whether you are subject to federal unemployment tax for your other farm workers under rule (3) above.

**Wages paid by crew leaders.** To obtain farm labor, some farmers use the services of, or employ, individuals called "crew leaders." A crew leader is defined as anyone who:

- 1) Furnishes workers to perform farm labor;
- 2) Pays the workers (either on his or her own behalf or on behalf of the farmer) for the work they do; and
- 3) Has not entered into a written agreement with the farmer under which he or she is designated as an employee of the farmer.

Depending on the circumstances, workers furnished by a crew leader may be considered employees of the crew leader or employees of the farmer for federal unemployment tax.

The crew leader is considered the employer of the workers if:

- 1) He or she is registered under the Migrant and Seasonal Agricultural Worker Protection Act, or
- 2) Substantially all crew members operate or maintain mechanized equipment provided by the crew leader as part of the service to the farmer.

The farmer is considered the employer of the workers in all other situations. The farmer is also considered the employer of workers furnished by a registered crew leader if the workers are employees of the farmer under the common-law test. For example, some farmers employ crew leaders to recruit farm workers exclusively for them. Although these crew leaders may be required to register under the Migrant and Seasonal Agricultural Worker Protection Act, the workers are hired directly by the farmer. The farmer is considered to be the employer in these cases.

**Payments to survivor or estate.** Payments made by an employer to a survivor or the estate of a former employee after the calendar

year in which the employee died are not subject to federal unemployment tax.

**Camp counselor.** Wages paid by certain camps to employees who are full-time students are exempt from federal unemployment tax. The students must have worked for the camp less than 13 weeks in the calendar year.

To qualify, the camp must have operated 7 months or less in the current calendar year and 7 months or less in the preceding calendar year, or had gross receipts for any 6 months in the preceding calendar year which were 1/3 or less of its average gross receipts for the other 6 months in the preceding year.

**Employer plans.** Payments you make to employees or their dependents under a written plan, fund, or insurance policy, providing benefits to employees for their retirement, sickness, disability, medical care, or for the death of an employee, are not subject to federal unemployment tax.

**Additional information.** The tax does not apply to certain types of employment. For example, if you hire cooperative education students, you are not subject to the federal unemployment tax on their wages. See Circular E (Circular A for farm labor) for a chart showing different kinds of employment and whether the wage payments are exempt from federal unemployment tax.

## Figuring the Tax

The federal unemployment tax is figured on the first \$7,000 in wages paid to each employee during 1994. This \$7,000 maximum remains the same for 1995. The tax is imposed on you as the employer. You must not collect it or deduct it from the wages of your employees.

**Example.** In November 1993, you hire Alice Green and pay her \$3,500 in wages before the year ends. All \$3,500 is subject to the federal unemployment tax. The first \$7,000 you pay her in 1994 is also subject to the tax. Her total wages for 1994 reach the \$7,000 mark in mid-March. The wages you pay her after that in 1994 are not subject to the tax. Then, in July, she quits her job, and you hire someone to replace her. The first \$7,000 you pay her replacement in 1994 is also subject to the tax.

**Tax rate and credit.** The federal unemployment tax rate for 1994 and 1995 is 6.2%. However, you are given a credit of up to 5.4% for the state unemployment tax you pay. The tax rate, therefore, can be as low as 0.8% (6.2% minus 5.4%) if your state is not subject to a credit reduction. If your state tax rate (experience rate) is less than 5.4%, you are still allowed the full 5.4% credit. But you cannot take the credit for any state taxes you do not pay. If for any reason you are exempt from state unemployment tax, the full 6.2% rate applies.

**Credit reduction.** The 5.4% credit may be reduced for employers in some states. A credit reduction is required if a state's unemployment fund borrows from the federal government and keeps an outstanding balance for two or more

years. For 1994, no state is subject to a credit reduction.

**Successor employer.** If you acquire substantially all the business property of an employer who was subject to the federal unemployment tax and use that property in your business, you are considered a successor employer. You may, in figuring the \$7,000 limit, count wages paid by that employer to employees who continue to work for you.

**Concurrent employment by related corporations.** If two or more related corporations employ the same individual at the same time and they pay this individual through only one of the corporations (the “**common paymaster**”), the corporations are considered a single employer. They have to pay, in total, no more in federal unemployment taxes than a single employer would pay.

Each corporation must pay its own share of employment taxes and may deduct only its own share of the wages paid.

To take the deduction, the corporation must reimburse the common paymaster for its share of wages and tax payments. The common paymaster cannot deduct wage and tax payments for employee services performed for another corporation in the related group.

## Reporting and Paying the Tax

The federal unemployment tax is reported on **Form 940**. This form covers one calendar year and is generally due one month after the year ends. However, you may have to make deposits of the tax before filing the return.

**Form 940-EZ.** You can use Form 940-EZ, a simplified version of Form 940, if: (1) you paid state unemployment taxes to only one state; (2) you paid all the state unemployment taxes by the due date of Form 940 or Form 940-EZ; (3) all wages taxable for FUTA tax were also taxable for state unemployment tax; and (4) you paid no wages subject to the unemployment compensation laws of a credit reduction state.

**Deposit due dates.** If at the end of any calendar quarter, you owe, but have not yet deposited, more than \$100 in federal unemployment tax for the year, you must make a deposit by the end of the next month. The due dates are shown on the following chart:

If your undeposited FUTA tax is more than \$100 on:	Deposit the full amount by:
March 31 .....	April 30
June 30 .....	July 31
September 30 .....	October 31
December 31 .....	January 31

If the tax is \$100 or less at the end of a quarter, you do not have to deposit it. But you must add it to the tax for the next quarter. Then, in the next quarter, if the total undeposited tax is more than \$100, a deposit will be required. If the undeposited tax for the 4th quarter (plus any undeposited tax for an earlier quarter) is less than \$100, you can either make

a deposit or pay it with your return by the January 31 due date. If you mail the tax payment with your return, complete the Payment Voucher on the return, but do **not** detach it. Mail the return with the payment to the address shown for “Return with payment” in the instructions.

If a due date falls on a Saturday, Sunday, or legal holiday, it is postponed until the next day that is not a Saturday, Sunday, or legal holiday. A statewide legal holiday delays a due date only if the IRS office where you are required to file is located in that state.

**Figuring deposits for a quarter.** To figure whether you must make a deposit for a quarter, assume that you will be able to take the full credit of 5.4%, that is, use an effective tax rate of 0.8% (6.2% — 5.4%). Next, figure what part of the wages you paid during the quarter is subject to the tax. Multiply that amount by 0.8% (.008). The result is the amount of federal unemployment tax you owe for the quarter.

**Additional liability because of credit reduction.** If your state is subject to a credit reduction for 1995, the state’s name and the amount of the credit reduction will be shown on the 1995 Form 940. If the 5.4% credit for 1995 is reduced for employers in your state, it creates an additional 4th quarter liability. Before the 4th quarter, you are not liable for depositing any tax owed because of a credit reduction. The credit reduction becomes final on November 10 each year. To figure the amount of federal unemployment tax you owe for the 4th quarter of 1995, whether or not your state is subject to a credit reduction, follow the Form 940 instructions.

**Making deposits.** For the proper way to make deposits of FUTA tax, see *How to make deposits under Paying Social Security, Medicare, and Withheld Income Taxes* and its discussion, *Deposits*, earlier.

**Filing the return.** If you deposit the tax on time and in full, you have an extra 10 days beyond the January 31 due date, or until February 10, to file Form 940 or Form 940-EZ.

**Additional information.** More information about the federal unemployment tax can be found in the instructions to Form 940.

## Advance Payment of Earned Income Credit

You must pay part of the earned income credit (EIC) in advance to eligible employees who have filed a Form W-5, *Earned Income Credit Advance Payment Certificate*, for 1995 with you. If an employee does not file a Form W-5, he or she cannot receive any advance payment. Any eligible employee who chooses not to get advance payment of the EIC will still get full benefit of the EIC on his or her tax return.

**Employees not eligible.** Employees whose wages are not subject to withholding for income tax, social security, or Medicare, are not eligible to receive advance EIC payments.

**Earned income credit notification.** You must notify each employee who worked for you at any time during the year and from whom you did not withhold any income tax about the EIC. However, you do not have to notify employees who claim exemption from withholding on Form W-4.

You can meet the notification requirement by giving each employee the official IRS Form W-2, which contains the notification on the back of Copy C, or you can give each employee Notice 797, *Possible Federal Tax Refund Due to the Earned Income Credit (EIC)*. You can also use your own written statement as long as it has the exact wording of Notice 797, or you can furnish substitute Forms W-2, containing the exact wording shown on the back of Copy C of the official Form W-2. You must so notify each employee, either in person or by First Class Mail, with his or her Form W-2, or within one week before or after that time, unless you use a substitute Form W-2 as the notice. If you do not furnish Form W-2 on time, you must notify the employee about the EIC by the date Form W-2 was required to be furnished. If Form W-2 is not required, you must notify the employee about the EIC by February 7 of the following year.

You can request supplies of Notice 797 by calling the IRS toll-free telephone number 1-800-TAX-FORM (1-800-829-3676).

**Eligible employee.** To receive advance payment of part of the EIC for 1995, your employee must first expect to be eligible for the EIC by meeting all of the following requirements.

- 1) The employee must have a qualifying child (defined below) living with him or her for more than half the tax year. Temporary absences, such as school or vacation, count as time in the home. The home must be in the United States. The requirement for an eligible foster child is a full year.
- 2) The employee’s earned income and adjusted gross income must both be less than \$24,396 in 1995. Do not continue advance payments to an employee once the employee’s wages reach this limit in 1995.
- 3) The employee must not claim the foreign earned income or housing expense exclusion, or the foreign housing expense deduction.
- 4) The employee, if married, must not file as married filing separately. He or she must file a joint return or qualify to file as head of household.
- 5) If the qualifying child is married, the employee generally must be able to claim the child as a dependent. An exception applies if the employee released the exemption to the other parent in writing, or if the exemption is granted to the child’s other parent by a pre-1985 separation agreement or divorce decree. This rule also applies if the employee files a joint return with his or her present spouse.

**Qualifying child.** A qualifying child is the employee's son, daughter, adopted child, or their descendants (i.e., grandchildren). It also includes a stepchild or foster child. The child must be under age 19, a full-time student under age 24, or permanently and totally disabled. The child must have a social security number if the child is age 1 or older. For more information on requirements for claiming the credit, see Publication 596, *Earned Income Credit*.

**Form W-5.** The employee must file Form W-5 with you before any advance EIC payment can be made. On Form W-5, the employee certifies that he or she expects to be eligible for the EIC, has one or more qualifying children, has no other certificate in effect with any other current employer, and whether the employee's spouse has a Form W-5 in effect. Once filed, it will stay in effect for one calendar year, unless it is revoked by the employee or another Form W-5 is filed to replace it. Employees must file a new Form W-5 each year.

On the Form W-5, the employee must show if his or her spouse has a Form W-5 in effect for the year with the spouse's employer. If your employee's spouse has one in effect, the maximum amount of the advance payments you can make to your employee will be reduced.

If after giving you a signed Form W-5, the employee later becomes ineligible for the EIC or the employee's spouse files a Form W-5, the employee must either revoke the previously filed form or file a new one within 10 days. If your employee gives you a Form W-5 certifying that his or her spouse has a Form W-5 in effect, and later the spouse revokes his or her form, your employee may file a new one showing the change. But he or she is not required to do so.

**Effective date.** The first Form W-5 filed by an employee each year becomes effective for the first payroll period ending on or after the day the form is received. If wage payments are made without regard to a payroll period, it becomes effective for the first payment on or after the day the form is filed. If a revised Form W-5 is filed, it takes effect on:

- 1) The day the first payment of wages is made on or after the first status determination date (January 1, May 1, July 1, or October 1) that occurs at least 30 days after the form is received; or
- 2) The day any wages are paid that is on or after the day the form is received, if you so choose.

**Figuring the payment.** To figure the amount of advance payment, take into account the wages paid, including reported tips, as well as whether your married employee's spouse has a Form W-5 in effect.

Wages for the advance EIC payment are generally the same as wages subject to income tax withholding. For employees who claim exemption from income tax withholding on Form W-4, the wages for advance EIC payments are those that would have been subject

to income tax withholding. For domestic employees, the wages for advance EIC payments are the same as wages subject to social security and Medicare taxes.

After considering these factors, you can figure the amount to include in the eligible employee's wage payments by using the tables contained in Circular E. The advance EIC payment does not change the amount of income or social security and Medicare taxes that you withhold from your employee's wages. The advance EIC payment you make is treated as if you paid the IRS on the day you paid that amount to your employee. The payment would normally be paid to the IRS through federal tax deposits or with your employment tax return. The advance EIC payment you make to your employee is not considered compensation for services and is not subject to payroll taxes.

You generally will make the advance EIC payment from withheld income, social security, and Medicare taxes (both the employee's and your share). If for any payroll period the advance EIC payments are more than the total withheld income, social security, and Medicare taxes (both the employee's and your share), you can:

- 1) Lower each advance EIC payment proportionately. Each payment is reduced by an amount with the same ratio to the excess as the payment has to total advance EIC payments for the payroll period; or
- 2) Elect to make full payment of the advance EIC amount and have the full amounts treated as an advance payment of your tax liability. See *Election to treat excess amounts as advance tax payment*, next.

**Election to treat excess amounts as advance tax payment.** If the advance EIC payments you will make are more than the total income tax withholding and social security taxes due for the period, you can elect not to lower the advance payment but to pay in full all advance EIC amounts for the payroll period. If you elect to make full payment, you must state on your employment tax return (Form 941 or Form 943) the amount of excess advance amounts paid and the payroll period to which the excess relates. If this is not done, you must proportionately lower each advance EIC payment.

You can make this election for each separate payroll period. When this election is made, the excess advance amounts you paid are treated as an advance payment of your employment taxes (income tax withholding, social security, and Medicare taxes) that are due for the period reported on the Form 941 or 943, which includes the payroll period during which the excess was paid. If your remaining employment tax liability for that period is less than the excess payment, you can claim a credit or refund of the difference.

**Employment tax returns.** The advance EIC payment that you make is added to each employee's pay. It does not change the amount you must withhold from that employee's pay for income, social security, and Medicare taxes. Instead, the advance EIC payments you

make are treated as made from the total of all amounts you withheld as income and employee social security and Medicare taxes and that you must pay as the employer's share of social security and Medicare taxes. Furthermore, the advance EIC payments you made are treated as if you had paid that amount to the IRS on the day you paid the wages. You will then take these payments into account when you file your employment tax return (Form 941, or 943).

If you file either Form 941 or Form 943, include the amount of advance EIC payments you made in completing the form. When you figure your total employment tax liability, use these amounts together with any actual federal tax deposits you made to lower any payment that may be due when you file the form.

The same rules that require you to show your employment tax liability for a specific period also apply for showing advance payments you made. If you are a semiweekly depositor and must show your employment tax liability on Schedule B (Form 941) on a daily basis, you show your tax liability (income tax withheld plus both the employee and employer social security and Medicare taxes minus any advance EIC payments) for each day a liability accrues.

**Guam and U.S. Virgin Islands.** Employers in Guam and the U.S. Virgin Islands should consult their local tax office for information on the earned income credit. These employers cannot take advance EIC payments into account on Form 941SS.

**Form W-2.** Show the total advance EIC payments made during the year in box 9 of the employee's Form W-2.

The amounts shown on Form W-2 for income, social security, and Medicare taxes withheld are not affected by any advance EIC payments the employee received. No other entries on Form W-2 are changed because of these payments.

## Employee Tips

Your employees must report to you each month cash tips of \$20 or more that they receive while on the job. This includes both tips received directly from customers and those that customers charge to the bill and you pay to the employee. However, no report needs to be made for any month in which the tips were less than \$20. Otherwise, they should be reported every month regardless of the total wages and tips the employee receives for the year. The written report must be made by the 10th day of the month after the month the tips are received. It should show:

- 1) The name, address, and social security number of the employee;
- 2) The name and address of the employer;
- 3) The calendar month or period covered by the statement; and
- 4) The total amount of the tips the employee received during the period covered by the statement.

Tips received by your employees in December 1993 and reported to you in January 1994 are considered income in 1994.

**Form 4070, *Employee's Report of Tips to Employer***, available from the IRS, may be used for reporting tips.

**Gratuities.** Service charges, sometimes called gratuities, collected by a club or other establishment through mandatory charges added to its members' bills are considered wages. These amounts are subject to both employer and employee taxes under social security and Medicare, the employer tax under federal unemployment, and income tax withholding.

**Social security, Medicare, and income taxes.** You must collect employee social security tax, Medicare tax, and income tax on tips reported by an employee. You can withhold these taxes either from wages due the employee or from other funds the employee makes available. You must also pay the employer portion of the social security and Medicare taxes on tips reported by an employee. Stop collecting **employee social security tax** and paying **employer social security tax** when the employee's combined wages and reported tips total \$60,600 for 1994. For 1995, the combined wages and tips limit is \$61,200. Collect **employee Medicare tax** and pay **employer Medicare tax** on all of the employee's combined wages and reported tips for 1994 and 1995.

You are not required to withhold or pay on tips not reported to you.

Income tax withholding applies to all wages paid during the year, even if the social security and Medicare limits have been reached.

**How to figure withholding on tips.** If your employees get both regular wages and tips, you can, in figuring the income tax to withhold, either:

- 1) Treat the tips as part of the employee's current or preceding wage payment and use the regular graduated withholding rates; or
- 2) Determine the tax to withhold from tips by using a flat 20% rate if income tax has already been withheld from the regular wage payment.

**Form W-2.** Employers must report on Form W-2 an employee's compensation, including the tips reported by the employee to the employer.

**Pooling or splitting of tips.** Employees who participate in a tip-splitting or tip-pooling arrangement must report to their employer only the tips they actually receive and keep. They may use Form 4070 or any other form provided by their employer.

**Example.** A restaurant pays its waiter \$400 in charged tips. The waiter then splits the tips with the busboy, giving the busboy one-fourth. The waiter includes in the amount he reports to the employer only the \$300 he kept. The busboy reports the \$100 he received from

the waiter. Both the waiter and the busboy may use Form 4070 to make their reports.

## Tip Reporting and Allocation Rules

Most large food or beverage establishments must make annual reports to the IRS concerning receipts from food or beverage operations and their employees' tip income. If you are subject to these reporting rules, you must provide the required information annually by filing **Form 8027, *Employer's Annual Information Return of Tip Income and Allocated Tips***, with the IRS. File this form with the Internal Revenue Service Center, Andover, MA 05501, by the end of February for the preceding calendar year.

You must file a separate Form 8027 for each establishment. If you need to file more than one Form 8027, use Form 8027-T, ***Transmittal of Employer's Annual Information Return of Tip Income and Allocated Tips***. If you file 250 or more Forms 8027, you must file on magnetic media. For information on magnetic media, see Publication 1239, ***Specifications for Filing Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips, on Magnetic Tape and 5¼- and 3½-Inch Diskettes***.

These rules impose additional reporting requirements for employers. Therefore, all the other rules for reporting employee tips and for withholding income tax and social security and Medicare taxes, discussed earlier under ***Employee Tips***, continue to apply.

**Reporting rules.** You must file Form 8027 if you provide food or beverages for consumption on your premises, tipping is customary, and you normally employ more than 10 people on a typical business day during the preceding calendar year. If you did not operate at least one month during the preceding year, see ***New businesses***, later.

**Exceptions.** Food or beverage operations where tipping is not customary do not file Form 8027. For example, a cafeteria or "fast food" operation would generally not be covered by the tip reporting rules because tipping is not customary at such places. Your operation is likewise not covered by the rules if you add a service charge of 10% or more to 95% or more of your food or beverage sales. Nor do these rules apply to food or beverage operations outside the United States.

If your business operates as a cafeteria for part of the day and as a full-service restaurant with tipping customary for the rest of the day, it is treated as a single operation covered by the rules if it employed more than 10 people. However, if you record gross receipts for the two operations separately, the receipts from your cafeteria-style service are not covered by the rules.

Most restaurants that provide table or counter service for seated customers and cocktail lounges with similar service are covered by the rules if they employ more than 10 people. An establishment may be part of a larger operation such as a hotel.

**More than 10 employees.** You are considered to have normally employed more than 10 people on a typical business day if the average number of hours worked by all employees in all your food or beverage operations on a typical business day is more than 80 hours. An individual who owns 50% or more in value of the stock of a corporation that operates a business is not considered an employee for this purpose. To figure this average:

- 1) Consider the month of your greatest and the month of your least gross receipts during the preceding calendar year. The month of your least gross receipts must be a month your establishment was open for business. If your establishment was not open for business during the preceding year, see ***New businesses***, later.
- 2) Include the hours worked by all your employees at all your food or beverage operations, not just tipped employees.
- 3) Treat all members of a group of businesses under common control as one employer.
- 4) Estimate the number of hours an employee worked for a given food or beverage operation in a month if he or she worked for more than one of your food or beverage operations during the month, or worked for both your food or beverage operation and your nonfood or beverage operation.

**Example.** You had three food or beverage operations open for business in January (the month of your greatest total gross receipts) and September (the month of your least total gross receipts). In January, Operation A was open 31 days with 2,500 hours worked. Operation B was open 20 days with 1,000 hours worked. Operation C was open 24 days with 1,500 hours worked. This made a total of 75 days and 5,000 hours. The average number of days your operations were open for business in January is 25 days (75 days divided by 3 operations). The average number of employee hours worked per business day during January is 200 (5,000 hours divided by 25 days). During September, the average number of employee hours worked per business day is 60. You are considered to have normally employed more than 10 employees on a typical business day because the 2-month average is greater than 80 hours ( $200 + 60 = 260$ ;  $260 \div 2 = 130$  hours).

Note that if the average number of employee hours worked per business day during any month is more than 160 hours, you will meet the more-than-10-employees test automatically, since the 2-month average will be at least 80 ( $160 \div 2$ ). In this case, your food or beverage operations are covered by the rules, regardless of what the average is during any other month.

**New businesses.** If your food or beverage operation is a new business, you must use a special method to figure whether you normally

employ more than 10 people on a typical business day and are thus subject to the tip allocation rules.

Your food or beverage operation is a new business if you did not have any food or beverage operations during the preceding calendar year. You are not considered to have had a food or beverage operation during a calendar year if each of your food or beverage operations was operated for less than one calendar month during the year.

If your food or beverage operation is a new business, you must figure the average number of employee hours worked per business day over each of any 2 consecutive calendar months of the current calendar year. If there are any 2 consecutive calendar months in which the average number of hours worked per business day by all of your employees is more than 80 hours, your new business is considered to have more than 10 employees on a typical business day. To figure this average, follow the rules discussed for all other businesses under *More than 10 employees*, earlier.

Your new business must comply with the tip reporting rules from the first payroll period that begins after the first 2-month period in which the average employee hours worked per business day exceeds 80 hours.

**What you must report.** If the reporting rules apply to your food or beverage operation, you must report the following information to the IRS each calendar year for each of your separate food or beverage operations:

- 1) Your name, address, and employer identification number.
- 2) Your establishment's name, address, and identification number.
- 3) Your total gross receipts (other than nonallocable receipts, defined below) from providing food and beverages.
- 4) Your total charge receipts (other than nonallocable receipts) on which customers showed tips.
- 5) The total tips on your charge receipts.
- 6) The total tips your employees reported to you.
- 7) The total service charges of less than 10% you collected from customers and paid to employees as wages.
- 8) The name and social security number of each employee you allocated tips to under these reporting rules and the amount of tips you allocated to each one. This requirement will be satisfied by including a copy of the Form W-2 for each employee to whom an allocation was made.

**Nonallocable receipts.** Nonallocable receipts include receipts from carryout sales or sales with a service charge of 10% or more.

**State or local taxes.** Gross receipts do not include state or local taxes.

**Withholding.** The allocated amount in item (8) above is for information purposes

only. **Do not withhold any taxes from the allocated amount.** However, you report allocated tips on Form W-2 separately from wages and reported tips.

**Employee request for early W-2.** If an employee leaves your employment before the end of the calendar year and requests an early Form W-2, you do not have to include a tip allocation on the Form W-2. However, you may show either the actual allocated amount if you know how much it is, or an estimated allocation. If you show an estimate, put the word "estimate" next to the allocated amount. In January of the next year, you must provide an amended Form W-2 to the employee if the earlier Form W-2 showed no allocation or the estimated allocation was wrong by more than 5%.

**Allocation rules.** You must allocate tips among your employees only if the total amount of tips they reported to you during any allocation period is less than 8% (or a lower percentage approved by the District Director) of your establishment's total food and beverage sales during that period. These sales do not include carryout sales, state or local taxes, and sales with a service charge of 10% or more. But they do include the retail value of complimentary food and beverages, if tipping is customary under the circumstances. An allocation period can be your regular payroll period, the calendar year, or some reasonable division of a year, such as a calendar month or calendar quarter.

If your employees report tips totaling less than 8% of your total sales, you must allocate the excess of 8% of total sales over reported tips among your employees. You may allocate the excess either among your employees who receive tips directly from customers, or among all tipped employees, if your agreement with your employees provides for allocating them this way. However, do not allocate any tips to an employee who reports tips at least equal to his or her share of 8% of your total sales.

If your customers tip less than 8% on average, you or a majority of your employees may apply to have the allocation percentage reduced from 8%. However, it cannot be reduced below 2%. The application should be made in writing to the District Director for the Internal Revenue District in which your establishment is located. See Revenue Procedure 86-21 in Cumulative Bulletin 1986-1, page 560, for guidelines in applying for the allocation reduction.

**Allocation methods.** You can allocate tips under a formula agreed to by both you and your employees. If you cannot agree on a formula, you must allocate them according to IRS regulations. If you allocate tips according to a good-faith agreement between you and your employees or according to the regulations, you will not be liable to any employee for any amount allocated improperly.

According to the formula in the regulations, you make tip allocations only to your directly tipped employees. A directly tipped employee receives tips directly from customers, even if

the tips are turned over to a tip pool. For example, waiters, waitresses, and bartenders are usually considered directly tipped employees. An employee who does not normally receive tips directly from customers is an indirectly tipped employee. Busboys, service bartenders, and cooks are examples of indirectly tipped employees. If an employee receives tips both directly and indirectly, such as through a tip-splitting or tip-pooling arrangement, the employee is treated as a directly tipped employee.

You may allocate tips under the regulations on the basis of each directly tipped employee's share of either gross receipts or total hours worked.

However, the method of allocation based on the number of hours worked may be used only if you employ less than the equivalent of 25 full-time employees at an establishment during a payroll period. For this purpose, less than the equivalent of 25 full-time employees means that the average number of employee hours worked each business day during a payroll period is less than 200 hours.

See the instructions for Form 8027 or Regulation 31.6053-3(f) for an illustration of an allocation made using the gross receipts method.

**Note:** The tip allocation amount may be added to a tipped employee's gross income unless he or she is able to prove a lesser amount with adequate records. The IRS may determine that a tipped employee received more tip income than reflected in the tip allocation.

## Information Returns

In your trade or business activities, you may make payments that are not wages that you must report to the IRS. **Form 1099-MISC**, is the information return used most often by a small business to report these payments.

File Form 1099-MISC with **Form 1096**, *Annual Summary and Transmittal of U.S. Information Returns*, by February 28, 1995, with the IRS if you:

- 1) Made payments of \$600 or more for **fees, commissions**, or other forms of payments to persons not treated as your employees for services rendered in your trade or business;
- 2) Gave **prizes, awards**, or made other payments, of \$600 or more that are not for services rendered, or made direct sales of \$5,000 or more of **consumer products for resale**;
- 3) Made payments of \$10 or more for **royalties**, or \$600 or more for **rents** other than rent payments to real estate agents;
- 4) Withheld federal income tax on miscellaneous income under the **backup withholding** rules;
- 5) Made payments of \$600 or more to physicians or other suppliers or providers of health care services in connection with **medical assistance programs**, or



**health, accident, and sickness insurance programs;**

- 6) Made payments in connection with the sale of a **fishing** catch, or made a distribution in-kind reported at the fair market value of the catch, to each crew member of fishing boats with normally fewer than 10 members;
- 7) Received payments of \$10 or more as a **broker** on behalf of a customer, in lieu of a dividend or tax-exempt interest, as a result of the transfer of a customer's securities for use in a short sale.

Report only payments made in the course of your trade or business (including government agencies and nonprofit activities), or from which you withheld federal income tax or foreign tax. Payments include the fair market value of exchanges of property or services between individuals in the course of a trade or business.

You must furnish a statement to each recipient by January 31, 1995. A copy of Form 1099-MISC can be used for this purpose. However, if you file Form 1099-MISC to report substitute payments in lieu of dividends or tax-exempt interest, you must furnish a copy of Form 1099-MISC to the recipient.

**Royalty payments.** Examples of royalty payments to be reported on Form 1099-MISC include payments for the right to exploit natural resources, such as oil, gas, coal, timber, sand, gravel, and other mineral interests. Also included are payments for the right to exploit intangible property, such as copyrights, trade names, trademarks, franchises, books and other literary compositions, musical compositions, artistic works, secret processes and formulas, and patents.

**Nonemployee compensation.** The kinds of nonemployee compensation to be reported on Form 1099-MISC include fees, commissions, prizes, awards, or other forms of compensation for services rendered for your trade or business by an individual who is not your employee. Also include expenses incurred for the use of an entertainment facility that you treat as compensation to a nonemployee.

Examples of payments to be reported as nonemployee compensation are:

- 1) Fees paid to attorneys and accountants for professional services.
- 2) Fees paid by one professional to another, such as fee-splitting or referral fees.
- 3) Payments by attorneys to witnesses or experts in legal adjudication.
- 4) Payments for services, including payment for parts or materials used to render the services, unless the provider of the services is in the business of selling parts and materials. For example, payments by insurance companies for labor and parts to an auto repair shop under a repair contract indicating an amount for labor and another amount for parts, as long as the repair shop does not hold itself out as a parts dealer. See *Example 2*, later.

- 5) Commissions paid to nonemployee salespersons, subject to repayment but not repaid during the calendar year.
- 6) Fees paid to a nonemployee and travel reimbursement for which the nonemployee did not account to the payer, if the fees and reimbursements aggregate at least \$600.
- 7) Payments to nonemployee entertainers for services.
- 8) Exchanges of services between individuals in the course of their trades or businesses.
- 9) Taxable fringe benefits for nonemployees. See Publication 535, *Business Expenses*, for information on the valuation of fringe benefits.
- 10) Oil or gas payments for a working interest.
- 11) Amounts retained by licensed lottery ticket sales agents from the sale proceeds of state lottery tickets.

**Payments not reportable on Form 1099-MISC.** Payments that do **not** require a Form 1099-MISC include the following:

- 1) Payments for merchandise, including inventory, freight, storage, and similar charges;
- 2) Payments for telephone, telegraph, and similar services;
- 3) Payments of rent to real estate agents;
- 4) Payments to your employees for any services they perform in the course of their employment, or for their traveling and other business expenses; and
- 5) Payments to corporations, except for medical payments and substitute payments in lieu of dividends and tax-exempt interest.

**Examples.** The following examples illustrate the filing of information returns for miscellaneous payments:

**Example 1.** Mr. Black, a real estate agent, collected \$1,000 in rental payments from the tenants of a building. He deducted his commission of \$100 and paid \$900 to the building owner. He must report the gross amount of \$1,000 on Form 1099-MISC even though he deducted his commission of \$100 from the \$1,000 and paid the owner \$900.

**Example 2.** Mr. Jones is in the business of renting houses. He pays Mr. Smith, who operates a painting business as a sole proprietor, \$1,750 to paint one of his rental houses. Mr. Jones must report the \$1,750 on Form 1099-MISC.

**Other information returns.** Other information returns that you may be required to file are discussed in the *1994 Instructions for Forms 1099, 1098, 5498, and W-2G*.

For information on the requirements for withholding taxes on payments made to nonresident aliens, and the requirements for exemption from tax withholding, see Publication

515, *Withholding of Tax on Nonresident Aliens and Foreign Corporations*.

For information on the requirements for reporting cash payments received in a trade or business, see Publication 1544, *Reporting Cash Payments of Over \$10,000*.

## Backup Withholding

In certain cases, you may be required to withhold income tax at 31% on payments of interest, dividends, patronage dividends, rents, royalties, commissions, nonemployee compensation, and certain other payments you make in the course of your trade or business. In addition, transactions by brokers and barter exchanges and certain payments made by fishing boat operators are subject to backup withholding. Real estate transactions, however, are not subject to backup withholding.

Generally, you are required to withhold 31% of the payment if the payee does not furnish a correct taxpayer identification number (TIN) or does not certify that the TIN is correct.

**Form W-9.** You can use Form W-9, *Request for Taxpayer Identification Number and Certification*, to request payees to furnish a taxpayer identification number and to certify that the number furnished is correct.

You can also use Form W-9 to obtain certifications from payees that they are not subject to backup withholding or that they are exempt from backup withholding. Form W-9 includes a list of types of payees who are exempt from backup withholding.

For more information about backup withholding, see *1994 Instructions for Forms 1099, 1098, 5498, and W-2G*.

## Recordkeeping

As an employer, you are subject to recordkeeping requirements on all employment taxes. These requirements apply to withholding for income, social security, and Medicare taxes; federal unemployment tax; and payments of advance earned income credit (EIC). You should keep your records until the later of:

- 1) 4 years after the due date of the tax for the return period to which the records relate; or
- 2) the date the tax is paid.

In addition to the following items required for each specific type of employment tax, your records should also contain your employer identification number, copies of the returns you have filed, and the dates and amounts of deposits you have made.

**Income tax withholding.** The specific records you must keep for income tax withholding are:

- 1) Each employee's name, address, and social security number;
- 2) The total amount and date of each wage payment and the period of time the payment covers;
- 3) The amount subject to withholding for each wage payment;

- 4) The amount of withholding tax collected on each payment and, if different from the date of payment, the date it was collected;
- 5) The reason why the taxable amount is less than the total payment if they differ;
- 6) Copies of any statements furnished by employees relating to nonresident alien status, residence in Puerto Rico or the Virgin Islands, or residence or physical presence in a foreign country;
- 7) The fair market value and date of each payment of noncash compensation made to a retail commission salesperson, if no income tax was withheld;
- 8) Information about the amount of each payment under a wage continuation plan;
- 9) The withholding allowance certificates (Form W-4) filed by each employee;
- 10) Any agreement between you and the employee on Form W-4 for the voluntary withholding of additional amounts of tax;
- 11) If needed to figure tax liability, the dates in each calendar quarter on which the employee worked for you, but **not** in the course of your trade or business, and the amount paid for that nonbusiness work;
- 12) Copies of statements furnished by employees reporting tips received in their work, unless the information shown on the statements appears in another item on this list; and
- 13) Requests by employees to have the tax withheld figured on the basis of their individual cumulative wages, and any notice that the request was revoked.

An employee's earnings ledger, which you can buy at most office supply stores, normally

has space for the information required in items (1) through (4).

**Social security and Medicare taxes.** You must also maintain the following information in your records on the social security and Medicare taxes of your employees:

- 1) The amount of each wage payment subject to social security tax;
- 2) The amount of each wage payment subject to Medicare tax;
- 3) The amount of social security and Medicare taxes collected for each payment and the date collected; and
- 4) The reason why the total wage payment is more than the taxable amount if they differ.

**Federal unemployment tax.** For federal unemployment tax purposes, your records must include:

- 1) The total amount paid to your employees during the calendar year;
- 2) The amount of compensation subject to the unemployment tax, and why it differs from the total compensation if they differ;
- 3) The amount you paid into the state unemployment fund; and
- 4) Any other information required to be shown on the unemployment tax return, and the amount of the tax.

**Earned income credit (EIC).** The following records must be kept for advance EIC payments:

- 1) Copies of employees' Forms W-5;
- 2) Amounts and dates of all wage payments and advance EIC payments; and
- 3) Dates of each employee's employment.

**Magnetic media reports.** Copy A of Form W-2 may be filed on magnetic media with the SSA. Employers and other payers who are required to file 250 or more Forms W-2 for 1994 must use magnetic media. The 250 requirement applies separately to each type of form. If you are unable to comply with the magnetic media requirements, you may request a waiver for up to one year on **Form 8508, Request for Waiver From Filing Information Returns on Magnetic Media.**

The reporting specifications and procedures for magnetic media filing of Copy A of Forms W-2 are in TIB-4, *Magnetic Media Reporting, Submitting Annual W-2 Copy A Information to the Social Security Administration.* You can get magnetic media reporting specifications by contacting any of the Social Security Magnetic Media Coordinators. Call 1-800-772-1213 for a telephone number of the coordinator in your area, or you may write to:

Social Security Administration  
 OCRO, DEA Attn: Resubmittal Unit  
 3-E-10 NB Metro West  
 300 N. Green Street  
 Baltimore, MD 21201

