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Understanding the Element of Employee Compensation

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Employee or Independent contractor

Whether someone who works for you is an employee or an independent contractor is an important question. The answer determines your liability to pay and withhold Federal income tax, social security and Medicare taxes, and Federal unemployment tax.

In general, someone who performs services for you is your employee if you can control what will be done and how it will be done.

The courts have considered many facts in deciding whether a worker is an independent contractor or an employee. These facts fall into three main categories:

- **Behavioral Control –** Facts that show whether the business has a right to direct and control. These include:
  - Instructions - an employee is generally told:
    1. when, where, and how to work
    2. what tools or equipment to use
    3. what workers to hire or to assist with the work
    4. where to purchase supplies and services
    5. what work must be performed by a specified individual
    6. what order or sequence to follow
  - Training – an employee may be trained to perform services in a particular manner.
- **Financial Control –** Facts that show whether the business has a right to control the business aspects of the worker's job include:
  - The extent to which the worker has unreimbursed expenses
  - The extent of the worker's investment
  - The extent to which the worker makes services available to the relevant market
  - How the business pays the worker
  - The extent to which the worker can realize a profit or loss
- **Type of Relationship –** Facts that show the type of relationship include:
  - Written contracts describing the relationship the parties intended to create

- Whether the worker is provided with employee-type benefits
- The permanency of the relationship
- How integral the services are to the principal activity

For a worker who is considered your employee, you are responsible for:

- Withholding Federal income tax,
- Withholding and paying the employer social security and Medicare tax,
- Paying Federal unemployment tax (FUTA)
- Issuing Form W-2, Wage and Tax Statement, annually,
- Reporting wages on Form 941, Employer's Quarterly Federal Tax Return.

For a worker who is considered an independent contractor, you may be responsible for issuing Form 1099MISC, *Miscellaneous Income*, to report compensation paid.

Who is an employee?

Under the common law rules, every individual who performs services subject to the will and control of an employer, both as to what shall be done and how it shall be done, is an employee. It does not matter that the employer allows the employee considerable 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.

If an employer-employee relationship exists, it does not matter what the parties call the relationship. It does not matter if the employee is called a partner, co-adventurer, agent, or independent contractor. It does not matter how the pay is measured, how the individual is paid, or what the payments are called. Nor does it matter whether the individual works full-time or part-time.

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

1. **INSTRUCTIONS -** A worker who is required to comply with other persons' instructions about when, where, and how he or she is to work is ordinarily an employee. This control factor is present if the person or persons for whom the services are performed have the RIGHT to require compliance with instructions.

2. **TRAINING -** Training a worker by requiring an experienced employee to work with the worker, by corresponding with the worker, by requiring the worker to attend meetings, or by using other methods, indicates that the person or persons for whom the services are performed want the services performed in a particular method or manner.
3. **INTEGRATION -** Integration of the worker's services into the business operations generally shows that the worker is subject to direction and control. When the success or continuation of a business depends to an appreciable degree upon the performance of certain services, the workers who perform those services must necessarily be subject to a certain amount of control by the owner of the business.
4. **SERVICES RENDERED PERSONALLY -** If the Services must be rendered personally, presumably the person or persons for whom the services are performed are interested in the methods used to accomplish the work as well as in the results.
5. **HIRING, SUPERVISING, AND PAYING ASSISTANTS -** If the person or persons for whom the services are performed hire, supervise, and pay assistants, that factor generally shows control over the workers on the job. However, if one worker hires, supervises, and pays the other assistants pursuant to a contract under which the worker agrees to provide materials and labor and under which the worker is responsible only for the attainment of a result, this factor indicates an independent contractor status.
6. **CONTINUING RELATIONSHIP -** A continuing relationship between the worker and the person or persons for whom the services are performed indicates that an employer-employee relationship exists. A continuing relationship may exist where work is performed at frequently recurring although irregular intervals.
7. **SET HOURS OF WORK -** The establishment of set hours of work by the person or persons for whom the services are performed is a factor indicating control
8. **FULL TIME REQUIRED -** If the worker must devote substantially full time to the business of the person or persons for whom the services are performed, such person or persons have control over the amount of time the worker spends working and impliedly restrict the worker from doing other gainful work. An independent contractor on the other hand, is free to work when and for whom he or she chooses.
9. **DOING WORK ON EMPLOYER'S PREMISES -** If the work is performed on the premises of the person or persons for whom the services are performed, that factor suggests control over the worker, especially if the work could be done elsewhere. Work done off the premises of the person or persons receiving the services, such as at the office of the worker, indicates some freedom from control. However, this fact by itself does not mean that the worker is not an employee. The importance of this factor depends on the nature of the service involved and the extent to which an employer generally would require that employees perform such services on the employer's premises. Control over the place of work is indicated when the person or persons for whom the services are performed have the right to compel the worker to travel a designated route, to canvass a territory within a certain time, or to work at specific places as required.
10. **ORDER OR SEQUENCE SET -** If a worker must perform services in the order or sequence set by the person or persons for whom the services are performed, that factor shows that the worker is not free to follow the worker's own pattern of work but must follow the established routines and schedules of the person or persons for whom the services are performed. Often, because of the nature of an occupation, the person or

persons for whom the services are performed do not set the order of the services or set the order infrequently. It is sufficient to show control, however, if such person or persons retain the right to do so.

11. **ORAL OR WRITTEN REPORTS -** A requirement that the worker submit regular or written reports to the person or persons for whom the services are performed indicates a degree of control.
12. **PAYMENT BY HOUR, WEEK, MONTH -** Payment by the hour, week, or month generally points to an employer-employee relationship, provided that this method of payment is not just a convenient way of paying a lump sum agreed upon as the cost of a job. Payment made by the job or on s straight commission generally indicates that the worker is an independent contractor.
13. **PAYMENT OF BUSINESS AND/OR TRAVELING EXPENSES -** If the person or persons for whom the services are performed ordinarily pay the worker's business and/or traveling expenses, the worker is ordinarily an employee. An employer, to be able to control expenses, generally retains the right to regulate and direct the worker's business activities.
14. **FURNISHING OF TOOLS AND MATERIALS -** The fact that the person or persons for whom the services are performed furnish significant tools, materials, and other equipment tends to show the existence of an employer-employee relationship.
15. **SIGNIFICANT INVESTMENT** - If the worker invests in facilities that are used by the worker in performing services and are not typically maintained by employees (such as the maintenance of an office rented at fair value from an unrelated party), that factor tends to indicate that the worker is an independent contractor. On the other hand, lack of investment in facilities indicates dependence on the person or persons for whom the services are performed for such facilities and, accordingly, the existence of an employer- employee relationship. Special scrutiny is required with respect to certain types of facilities, such as home offices.
16. **REALIZATION OF PROFIT OR LOSS -** A worker who can realize a profit or suffer a loss as a result of the worker's services (in addition to the profit or loss ordinarily realized by employees) is generally an independent contractor, but the worker who cannot is generally an employee. For example, if the worker is subject to a real risk of economic loss due to significant investments or a bona fide liability for expenses, such as salary payments to unrelated employees, that factor indicates that the worker is an independent contractor. The risk that a worker will not receive payment for his or her services, however, is common to both independent contractors and employees and thus does not constitute a sufficient economic risk to support treatment as an independent contractor.
17. **WORKING FOR MORE THAN ONE FIRM AT A TIME -** If a worker performs more than de minimis services for a multiple of unrelated persons or firms at the same time, that factor generally indicates that the worker is an independent contractor. However, a worker who performs services for more than one person may be an employee of each of the persons, especially where such persons are part of the same service arrangement.
18. **MAKING SERVICE AVAILABLE TO GENERAL PUBLIC -** The fact that a worker makes his or her services available to the general public on a regular and consistent basis indicates an independent contractor relationship.

19. **RIGHT TO DISCHARGE -** The right to discharge a worker is a factor indicating that the worker is an employee and the person possessing the right is an employer. An employer exercises control through the threat of dismissal, which causes the worker to obey the employer's instructions. An independent contractor, on the other hand, cannot be fired so long as the independent contractor produces a result that meets the contract specifications.
20. **RIGHT TO TERMINATE -** If the worker has the right to end his or her relationship with the person for whom the services are performed at any time he or she wishes without incurring liability, that factor indicates an employer-employee relationship

In its Independent Contractor or Employee Training Manual, the IRS identified certain other facts that were relevant in recent court decisions regarding worker classification. The other facts presented in the training manual primarily relate to how the worker and employer perceive their relationship. We have presented a few examples below of the other factors for informational purposes.

Intent of parties/written contract – A written agreement describing the worker's classification is evidence of the intent regarding the working relationship. However, the contract itself is not sufficient evidence regarding worker classification. Therefore, the substance of the written agreement should be assessed in combination with all other relevant facts and circumstances.

Forms W-2 – Filing a Form W-2 for a worker generally indicates employee status.

Incorporation – Workers who create a corporation and provide services to a business are generally considered independent contractors of the business.

Employee benefits – If a worker receives employee benefits, such as paid vacation days, paid sick days, health insurance, life or disability insurance, or a pension, the worker generally would have employee status. Employee benefit facts lending towards employee status are generally strongest if the worker is provided with a tax-qualified retirement plan, IRC section 403(b) annuity, or cafeteria plan.

Discharge/termination – The circumstances under which a business or worker can terminate their relationship with the other party are generally considered useful evidence regarding worker classification. However, due to the complexity regarding the right to discharge or terminate, this type or evidence should be used with caution.

If you want the IRS to determine whether a specific individual is an independent contractor or an employee, file Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*.

What are the components of Employee Compensation

Generally, you must include in gross income everything you receive in payment for personal services. In addition to wages, salaries, commissions, fees, and tips, this includes other forms of compensation such as fringe benefits and stock options.

You should receive a **Form W–2,** *Wage and Tax Statement,* from your employer showing the pay you received for your services. Include your pay on line 7 of Form 1040 or Form 1040A, or on line 1 of Form 1040EZ, even if you do not receive a Form W–2.

This section discusses many types of employee compensation. The subjects are arranged in alphabetical order.

Advance commissions and other earnings. If you receive advance commissions or other amounts for services to be performed in the future and you are a cash method taxpayer, you must include these amounts in your income in the year you receive them.

If you repay unearned commissions or other amounts in the same year you receive them, reduce the amount included in your income by the repayment. If you repay them in a later tax year, you can deduct the repayment as an itemized deduction on your Schedule A (Form 1040), or you may be able to take a credit for that year. See *Repayments,* later.

Allowances and reimbursements. If you receive travel, transportation, or other business expense allowances or reimbursements from your employer, get Publication 463, *Travel, Entertainment, Gift, and Car Expenses.* If you are reimbursed for moving expenses, get Publication 521, *Moving Expenses.*

Back pay awards. Include in income amounts you are awarded in a settlement or judgment for back pay. These include payments made to you for damages, unpaid life insurance premiums, and unpaid health insurance premiums. They should be reported to you by your employer on Form W–2.

Bonuses and awards. Bonuses or awards you receive for outstanding work are included in your income and should be shown on your Form W–2. These include prizes such as vacation trips for meeting sales goals. If the prize or award you receive is goods or services, you must include the fair market value of the goods or services in your income. However, if your employer merely promises to pay you a bonus or award at some future time, it is not taxable until you receive it or it is made available to you.

Employee achievement award. If you receive tangible personal property (other than cash, a gift certificate, or an equivalent item) as an award for length-of-service or safety achievement, you generally can exclude its value from your income. However, the amount you can exclude is limited to your employer's cost and cannot be more than $1,600 ($400 for awards that are not qualified plan awards) for all such awards you receive during the year. Your employer can tell you whether your award is a qualified plan award. Your employer must make the award as part of a meaningful presentation, under conditions and circumstances that do not create a significant likelihood of it being disguised pay.

However, the exclusion does not apply to the following awards.

- A length-of-service award if you received it for less than 5 years of service or if you received another length-of-service award during the year or the previous 4 years.
- A safety achievement award if you are a manager, administrator, clerical employee, or other professional employee or if more than 10% of eligible employees previously received safety achievement awards during the year.

Note received for services. If your employer gives you a secured note as payment for your services, you must include the fair market value (usually the discount value) of the note in your income for the year you receive it. When you later receive payments on the note, a proportionate part of each payment is the recovery of the fair market value that you previously included in your income. Do not include that part again in your income. Include the rest of the payment in your income in the year of payment.

If your employer gives you a nonnegotiable unsecured note as payment for your services, payments on the note that are credited toward the principal amount of the note are compensation income when you receive them.

Severance pay. Amounts you receive as severance pay are taxable. A lump-sum payment for cancellation of your employment contract must be included in your income in the tax year you receive it.

Outplacement services. If you choose to accept a reduced amount of severance pay so that you can receive outplacement services (such as training in resumé writing and interview techniques), you must include the unreduced amount of the severance pay in income.

However, you can deduct the value of these outplacement services (up to the difference between the severance pay included in income and the amount actually received) as a miscellaneous deduction (subject to the 2% limit) on Schedule A (Form 1040).

Sick pay. Pay you receive from your employer while you are sick or injured is part of your salary or wages. In addition, you must include in your income sick pay benefits received from any of the following payers.

- A welfare fund.
- A state sickness or disability fund.
- An association of employers or employees.
- An insurance company, if your employer paid for the plan.

However, if you paid the premiums on an accident or health insurance policy, the benefits you receive under the policy are not taxable. For more information, see *Other Sickness and Injury Benefits* under *Sickness and Injury Benefits,* later.

Social security and Medicare taxes paid by employer. If you and your employer have an agreement that your employer pays your social security and Medicare taxes without deducting them from your gross wages, you must report the amount of tax paid for you as taxable wages on your tax return. The payment is also treated as wages for figuring your social security and Medicare taxes and your social security and Medicare benefits. However, these payments are not treated as social security and Medicare wages if you are a household worker or a farm worker.

Stock appreciation rights. Do not include a stock appreciation right granted by your employer in income until you exercise (use) the right. When you use the right, you are entitled to a cash payment equal to the fair market value of the corporation's stock on the date of use, minus the fair market value on the date the right was granted. You include the cash payment in income in the year you use the right.

Fringe Benefits

Fringe benefits you receive in connection with the performance of your services are included in your income as compensation unless you pay fair market value for them or they are specifically excluded by law. Abstaining from the performance of services (for example, under a covenant not to compete) is treated as the performance of services for purposes of these rules.

Recipient of fringe benefit. You are the recipient of a fringe benefit if you perform the services for which the fringe benefit is provided. You are considered to be the recipient even if it is given to another person, such as a member of your family. An example is a car your employer gives to your spouse for services you perform. The car is considered to have been provided to you and not to your spouse.

You do not have to be an employee of the provider to be a recipient of a fringe benefit. If you are a partner, director, or independent contractor, you can also be the recipient of a fringe benefit.

Provider of benefit. Your employer or another person for whom you perform services is the provider of a fringe benefit regardless of whether that person actually provides the fringe benefit to you. The provider can be a client or customer of an independent contractor.

Accounting period. You must use the same accounting period your employer uses to report your taxable noncash fringe benefits. Your employer has the option to report taxable noncash fringe benefits by using either of the following rules.

- The general rule: benefits are reported for a full calendar year (January 1 – December 31).
- The special accounting period rule: benefits provided during the last 2 months of the calendar year (or any shorter period) are treated as paid during the following calendar year. For example, each year your employer reports the value of benefits provided during the last 2 months of the prior year and the first 10 months of the current year.

Your employer does not have to use the same accounting period for each fringe benefit, but must use the same period for all employees who receive a particular benefit.

You must use the same accounting period that you use to report the benefit to claim an employee business deduction (for use of a car, for example).

Form W–2. Your employer reports your taxable fringe benefits in box 1 (*Wages, tips, other compensation*) of Form W–2. The total value of your fringe benefits may also be noted in box 12. The value of your fringe benefits may be added to your other compensation on one Form W–2, or you may receive a separate Form W–2 showing just the value of your fringe benefits in box 1 with a notation in box 12.

Accident or Health Plan Generally, the value of accident or health plan coverage provided to you by your employer is not included in your income. Benefits you receive from the plan may be taxable, as explained, later, under *Sickness and Injury Benefits.*

Long-term care coverage. Contributions by your employer to provide coverage for long-term care services generally are not included in your income. However, contributions made through a flexible spending or similar arrangement (such as a cafeteria plan) must be included in your income. This amount will be reported as wages in box 1 of your Form W–2.

Archer MSA contributions. Contributions by your employer to your Archer MSA generally are not included in your income. Their total will be reported in box 12 of Form W–2 with code R. You must report this amount on Form 8853, *Archer MSAs and Long-Term Care Insurance Contracts*. File the form with your return. **Adoption Assistance** You may be able to exclude from your income amounts paid or expenses incurred by your employer for qualified adoption expenses in connection with your adoption of an eligible child. See Publication 968, *Tax Benefits for Adoption,* for more information.

Athletic Facilities. If your employer provides you with the free or low-cost use of an employer-operated gym or other athletic club on your employer's premises, the value is not included in your compensation. The gym must be used primarily by employees, their spouses, and their dependent children.

If your employer pays for a fitness program provided to you at an off-site resort hotel or athletic club, the value of the program is included in your compensation. **De Minimis (Minimal) Benefits.** If your employer provides you with a product or service and the cost of it is so small that it would be unreasonable for the employer to account for it, the value is not included in your income. Generally, the value of benefits such as discounts at company cafeterias, cab fares home when working overtime, and company picnics are not included in your income. Also see *Employee Discounts,* later.

Holiday gifts. If your employer gives you a turkey, ham, or other item of nominal value at Christmas or other holidays, do not include the value of the gift in your income. However, if your employer gives you cash, a gift certificate, or a similar item that you can easily exchange for cash, you include the value of that gift as extra salary or wages regardless of the amount involved.

Dependent Care Benefits. If your employer provides dependent care benefits under a qualified plan, you may be able to exclude these benefits from your income. Dependent care benefits include:1. Amounts your employer pays directly to either you or your care provider for the care of your qualifying person while you work, and 2. The fair market value of care in a daycare facility provided or sponsored by your employer.

The amount you can exclude is limited to the lesser of:

- The total amount of dependent care benefits you received during the year,
- The total amount of qualified expenses you incurred during the year,
- Your earned income,
- Your spouse's earned income, or
- $5,000 ($2,500 if married filing separately).

Educational Assistance. You can exclude from your income up to $5,250 of qualified employer-provided educational assistance. The exclusion applies to undergraduate and graduate-level courses. For more information, get Publication 970.

Employee Discounts If your employer sells you property or services at a discount, you may be able to exclude the amount of the discount from your income. The exclusion applies to discounts on property or services offered to customers in the ordinary course of the line of business in which you work. However, it does not apply to discounts on real property or property commonly held for investment (such as stocks or bonds).

Financial Counseling Fees. Financial counseling fees paid for you by your employer are included in your income and must be reported as part of wages. If the fees are for tax or investment counseling, they can be deducted on Schedule A (Form 1040) as a miscellaneous deduction (subject to the 2% limit).

Group-Term Life Insurance Generally, the cost of up to $50,000 of group-term life insurance coverage provided to you by your employer (or former employer) is not included in your income. However, you must include in income the cost of employer-provided insurance that is more than the cost of $50,000 of coverage reduced by any amount you pay toward the purchase of the insurance.

Meals and Lodging. You do not include in your income the value of meals and lodging provided to you and your family by your employer at no charge if the following conditions are met.

1. The meals are:
    a. Furnished on the business premises of your employer, and
    b. Furnished for the convenience of your employer.
2. The lodging is:
    a. Furnished on the business premises of your employer,
    b. Furnished for the convenience of your employer, and
    c. A condition of your employment. (You must accept it in order to be able to properly perform your duties.)

You also do not include in your income the value of meals or meal money that qualifies as a de minimis fringe benefit. See *De Minimis (Minimal) Benefits,* earlier.

Faculty lodging. If you are an employee of an educational institution or an academic health center and you are provided with lodging that does not meet the three conditions above, you still may not have to include the value of the lodging in income. However, the lodging must be qualified campus lodging, and you must pay an adequate rent.

Qualified campus lodging. Qualified campus lodging is lodging furnished to you, your spouse, or one of your dependents by, or on behalf of, the institution or center for use as a home. The lodging must be located on or near a campus of the educational institution or academic health center.

Moving Expense Reimbursements. Generally, if your employer pays for your moving expenses (either directly or indirectly) and the expenses would have been deductible if you paid them yourself, the value is not included in your income. Get Publication 521 for more information.

No-Additional-Cost Services. The value of services you receive from your employer for free, at cost, or for a reduced price is not included in your income if your employer.

Retirement Planning Services If your employer has a qualified retirement plan, qualified retirement planning services provided to you (and your spouse) by your employer are not included in your income. Qualified services include retirement planning advice, information about your employer's retirement plan, and information about how the plan may fit into your overall individual retirement income plan. You cannot exclude the value of any tax preparation, accounting, legal, or brokerage services provided by your employer.

Transportation. If your employer provides you with a qualified transportation fringe benefit, it can be excluded from your income, up to certain limits. A qualified transportation fringe benefit is: Transportation in a commuter highway vehicle (such as a van) between your home and work place, A transit pass, or Qualified parking. Cash reimbursement by your employer for these expenses under a bona fide reimbursement arrangement is also excludable. However, cash reimbursement for a transit pass is excludable only if a voucher or similar item that can be exchanged only for a transit pass is not readily available for direct distribution to you.

Tuition Reduction You can exclude a qualified tuition reduction from your income. This is the amount of a reduction in tuition. For more information, get IRS Publication 970.

Working Condition Benefits If your employer provides you with a product or service and the cost of it would have been allowable as a business or depreciation deduction if you paid for it yourself, the cost is not included in your income. **Example.** You work as a software engineer and your employer provides you with a subscription to a software engineering trade magazine.

The cost of the subscription is not included in your income because the cost would have been allowable to you as a business deduction if you had paid for the subscription yourself.
Valuation of Fringe Benefits. If a fringe benefit is included in your income, the amount included is generally its value determined under the general valuation rule or under the special valuation rules. For an exception, see *Group-Term Life Insurance,* earlier.
General valuation rule. You must include in your income the amount by which the fair market value of the fringe benefit is more than the sum of:

1. The amount, if any, you paid for the benefit, plus
2. The amount, if any, specifically excluded from your income by law.

If you pay fair market value for a fringe benefit, no amount is included in your income.
Fair market value. The fair market value of a fringe benefit is determined by all the facts and circumstances. It is the amount you would have to pay a third party to buy or lease the benefit. This is determined without regard to:

- Your perceived value of the benefit, or
- The amount your employer paid for the benefit.

Employer-provided vehicles. If your employer provides a car (or other highway motor vehicle) to you, your personal use of the car is usually a taxable non-cash fringe benefit.
Flights on employer-provided aircraft. Under the general valuation rules, if your flight on an employer-provided piloted aircraft is primarily personal and you control the use of the aircraft for the flight, the value is the amount it would cost to charter the flight from a third party.
Special valuation rules. You generally can use a special valuation rule for a fringe benefit only if your employer uses the rule. If your employer uses a special valuation rule, you cannot use a different special rule to value that benefit. You always can use the general valuation rule discussed earlier, based on facts and circumstances, even if your employer uses a special rule.

If you and your employer use a special valuation rule, you must include in your income the amount your employer determines under the special rule minus the sum of: any amount you repaid your employer, plus any amount specifically excluded from income by law.
The special valuation rules are the following: The automobile lease rule, the vehicle cents-per-mile rule, the commuting rule, the unsafe conditions commuting rule, and the employer-operated eating-facility rule. For more information on these rules, see Publication 15–B, *Employer's Tax Guide to Fringe Benefits*.

For information on the non-commercial flight and commercial flight valuation rules, see sections 1.61–21(g) and 1.61–21(h) of the regulations.

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Sickness and Injury Benefits Generally, you must report as income any amount you receive for personal injury or sickness through an accident or health plan that is paid for by your employer. If both you and your employer pay for the plan, only the amount you receive that is due to your employer's payments is reported as income. However, certain payments may not be taxable to you. For information on nontaxable payments, see *Military and Government Disability Pensions* and *Other Sickness and Injury Benefits,* later in this discussion. **Cafeteria plans.** Generally, if you are covered by an accident or health insurance plan through a cafeteria plan, and the amount of the insurance premiums was not included in your income, you are not considered to have paid the premiums and you must include any benefits you receive in your income. If the amount of the premiums was included in your income, you are considered to have paid the premiums and any benefits you receive are not taxable.

Disability Pensions If you retired on disability, you must include in income any disability pension you receive under a plan that is paid for by your employer. You must report your taxable disability payments as wages on line 7 of Form 1040 or Form 1040A until you reach minimum retirement age. Minimum retirement age generally is the age at which you can first receive a pension or annuity if you are not disabled. For more information on pensions and annuities, get Publication 575.

Long-Term Care Insurance Contracts

Long-term care insurance contracts generally are treated as accident and health insurance contracts. Amounts you receive from them (other than policyholder dividends or premium refunds) generally are excludable from income as amounts received for personal injury or sickness. To claim an exclusion for payments made on a per diem or other periodic basis under a long-term care insurance contract, you must file Form 8853 with your return. See Section C of Form 8853 and its instructions for more information.

Workers' Compensation Amounts you receive as workers' compensation for an occupational sickness or injury are fully exempt from tax if they are paid under a workers' compensation act or a statute in the nature of a workers' compensation act. The exemption also applies to your survivors. The exemption, however, does not apply to retirement plan benefits you receive based on your age, length of service, or prior contributions to the plan, even if you retired because of an occupational sickness or injury.

Disability pension. If your disability pension is paid under a statute that provides benefits only to employees with service-connected disabilities, part of it may be workers' compensation. That part is exempt from tax. The rest of your pension, based on years of service, is taxable as pension or annuity income. If you die, the part of your survivors' benefit that is a continuation of the workers' compensation is exempt from tax.

Other Sickness and Injury Benefits Many other amounts you receive as compensation for sickness or injury are not taxable. These include the following amounts.

- Compensatory damages you receive for physical injury or physical sickness, whether paid in a lump sum or in periodic payments. See *Court awards and damages* under *Other Income,* later.
- Benefits you receive under an accident or health insurance policy on which either you paid the premiums or your employer paid the premiums but you had to include them in your income.
- Disability benefits you receive for loss of income or earning capacity as a result of injuries under a no-fault car insurance policy.
- Compensation you receive for permanent loss or loss of use of a part or function of your body, or for your permanent disfigurement. This compensation must be based only on the injury and not on the period of your absence from work. These benefits are not taxable even if your employer pays for the accident and health plan that provides these benefits.

Reimbursement for medical care. A reimbursement for medical care generally is not taxable. However, it may reduce your medical expense deduction. If you receive reimbursement for an expense you deducted in an earlier year, see *Recoveries,* later.

B*artering.* Bartering is an exchange of property or services. You must include in your income, at the time received, the fair market value of property or services you receive in bartering. If you exchange services with another person and you both have agreed ahead of time as to the value of the services, that value will be accepted as fair market value unless the value can be

shown to be otherwise. Generally, you report this income on Schedule C or Schedule C–EZ (Form 1040). However, if the barter involves an exchange of something other than services, such as in *Example 4* below, you may have to use another form or schedule instead. **Example 1.** You are a self-employed artist who performs artistic services for a client, a small game corporation. The corporation gives you shares of its stock as payment for your services. You must include the fair market value of the shares in your income on Schedule C or Schedule C–EZ (Form 1040) in the year you receive them. **Example 2.**You are a self-employed programmer. You and a house painter are members of a barter club. Members get in touch with each other directly and bargain for the value of the services to be performed. In return for programming services you provided, the house painter painted your home. You must report as your income on Schedule C or Schedule C–EZ (Form 1040) the fair market value of the house painting services you received. The house painter must include in income the fair market value of the programming services you provided. **Example 3.** You are self-employed and a member of a barter club. The club uses credit units as a means of exchange. It adds credit units to your account for goods or services you provide to members, which you can use to purchase goods or services offered by other members of the barter club. The club subtracts credit units from your account when you receive goods or services from other members. You must include in your income the value of the credit units that are added to your account, even though you may not actually receive goods or services from other members until a later tax year. **Example 4.** You own a small apartment building. In return for 6 months rent-free use of an apartment, an artist gives you a work of art she created. You must report as rental income on Schedule E (Form 1040) the fair market value of the artwork, and the artist must report as income on Schedule C or Schedule C–EZ (Form 1040) the fair rental value of the apartment.
Form 1099–B from barter exchange. If you exchanged property or services through a barter exchange, Form 1099–B, *Proceeds from Broker and Barter Exchange Transactions*, or a similar statement from the barter exchange should be sent to you by February 2, 2004. It should show the value of cash, property, services, credits, or scrip you received from exchanges during 2003. The IRS will also receive a copy of Form 1099–B.
Unemployment compensation. You must include in your income all unemployment compensation you receive. You should receive a Form 1099–G showing the amount paid to you. Generally, you enter unemployment compensation on line 19 of Form 1040, line 13 of Form 1040A, or line 3 of Form 1040EZ.

What is a Cafeteria Plan?

Section 125 of the Internal Revenue Code makes it possible for employers to offer their employees a choice between cash and a variety of nontaxable benefits without the application of the constructive receipt rules with respect to income recognition by the employees. See, §125(a), §1.125-1

A cafeteria plan is a written benefit plan maintained by an employer for the benefit of its employees. The plan must allow employees to choose between two or more benefits consisting of cash (or a taxable benefit which is treated as cash) and certain "qualified benefits." See, §125(d), §1.125-1,

The written plan must include the following provisions:

1. A specific description of each benefit available under the plan and the period of coverage.
2. The rules governing which employees are eligible to participate in the plan.
3. The procedures for making elections under the plan, including when elections may be made, the rules governing irrevocability of elections and the periods for which elections are effective.
4. The manner in which employer contributions may be made such as by salary reduction agreement between the employer and employee, by nonelective employer contributions or by both.
5. The maximum amount of employer contributions available to any participant. To meet this requirement, the plan must describe the maximum amount of elective contributions available to any employee either by stating the maximum dollar amount or maximum percentage of compensation that may be contributed as elective contributions or by stating the method for determining the maximum amount or percentage of elective contributions that an employee may make.

Employee
The term "employee" includes both present and former employees, but not self-employed individuals described in section 401(c). Thus, sole proprietors, partners in a partnership and 2% or greater shareholders in an S-corporation are ineligible to participate in a cafeteria plan. In addition, the plan may not be established primarily for the benefit of former employees. A spouse or other beneficiary of a plan participant may receive benefits under a cafeteria plan; however, only the plan participant may make the election of benefits under the plan. See, §125(d)(1)(A), §1.125-1.

Deferred Compensation
A cafeteria plan may not offer any benefit which defers the receipt of compensation (other than a section 401(k) plan). Therefore, the plan may not permit participants to use one plan year's contributions to purchase benefits in a subsequent plan year, or to carryover unused benefits from year to year. See, §125(d)(2), §1.125-1.

Qualified Benefits
A qualified benefit is a benefit that does not defer compensation and which is excludable from an employee's gross income under a specific provision of the Code. Qualified benefits include the following:
a. **Employer-provided accident or health coverage** under sections 105 and 106. This includes health, medical, hospitalization coverage, disability insurance and coverage under an accidental death and dismemberment policy. It also includes reimbursement for health care expenses under a health flexible spending arrangement (FSA). Individually owned accident or health insurance policies may be offered under a cafeteria plan provided that the employer requires an accounting to insure that the health insurance is in force and is being paid by the employees. See, Rev. Rul. 61-146, 1961-2 C.B. 25. Moreover, the plan may not reimburse the health insurance premiums under a health FSA.
b**. Employer-provided group-term life insurance coverage** which is either excludable from income under section 79 or includible in income solely because the benefit exceeds the dollar limit of section 79 ($50,000). Only the first $50,000 of coverage is nontaxable. Dependent group term life insurance may not be included in a cafeteria plan if the benefit is eligible for exclusion under section 132. See, Notice 89-110, 1989-2 C.B. 447.

c. **Employer-provided dependent care assistance** under section 129.
d. **Employer-provided adoption assistance** under section 137.
e. **A 401(k) plan** or purchase of retiree group term life insurance by participants employed by certain educational institutions described in section 170(b)(l)(A)(ii).

The following benefits are not qualified benefits and not permitted in a cafeteria plan:
a**. Contributions to medical savings accounts** under section 106(b);
b**. Qualified scholarships** under section 117;
c. **Educational assistance programs** under section 127;
d. **Certain fringe benefits under section 132**; and
e. **Qualified long-term care insurance** under section 7702B.
See, §125(f), §1.125-1.

Cash Requirement
A cafeteria plan must offer cash as an option (this is usually in the form of a salary reduction agreement). Cash benefits include not only cash, but also benefits which may be purchased with after-tax dollars, or the value of which is generally treated as taxable compensation to the employee. See, §125(d)(1)(B)
.
Salary Reduction
Employer contributions to the cafeteria plan are usually made pursuant to salary reduction agreements between the employer and the employee in which the employee agrees to contribute a portion of his or her salary on a pre-tax basis to pay for the qualified benefits. Salary reduction contributions are not actually or constructively received by the participant. Therefore, those contributions are not considered wages for federal income tax purposes. In addition, those sums generally are not subject to FICA and FUTA. A salary reduction agreement is sufficient to satisfy the "cash" requirement of a cafeteria plan. Thus, a cafeteria plan need only offer a choice between one qualified benefit and salary reduction. See, §1.125-1.

Election Requirements
For participants to avoid constructive receipt of taxable benefits, the plan must offer an election, and participants must elect the amounts and types of benefits to be received prior to the beginning of the plan year. If salary reduction is permitted to pay for the benefits chosen, the salary reduction amount must be elected prior to the beginning of the plan year. Generally, the plan may not permit participants to elect their benefit coverage, benefit reimbursement, or salary reduction for less than 12 months. However, this does not prohibit new employees from electing benefits for a part of the cafeteria plan year.
See, §125(d)(2), §1.125-1.

Overview of Retirement Plans

Retirement Plan Contributions

Your employer's contributions to a qualified retirement plan for you are not included in income at the time contributed. (Your employer can tell you whether your retirement plan is qualified.) However, the cost of life insurance coverage included in the plan may have to be included. See *Group-Term Life Insurance,* earlier, under *Fringe Benefits.*

If your employer pays into a nonqualified plan for you, you generally must include the contributions in your income as wages for the tax year in which the contributions are made. However, if your interest in the plan is not transferable or is subject to a substantial risk of forfeiture (you have a good chance of losing it) at the time of the contribution, you do not have to include the value of your interest in your income until it is transferable or is no longer subject to a substantial risk of forfeiture.

Elective Deferrals

If you are covered by certain kinds of retirement plans, you can choose to have part of your compensation contributed by your employer to a retirement fund, rather than have it paid to you. The amount you set aside (called an elective deferral) is treated as an employer contribution to a qualified plan. It is not included in wages subject to income tax at the time contributed. However, it is included in wages subject to social security and Medicare taxes. Elective deferrals include elective contributions to the following retirement plans.

1. Cash or deferred arrangements (section 401(k) plans).
2. The Thrift Savings Plan for federal employees.
3. Salary reduction simplified employee pension plans (SARSEP).
4. Savings incentive match plans for employees (SIMPLE plans).
5. Tax-sheltered annuity plans (403(b) plans).
6. Section 501(c)(18)(D) plans. (But see *Reporting by employer,* later.)
7. Section 457 plans.

Overall limit on deferrals. For 2003, you generally should not have deferred more than a total of $12,000 of contributions to the plans listed in (1) through (6) above. Your employer or plan administrator should apply the proper annual limit when figuring your plan contributions. However, you are responsible for monitoring the total you defer to ensure that the deferrals are not more than the overall limit.

Catch-up contributions. You may be allowed catch-up contributions (additional elective deferrals) if you are age 50 or older by the end of your tax year. For more information about catch-up contributions to 403(b) plans, see chapter 6 of Publication 571, *Tax Sheltered Annuity Plans (403(b) Plans).*

For more information about additional elective deferrals to:

- SEPs (SARSEPs), see *Salary Reduction Simplified Employee Pension* in Publication 560, *Retirement Plans for Small Business*.
- Simple plans, see *How Much Can Be Contributed to a SIMPLE IRA on Your Behalf* in chapter 3 of Publication 590, *Individual Retirement Arrangements (IRAs).*.

Limit for deferrals under SIMPLE plans. If you are a participant in a SIMPLE plan, you generally should not have deferred more than $8,000 in 2003. Amounts you defer under a SIMPLE plan count toward the overall limit ($12,000 for 2003) and may affect the amount you can defer under other elective deferral plans.

Section 501(c)(18)(D) contributions. Wages shown in box 1 of your Form W–2 should not have been reduced for contributions you made to a section 501(c)(18)(D) retirement plan. The amount you contributed should be identified with code "H" in box 12. You may deduct the amount deferred subject to the limits that apply. Include your deduction in the total on line 33 (Form 1040). Enter the amount and "501(c)(18)(D)" on the dotted line next to line 33.

Excess deferrals. If your deferrals exceed the limit, you must notify your plan by the date required by the plan. If the plan permits, the excess amount will be distributed to you. If you participate in more than one plan, you can have the excess paid out of any of the plans that permit these distributions. You must notify each plan by the date required by that plan of the amount to be paid from that particular plan. The plan must then pay you the amount of the excess, along with any income earned on that amount, by April 15 of the following year.

You must include the excess deferral in your income for the year of the deferral. File Form 1040 to add the excess deferral amount to your wages on line 7. Do not use Form 1040A or Form 1040EZ to report excess deferral amounts.

Excess not distributed. If you do not take out the excess amount, you cannot include it in the cost of the contract even though you included it in your income. Therefore, you are taxed twice on the excess deferral left in the plan—once when you contribute it, and again when you receive it as a distribution.

Excess distributed to you. If you take out the excess after the year of the deferral and you receive the corrective distribution by April 15 of the following year, do not include it in income again in the year you receive it. If you receive it later, you must include it in income in both the year of the deferral and the year you receive it. Any income on the excess deferral taken out is taxable in the tax year in which you take it out. If you take out part of the excess deferral and the income on it, allocate the distribution proportionately between the excess deferral and the income.

- You should receive a Form 1099–R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* for the year in which the excess deferral is distributed to you

Report a loss on a corrective distribution of an excess deferral in the year the excess amount (reduced by the loss) is distributed to you. Include the loss as a negative amount on line 21 (Form 1040) and identify it as "Loss on Excess Deferral Distribution."

Even though a corrective distribution of excess deferrals is reported on Form 1099–R, it is not otherwise treated as a distribution from the plan. It cannot be rolled over into another plan, and it is not subject to the additional tax on early distributions.

Excess Contributions If you are a highly compensated employee, the total of your elective deferrals and other contributions made for you for any year under a section 401(k) plan or SARSEP can be, as a percentage of pay, no more than 125% of the average deferral percentage (ADP) of all eligible non-highly compensated employees. If the total contributed to the plan is more than the amount allowed under the ADP test, the excess contributions must be either distributed to you or recharacterized as after-tax employee contributions by treating them as distributed to you and then contributed by you to the plan. You must include the excess contributions in your income as wages on line 7 of Form 1040. You cannot use Form 1040A or Form 1040EZ to report excess contribution amounts.

If you receive excess contributions from a 401(k) plan and any income earned on the contributions within 2½ months after the close of the plan year, you must include them in your income in the year of the contribution. If you receive them later, or receive less than $100 excess contributions, include the excess contributions and earnings in your income in the year distributed. If the excess contributions are recharacterized, you must include them in income in the year a corrective distribution would have occurred. For a SARSEP, the employer must notify you by March 15 following the year in which excess contributions are made that you must withdraw the excess and earnings. You must include the excess contributions in your income in the year of the contribution (or the year of the notification if less than $100) and include the earnings in your income in the year withdrawn.

You should receive a Form 1099–R for the year in which the excess contributions are distributed to you (or are recharacterized). Add excess contributions or earnings shown on Form 1099–R for 2003 to your wages on your 2003 tax return if code “8” is in box 7. If code “P” or “D” is in box 7, you may have to file an amended 2002 or 2001 return on Form 1040X to add the excess contributions or earnings to your wages in the year of the contribution.

Even though a corrective distribution of excess contributions is reported on Form 1099–R, it is not otherwise treated as a distribution from the plan. It cannot be rolled over into another plan, and it is not subject to the additional tax on early distributions.

Excess Annual Additions The amount contributed in 2003 to a defined contribution plan is generally limited to the lesser of 100% of your compensation or $40,000. Under certain circumstances, contributions that exceed these limits (excess annual additions) may be corrected by a distribution of your elective deferrals or a return of your after-tax contributions and earnings from these contributions. A corrective payment of excess annual additions consisting of elective deferrals or earnings from your after-tax contributions is fully taxable in the year paid. A corrective payment consisting of your after-tax contributions is not taxable. If you received a corrective payment of excess annual additions, you should receive a separate Form 1099–R for the year of the payment with the code “E” in box 7. Report the total payment shown in box 1 of Form 1099–R on line 16a of Form 1040 or line 12a of Form 1040A. Report the taxable amount shown in box 2a of Form 1099–R on line 16b of Form 1040 or line 12b of Form 1040A. Even though a corrective distribution of excess annual additions is reported on Form 1099–R, it is not otherwise treated as a distribution from the plan. It cannot be rolled over into another plan, and it is not subject to the additional tax on early distributions.

Specific Plan overview

Defined Benefit Plan Overview:

Who Can Offer This Plan: Any size business.

Advantage: Allows employers to contribute more than other retirement plans. Allows employers to provide substantial predictable, retirement benefits based on a formula in the plan. Can produce a substantial retirement fund in a few years and is appropriate for employers who can make contributions based on actuarial calculations of the amounts necessary to pay the promised benefit.

Administrative Expense: Higher than defined contribution plans.

Administrative Complexity: High.

Funding: Generally employer contributions.

Annual Contribution Limits: Employer's maximum and minimum contribution is determined actuarially and must be sufficient to pay the participant's benefits as they come due in future years.

Participant Loans: Generally not a feature of the plan.

In-service Withdrawals: Not permitted.

Vesting: Immediate or may vest over years of service not to exceed seven years.

401 (k) Plan Overview:

Who Can Offer This Plan: Any size business.

Advantage: Allows greater employee payroll reduction contributions than most other plans and, if the employer chooses, employees may direct the investment of their assets. Appropriate for larger companies who want to share plan funding with their employees. May be combined with employer profit sharing.

Administrative Expense: Moderate to High.

Administrative Complexity: Moderate to High.

Funding: Pretax employee contributions, and if chosen by the employer, employer matching contributions.

Annual Contribution Limits: *Employee:* $12,000 per year (indexed). *Employer and Employee Combined:* Lesser of 100% of the participant's compensation or $40,000.

Annual Catch-up Contribution Limits: Employees age 50 and older can defer an additional "catch-up" contribution of up to $2,000 for 2003.

Annual Deduction Limit: Company can only contribute and deduct up to 25% of total participant compensation. Included in this 25% are employee pre-tax contributions.

Participant Loans: Participant loans may be a feature of the plan.

In-service Withdrawals: In-service withdrawals for hardship or after age 59 1/2 may be a feature of the plan.

Vesting: Immediate for employee contributions. Employer matching contributions may vest immediately or over years of service not to exceed seven years.

Money Purchase Plan Overview:

Who Can Offer This Plan: Any size business.

Advantage: Allows employers to contribute and deduct more than other defined contribution plans. Guarantees that employees receive an annual contribution.

Administrative Expense: Low.

Administrative Complexity: Moderate.

Funding: Generally employer contributions.

Annual Contribution Limits: Total contributions to a participant's account are limited to the lesser of 100% of the participant's compensation or $40,000.
Annual Deduction Limit: Company can only deduct up to 25% of participant's compensation.
<u>Loans</u>: Participant loans may be a feature of the plan.
<u>In-service Withdrawals</u>: Not permitted.
<u>Vesting</u>: Immediate or may vest over years of service not to exceed seven years.

<u>Profit Sharing Plan Overview:</u>

Who Can Offer This Plan: Any size business.
Advantage: Employers have flexibility to vary the annual <u>contributions</u>. Appropriate for businesses with unpredictable cash flow.
Administrative Expense: Moderate.
Administrative Complexity: Low.
Funding: <u>Employer contributions</u>.
Annual Contribution Limits: Total contributions to a participant's account are limited to the lesser of 100% of the participant's compensation or $40,000.
Annual Deduction Limit: Company can only deduct up to 25% of compensation of all plan participants.
<u>Participant Loans</u>: Participant loans may be a feature of the plan.
<u>In-service Withdrawals</u>: In-service withdrawals may be a feature of the plan.
<u>Vesting</u>: Immediate or may vest over years of service not to exceed seven years.

<u>SEP-IRA Plan Overview:</u>

Who Can Offer This Plan: Any size business that doesn't currently offer a retirement plan.
Advantage: Low cost, easy to set up and maintain, employer has flexibility to vary annual contributions. Appropriate for businesses with unpredictable cash flow.
Administrative Expense: Low.
Administrative Complexity: Minimal.
Funding: <u>Employer contributions</u>.
Annual Contribution Limits: Total contributions to a participant's account are limited to the lessor of 25% of the participant's compensation or $40,000.
Annual Deduction Limit: Company can deduct contributions up to 25% of compensation of all plan participants.
<u>Participant Loans</u>: Not permitted.
<u>In-service Withdrawals</u>: Must be permitted.
<u>Vesting</u>: Must be 100% immediate.

<u>SIMPLE-IRA Plan Overview</u>:

Who Can Offer This Plan: A business with 100 or fewer employees that doesn't currently offer a retirement plan.
Advantage: An easy and affordable plan with few administrative responsibilities, employer flexibility to vary annual contributions. Appropriate for employers who want to share the funding of a plan with employees, while still maintaining some flexibility in <u>employer contributions</u>.
Administrative Expense: Low.
Administrative Complexity: Minimal.
Funding: Pre-tax employee contributions and <u>mandatory employer contributions</u>.
Annual Contribution Limits: *Employee:* $8,000 per year. *Employer:* 100% matching contributions up to 3% of pay, not to exceed $8,000, or employer contribution of 2% of each participant's compensation up to $4,000.

Annual Catch-up Contribution Limits: Employees age 50 and older can defer an additional "catch-up" contribution of up to $1,000 for 2003.
Annual Deduction Limit: Employer deductible contribution maximum is 3% of compensation up to $8,000.
<u>Participant Loans</u>: Not permitted.
<u>In-service Withdrawals</u>: Permitted.
<u>Vesting</u>: Must be 100% immediate.

Discussion of Stock Options

Employer treatment of Stock options

Financial Accounting for Stock Options:

- Accounting for stock options occurs at the time they are granted to the employee. Such accounting recognizes the inability to place an accurate value on employee options at that time. A stock option represents the right to buy corporate stock at some time in the future at today's price. On the date of grant, there is complete uncertainty whether the market price will be above or below the option price at a time when the employee can exercise the option. The formulas available for estimating the value of options on the date of grant are imperfect. The accounting rules also recognize uncertainty over whether stock options are compensation for prior services or a device used to motivate future employee performance.

- Because of this uncertainty, financial accounting rules give companies the choice of either reducing their earnings by the estimated value of the options granted or disclosing in a footnote to the earnings statement the estimated impact of the stock options grants. Either choice discloses the relevant information to investors.

Tax Treatment of Stock Options:

- Federal tax law links the timing and amount of corporate deductions for employee stock options to the tax treatment accorded the employee. Tax law requires that an employee include in income the value of any stock options received, unless the option has no readily ascertainable market value. At the time an option is granted to an employee, the option has no readily ascertainable market value because it permits the holder to buy stock at the then current market price at some date in the future and because the option is not transferable. Because the employee includes nothing in income at the time an option is granted, the employer does not receive any tax deduction.

- When an option is exercised, the employee includes the difference between the market price and the option price as compensation income. The employer, likewise, is entitled to an income tax deduction in the amount that the employee is required to include in income. The tax law treats the transaction as a bargain sale to an employee and recognizes that the employer could have sold the stock subject to the employee's option on the open market and received market price.

COMPARISON OF ACCOUNTING AND TAX TREATMENT OF EMPLOYEE STOCK OPTIONS

	Accounting Treatment	Tax Treatment
Current Rules		
Date of Grant	**Earnings Statement**: Footnote disclosure of number of options granted during the period and display of impact on current earnings of estimated future value of options. Estimate is made using "Black-Sholes" formula that takes into account expected future volatility of stock. At time of grant, it is not known if stock price will rise, fall or stay the same. As an alternative, companies could reduce their earnings by the estimated future value of stock options. **Balance Sheet:** No impact	No tax impact. An option granted at current market price has no "readily ascertainable market value." The tax code links corporate deductions for stock options to the time when the employee exercising an option includes the "spread' on exercise in income. The employee has no income and the employer gets no deduction at the time the option is granted.
Date of Exercise	**Earnings Statement:** No earnings impact. Exercise of options by an employee is a transaction that is external to the operations of the company and has no place on the earnings statement. **Balance Sheet:** Company records receipt of payment for shares from employee as an increase in cash and an increase in paid-in capital in the amount of the exercise price.	Employee includes in income the difference between the market price and the option price of the stock and pays income tax at individual rate. Employer records deduction for the same amount that employee includes in income. Amount of tax paid by employee usually more than amount of tax saved by employer due to higher individual tax rate.

Employee Tax Treatment of Stock Options

If you receive a nonstatutory option to buy or sell stock or other property as payment for your services, you usually will have income when you receive the option, when you exercise the option (use it to buy or sell the stock or other property), or when you sell or otherwise dispose of the option. However, if your option is a statutory stock option (defined later), you will not have any income until you sell or exchange your stock. Your employer can tell you which kind of option you hold.

Nonstatutory Stock Options

If you are granted a nonstatutory stock option, the amount of income to include and the time to include it depend on whether the fair market value of the option can be readily determined. The fair market value of an option can be readily determined if it is actively traded on an established market.

The fair market value of an option that is not traded on an established market can be readily determined only if all of the following conditions exist.

- You can transfer the option.
- You can exercise the option immediately in full.
- The option or the property subject to the option is not subject to any condition or restriction (other than a condition to secure payment of the purchase price) that has a significant effect on the fair market value of the option.
- The fair market value of the option privilege can be readily determined.

The option privilege for an option to buy is the opportunity to benefit during the option's exercise period from any increase in the value of property subject to the option without risking any capital. For example, if during the exercise period the fair market value of stock subject to an option is greater than the option's exercise price, a profit may be realized by exercising the option and immediately selling the stock at its higher value. The option privilege for an option to sell is the opportunity to benefit during the exercise period from a decrease in the value of the property subject to the option.

Option with readily determined value. If you receive a nonstatutory stock option that has a readily determined fair market value at the time it is granted to you, the option is treated like other property received as compensation. See *Restricted Property,* later, for rules on how much income to include and when to include it. However, the rule described in that discussion for choosing to include the value of property in your income for the year of the transfer does not apply to a nonstatutory option.

Option without readily determined value. If the fair market value of the option is not readily determined at the time it is granted to you (even if it is determined later), you do not have income until you transfer or exercise the option. When you exercise this kind of option, the restricted property rules apply to the property received. The amount to include in your income is the difference between the amount you pay for the property and its fair market value when it becomes substantially vested. Your basis in the property you acquire under the option is the amount you pay for it plus any amount you must include in your gross income under this rule. For more information on restricted property, see *Restricted Property,* later. If you transferred this kind of option in an arm's-length transaction, you must include in your income the money or other property you received for the transfer, as if you had exercised the option. This does not apply to a transfer of the option to a related person after July 1, 2003. See Temporary Regulations section 1.83–7T for the definition of a related person.

Tax form. If you receive compensation from employer-provided nonstatutory stock options, it is reported in box 1 of Form W–2. It is also reported in box 12 using code “V.”

If you are a nonemployee spouse and you exercise nonstatutory stock options you received incident to a divorce, the income is reported to you on Form 1099–MISC, *Miscellaneous Income,* in box 3.

Statutory Stock Options

There are two kinds of statutory stock options.

- Incentive stock options (ISOs), and
- Options granted under employee stock purchase plans.

For either kind of option, you must be an employee of the company granting the option, or a related company, at all times beginning with the date the option is granted, until 3 months before you exercise the option (for an incentive stock option, 1 year before if you are disabled). Also, the option must be nontransferable except at death. If you do not meet the employment requirements, or you receive a transferable option, your option is a nonstatutory stock option. See *Nonstatutory Stock Options,* earlier in this discussion.

If you receive a statutory stock option, do not include any amount in your income either when the option is granted or when you exercise it. You have taxable income or deductible loss when you sell the stock that you bought by exercising the option. Your income or loss is the difference between the amount you paid for the stock (the option price) and the amount you receive when you sell it. You generally treat this amount as capital gain or loss and report it on Schedule D (Form 1040), *Capital Gains and Losses*, for the year of the sale.

However, you may have ordinary income for the year that you sell or otherwise dispose of the stock in either of the following situations.

- You do not meet the holding period requirement. This situation applies only if you sell the stock within 1 year after its transfer to you or within 2 years after the option was granted.
- You meet the holding period requirement but the option was granted under an employee stock purchase plan for an option price that was less than the stock's fair market value at that time.

Report your ordinary income as wages on line 7, Form 1040, for the year of the sale.

Incentive stock options (ISOs). If you sell stock acquired by exercising an ISO and meet the holding period requirement, your gain or loss from the sale is capital gain or loss.

If you do not meet the holding period requirement and you have a gain from the sale, the gain is ordinary income up to the amount by which the stock's fair market value when you exercised the option exceeded the option price. Any excess gain is capital gain. If you have a loss from the sale, it is a capital loss and you do not have any ordinary income.

Example.

Your employer, X Corporation, granted you an ISO on March 11, 2001, to buy 100 shares of X Corporation stock at $10 a share, its fair market value at the time. You exercised the option on January 17, 2002, when the stock was selling on the open market for $12 a share. On January 24, 2003, you sold the stock for $15 a share. Although you held the stock for more than a year, less than 2 years had passed from the time you were granted the option. In 2003, you must report the difference between the option price ($10) and the value of the stock when you exercised the option ($12) as wages. The rest of your gain is capital gain, figured as follows:

Selling price ($15 × 100 shares)	$ 1,500
Purchase price ($10 × 100 shares)	-1,000
Gain	$ 500
Amount reported as wages [($12 × 100 shares) - $1,000]	- 200
Amount reported as capital gain	$ 300

Alternative minimum tax (AMT). For the AMT, you must treat stock acquired through the exercise of an ISO as if no special treatment applied. This means that, when your rights in the stock are transferable or no longer subject to a substantial risk of forfeiture, you must include as an adjustment in figuring alternative minimum taxable income the amount by which the fair market value of the stock exceeds the option price. Enter this adjustment on line 13 of IRS Form 6251, *Alternative Minimum Tax—Individuals*. Increase your AMT basis in any stock you acquire by exercising the ISO by the amount of the adjustment. However, no adjustment is required if you dispose of the stock in the same year you exercise the option.

Your AMT basis in stock acquired through an ISO is likely to differ from your regular tax basis. Therefore, keep adequate records for both the AMT and regular tax so that you can figure your adjusted gain or loss.

Example.

The facts are the same as in the previous example. On January 17, 2003, when the stock was selling on the open market for $14 a share, your rights to the stock first became transferable. You include $400 ($1,400 value when your rights first became transferable minus $1,000 purchase price) as an adjustment on line 13 of Form 6251.

Employee stock purchase plan. If you sold stock acquired by exercising an option granted under an employee stock purchase plan, determine your ordinary income and your capital gain or loss as follows.

Option granted at a discount. If at the time the option was granted, the option price per share was less than 100% (but not less than 85%) of the fair market value of the share, and you dispose of the share after meeting the holding period requirement, or you die while owning the share, you must include in your income as compensation, the lesser of:

- The amount, if any, by which the price paid under the option was exceeded by the fair market value of the share at the time the option was granted, or

- The amount, if any, by which the price paid under the option was exceeded by the fair market value of the share at the time of the disposition or death.

For this purpose, if the option price was not fixed or determinable at the time the option was granted, the option price is figured as if the option had been exercised at the time it was granted.

Any excess gain is capital gain. If you have a loss from the sale, it is a capital loss, and you do not have any ordinary income.

Example.

Your employer, Y Corporation, granted you an option under its employee stock purchase plan to buy 100 shares of stock of Y Corporation for $20 a share at a time when the stock had a value of $22 a share. Eighteen months later, when the value of the stock was $23 a share, you exercised the option, and 14 months after that you sold your stock for $30 a share. In the year of sale, you must report as wages the difference between the option price ($20) and the value at the time the option was granted ($22). The rest of your gain ($8 per share) is capital gain, figured as follows:

Selling price ($30 × 100 shares)	$ 3,000
Purchase price (option price) ($20 × 100 shares)	-2,000
Gain	$ 1,000
Amount reported as wages [($22 × 100 shares) - $2,000]	- 200
Amount reported as capital gain	$ 800

Holding period requirement not met. If you do not meet the holding period requirement, your ordinary income is the amount by which the stock's fair market value when you exercised the option exceeded the option price. This ordinary income is not limited to your gain from the sale of the stock. Increase your basis in the stock by the amount of this ordinary income. The difference between your increased basis and the selling price of the stock is a capital gain or loss.

Example.

The facts are the same as in the previous example, except that you sold the stock only 6 months after you exercised the option. You did not hold the stock long enough, so you must report $300 as wages and $700 as capital gain, figured as follows:

Selling price ($30 × 100 shares)	$3,000
Purchase price (option price) ($20 × 100 shares)	-2,000
Gain	$1,000
Amount reported as wages [($23 × 100 shares) - $2,000]	- 300
Amount reported as capital gain [$3,000 – ($2,000 + $300)]	$700

Restricted Property

Generally, if you receive property for your services, you must include its fair market value in your income in the year you receive the property. However, if you receive stock or other property that has certain restrictions that affect its value, you do not include the value of the property in your income until it has been substantially vested. (You can choose to include the value of the property in your income in the year it is transferred to you, as discussed later, rather than the year it is substantially vested.)

Until the property becomes substantially vested, it is owned by the person who makes the transfer to you, usually your employer. However, any income from the property, or the right to use the property, is included in your income as additional compensation in the year you receive the income or have the right to use the property.

When the property becomes substantially vested, you must include its fair market value, minus any amount you paid for it, in your income for that year.

Example.

Your employer, the RST Corporation, sells you 100 shares of its stock at $10 a share. At the time of the sale the fair market value of the stock is $100 a share. Under the terms of the sale, the stock is under a substantial risk of forfeiture (you have a good chance of losing it) for a 5-year period. Your stock is not substantially vested when it is transferred, so you do not include any amount in your income in the year you buy it. At the end of the 5-year period, the fair market value of the stock is $200 a share. You must include $19,000 in your income [100 shares × ($200 fair market value - $10 you paid)]. Dividends paid by the RST Corporation on your 100 shares of stock are taxable to you as additional compensation during the period the stock can be forfeited.

Substantially vested. Property is substantially vested when:

- It is transferable, or
- It is not subject to a substantial risk of forfeiture. (You do not have a good chance of losing it.)

Transferable property. Property is transferable if you can sell, assign, or pledge your interest in the property to any person (other than the transferor), and if the person receiving your interest in the property is not required to give up the property, or its value, if the substantial risk of forfeiture occurs.

Substantial risk of forfeiture. A substantial risk of forfeiture exists if the rights in the property transferred depend on performing (or not performing) substantial services, or on a condition related to the transfer, and the possibility of forfeiture is substantial if the condition is not satisfied.

Example.

The Spin Corporation transfers to you as compensation for services 100 shares of its corporate stock for $100 a share. Under the terms of the transfer, you must resell the stock to the corporation at $100 a share if you leave your job for any reason within 3 years from the date of transfer. You must perform substantial services over a period of time and you must resell the stock to the corporation at $100 a share (regardless of its value) if you do not perform the services, so your rights to the stock are subject to a substantial risk of forfeiture.

Choosing to include in income for year of transfer. You can choose to include the value of restricted property at the time of transfer (minus any amount you paid for the property) in your income for the year it is transferred. If you make this choice, the substantial vesting rules do not apply and, generally, any later appreciation in value is not included in your compensation when the property becomes substantially vested. Your basis for figuring gain or loss when you sell the property is the amount you paid for it plus the amount you included in income as compensation.

If you make this choice, you cannot revoke it without the consent of the Internal Revenue Service. Consent will be given only if you were under a mistake of fact as to the underlying transaction.

If you forfeit the property after you have included its value in income, your loss is the amount you paid for the property minus any amount you realized on the forfeiture.

You cannot make this choice for a nonstatutory stock option.

How to make the choice. You make the choice by filing a written statement with the Internal Revenue Service center where you file your return. You must file this statement no later than 30 days after the date the property was transferred. A copy of the statement must be attached to your tax return for the year the property was transferred. You also must give a copy of this statement to the person for whom you performed the services and, if someone other than you received the property, to that person.

You must sign the statement and indicate on it that you are making the choice under section 83(b) of the Internal Revenue Code. The statement must contain all of the following information.

- Your name, address, and taxpayer identification number.
- A description of each property for which you are making the choice.
- The date or dates on which the property was transferred and the tax year for which you are making the choice.
- The nature of any restrictions on the property.
- The fair market value at the time of transfer (ignoring restrictions except those that will never lapse) of each property for which you are making the choice.
- Any amount that you paid for the property.
- A statement that you have provided copies to the appropriate persons.

Dividends received on restricted stock. Dividends you receive on restricted stock are treated as compensation and not as dividend income. Your employer should include these payments on your Form W–2. If they are also reported on a Form 1099–DIV, *Dividends and Distributions,* you should list them on Schedule B (Form 1040) or Schedule 1 (Form 1040A), *Interest and Ordinary Dividends for Form 1040A Filers,* with a statement that you have included them as wages. Do not include them in the total dividends received.

Stock you chose to include in your income. Dividends you receive on restricted stock you chose to include in your income in the year transferred are treated the same as any other dividends. You should receive a Form 1099–DIV showing these dividends. Do not include the dividends in your wages on your return. Report them as dividends.

Sale of property not substantially vested. These rules apply to the sale or other disposition of property that you did not choose to include in your income in the year transferred and that is not substantially vested.

If you sell or otherwise dispose of the property in an arm's-length transaction, include in your income as compensation for the year of sale the amount realized minus the amount you paid for the property. If you exchange the property in an arm's-length transaction for other property that is not substantially vested, treat the new property as if it were substituted for the exchanged property.

The sale or other disposition of a nonstatutory stock option to a related person after July 1, 2003, is not considered an arm's-length transaction. See Temporary Regulations section 1.83–7T for the definition of a related person.

If you sell the property in a transaction that is not at arm's length, include in your income as compensation for the year of sale the total of any money you received and the fair market value of any substantially vested property you received on the sale. In addition, you will have to report income when the original property becomes substantially vested, as if you still held it. Report as compensation its fair market value minus the total of the amount you paid for the property and the amount included in your income from the earlier sale.

Example. In 2000, you paid your employer $50 for a share of stock that had a fair market value of $100 and was subject to forfeiture until 2003. In 2002, you sold the stock to your spouse for $10 in a transaction not at arm's length. You had compensation of $10 from this transaction. In 2003, when the stock had a fair market value of $120, it became substantially vested. For 2003, you must report additional compensation of $60, figured as follows:

Fair market value of stock at time of substantial vesting		$120
Minus: Amount paid for stock	$50	
Minus: Compensation previously included in income from sale to spouse	10	-60
Additional income		$60

Inherited property not substantially vested. If you inherit property not substantially vested at the time of the decedent's death, any income you receive from the property is considered income in respect of a decedent and is taxed according to the rules for restricted property received for services. For information about income in respect of a decedent, get Publication 559.

What is alternative minimum tax?

The alternative minimum tax, or AMT, is a separate system of income taxation that operates in parallel to the regular income tax.

There are two AMTs, one for individuals and the other for corporations

The goal of the AMT for individuals is to make everyone with significant income pay some federal income tax. The AMT has a lower top rate than the regular income tax but tries to catch more income in its net by defining taxable income (the tax base) more broadly. Compared to the regular income tax, the AMT has fewer “tax preferences”—deductions and other ways of reducing tax liability. The AMT was originally devised to reduce certain deductions used frequently by high-income taxpayers and infrequently by other taxpayers. Hence the AMT has provisions concerning deductions for drilling oil wells, farm tax shelters, interest from tax-exempt “private activity bonds.”

How the AMT affects taxpayers. All taxpayers *potentially* affected by the AMT file a special form (IRS Form 6251). Among taxpayers who are actually affected by the AMT, some are affected directly and others indirectly. Taxpayers affected directly pay a special, higher tax—the AMT. Taxpayers affected indirectly still pay the regular income tax, but are not allowed to claim as many tax credits as they otherwise could. (A tax credit is a provision that allows a reduction in tax liability by a specific dollar amount, regardless of income. For example, a tax credit of $500 allows both taxpayers with income of $40,000 and those with income of $80,000 to reduce their taxes by $500, if they qualify for the credit.) Taxpayers who owe more under the regular income tax than under the AMT *before* tax credits, but less *after* credits, cannot pay less than the AMT amount. For them, the existence of the AMT makes the regular income tax higher than it would otherwise be.

Calculating the AMT. Calculating the AMT is a four-step process.

First, taxpayers calculate their regular income tax.

Second, they determine whether the AMT may apply. Some taxpayers are automatically subject to the AMT because the tax applies to everyone who claims certain kinds of adjustments to income, such as stock options not exercised in the same year they were received. Such taxpayers go straight to the third step. Other taxpayers may be subject to the AMT if their taxable income plus certain other items exceeds $45,000 for married couples filing a joint return (half that for each spouse if they file separately), or $33,750 for a single filer or head of household. Those taxpayers complete a worksheet provided in the instructions to IRS Forms 1040 and 1040A, the forms for the regular income tax. If the worksheet indicates that the AMT may apply, those taxpayers go on to the third step.

Third, taxpayers use IRS Form 6251, to recalculate taxable income using the rules of the AMT instead of the rules of the regular income tax. The result of this calculation is called the tentative AMT.

Finally, taxpayers compare their regular tax before credits with their tentative AMT, and pay whichever is greater. Technically, the AMT is not the whole amount of tax calculated under AMT rules; it is only the *difference* between tentative AMT and regular income tax.

The AMT has two rates. A tax rate of 26 percent applies if AMT income minus the exemption amount does not exceed $175,000. Each dollar beyond $175,000 is taxed at 28 percent. The exemption amount is $45,000 for married couples filing a joint return (half that for each spouse if they file separately), or $33,750 for a single filer or head of household. The two rates of the AMT compare to five rates currently for the regular income tax (15, 28, 31, 36, and 39.6 percent).7 Again, the AMT allows fewer ways to reduce tax liability than the regular income tax, so it raises additional revenue despite its relatively low rates.

An example of how the AMT can increase taxes. A recent study by the General Accounting Office gives examples of how the AMT for individuals can increase taxes for tax year 2000. One example is of a family comprising a husband, wife, and six children.

This hypothetical family had wage earnings of $80,000, rented rather than owning its house, and had no significant tax deductions. A standard deduction of $7,350 plus personal exemptions of $22,400 would reduce its taxable income to $50,250. Under the regular income tax, the family would owe $5,377 in federal income tax ($8,377 minus $3,000 for the child tax credit).

Under the AMT, not all the deductions and exemptions that the family has taken are allowed. Instead of paying $5377, the family must pay $6100 ($9100 minus $3000 for the child tax credit). The difference of $723 is an increase of more than 13 percent over the regular income tax.

Resources

1. IRS Publication 525
2. THE ALTERNATIVE MINIMUM TAX FOR INDIVIDUALS: A GROWING BURDEN Jim Saxton (R-NJ), Chairman Joint Economic Committee United States Congress May 2001 Joint Economic Committee
3. Software Finance and Tax Executives Council
4. US Chamber of Commerce www.selectaretirementplan.org/plans_types.htm
5. IRS Revenue Ruling 87-14
6. Introduction to Cafeteria Plans, Internal Revenue Service Chief Counsel
7. Independent Contractor or Employee IRS Training Manual