

## FRINGE BENEFITS:

### Taxation Timing and Taxable Value

Taxable fringe benefits may be CASH or NON-CASH benefits, but either way they are normally subject to employment tax withholding. The question then is WHEN to withhold the taxes.

The employer may elect to treat fringe benefits as paid by the pay period, quarterly, semi-annually, or on another basis, but withholding on the fringe benefit must occur no less frequently than annually. Conversely, the employer may also treat the value of a single fringe benefit as paid on one or more dates within the same calendar year, even if the employee receives the entire benefit at one time.

The employer has other options, too, provided the fringe benefit is not a transfer of tangible or intangible personal property of a kind normally held for investment, or the transfer of real property. For example, the payment date selected for a particular type of fringe benefit does not have to be the same for all employees. Later, the employer can change that date, provided it treats all benefits furnished in a calendar year as paid no later than December 31 of that calendar year. IRS approval of such changes is not required, and notification to the IRS of such elections is not necessary.

Generally, by January 31 of the following year, employers must determine the ACTUAL value of fringe benefits furnished to employees. But, under a special rule, the employer may elect to treat fringe benefits that actually are provided in November and December, as paid in the following year.

Naturally, employers who make this election must notify affected employees, since the employees must use the same rule in accounting for related deductions. The notification must occur at or before the time that Form W-2 is provided to the employees. Again, the employer does not have to notify the IRS of the election, and the election can be changed without IRS approval, as long as the appropriate amount of income is reported for the change period, and the applicable taxes are withheld and deposited.

Note that for certain types of non-cash fringe benefits the IRS provides special valuation rules. For example, special valuation rules exist for personal use of a company car, chauffeur services, personal flights on company aircraft, and meals provided at an employer-operated eating facility.

Employment taxes withheld on taxable fringe benefits must be deposited in the same manner as taxes withheld on cash wages. Before the payment date, the employer may make a reasonable estimate of the value of fringe benefits provided in order to make timely deposits. Also, the actual value of the fringe benefit and its related tax liability must be reported on Form 941 (or other employment tax return) for the reporting period in which the benefit is treated as paid.

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## QUALIFIED TRANSPORTATION

### FRINGE BENEFITS

Within certain dollar limits, qualified transportation benefits provided by the employer are not subject to Federal income tax withholding, or Social Security, Medicare or FUTA taxes. The employer-provided benefits included in this exclusion from the employee's gross income are: transit passes, tokens, fare cards, vanpool transportation in a commuter highway vehicle to and from work, and qualified parking at or near the place of work. The combined exclusion for transit passes and transportation

cannot exceed \$105 per month for 2006 (unchanged from \$105 in 2005). The exclusion for qualified parking cannot exceed \$205 per month for 2006 (compared to \$200 in year 2005). Note that many state and local jurisdictions do not follow this Federal exclusion.

Qualified transportation benefits can be provided directly by the employer or through a bona fide reimbursement arrangement. However, cash reimbursements for transit passes qualify only if a voucher or a similar item that the employee can exchange only for a transit pass is not readily available for direct distribution by the employer to the employee. A voucher is readily available for direct distribution only if the employee can obtain it from a voucher provider that does not impose fare media charges or other restrictions that effectively prevent the employer from obtaining vouchers.

Beginning January 1, 1998, employees were permitted to choose between any qualified transportation benefit and CASH, without losing the exclusion of the transportation benefit from employment taxes. Only if the cash is chosen by the employee, does the benefit become taxable income.

An employer may pay or reimburse an employee for a qualified transportation fringe in excess of the statutory limit. But, note that only the excess amount is taxable as income, not the entire benefit amount. Income tax withholding on the non-cash form of these "excess" benefits is performed in the same manner as for other non-cash fringe benefits. Should the value of the benefit be less than the statutory limit in any month, the unused portion may be carried over to subsequent months. In any case, the value of qualified transportation fringe benefits must be calculated on a monthly basis.

The employer may elect, for Federal income tax withholding, FICA, or FUTA, to treat such non-cash fringe benefits as paid either on a pay period, quarterly, semi-annual, annual, or other basis, but no less frequently than annually. Cash reimbursements, however, must be withheld upon when actually paid. The taxable amounts for both non-cash benefits and reimbursements must be reported as wages on an employee's Form W-2.

In general, all employees are eligible, including corporate officers. However, self-employed workers, such as independent contractors, partners, and more-than-2% S corporation shareholder/employees are not covered by qualified transportation fringes, but may have some transportation expenses excluded as "working condition" or "de minimis" fringes. For example, tokens or fare cards that enable an independent contractor or other self-employed person to commute on a public transit system are excludable as a "de minimis" fringe from the worker's gross income if the value of the tokens or fare cards does not exceed \$21 in a month. If the value exceeds \$21, however, the entire value of the pass is includable in gross income.

Any transportation fringe benefits plan offered by an employer must be separate from cafeteria plan benefits, even though the latter may offer "flex" benefits. Employers are prohibited under Section 125 of the Internal Revenue Code from offering in a cafeteria plan a salary reduction arrangement for transportation fringes. Unlike other salary reduction arrangements, however, there is no requirement to maintain a written plan for transportation benefits. Also, transportation fringes are not subject to the rules of Code Section 132 because they fall outside the ERISA definition of "employer welfare benefit plan." Therefore, the tax-favored status of transportation fringes is not jeopardized if the plan is "top heavy." Likewise, Form 5500 (Annual Return/Report of Employee Benefit Plan) ERISA filing requirements do not apply.

Finally, employers making cash reimbursements must establish a bona fide reimbursement arrangement to ensure that employees have, in fact, incurred the expenses claimed. For example, employees may present a used or new transit pass to the employer, and certify that he or she purchased it and used (or will use) the pass during the month.

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### DO BONUS AND OTHER SUPPLEMENTAL WAGE PAYMENTS HAVE SPECIAL WITHHOLDING TAX ALTERNATIVES?

Here is the problem: Suppose an employee is paid non-recurring compensation in addition to regular wages. Because federal and state income tax withholding tables are "progressive," they require a higher percentage of withholding as the compensation amount is increased. Therefore, an employee normally subject to a withholding rate of 15% may be withheld at 25% or more if one-time "supplemental wages" are included in the payment. Importantly, the amount of tax withheld might exceed the sum of tax amounts calculated separately on EACH payment. Therefore, the I.R.S. and many states offer alternative withholding calculations when supplemental wages are paid.

The term "supplemental wages" applies to compensation paid in addition to the employee's regular wages. For example, bonuses, commissions, overtime pay, payments for accumulated sick leave, severance pay, awards, prizes, back pay and retroactive pay increases for current employees, and payments for nondeductible moving expenses. Other payments subject to the supplemental wage rules include taxable fringe benefits and expense allowances paid under a non-accountable plan.

Special rules apply to withholding on supplemental wages when an employee receives more than \$1,000,000 of supplemental wages during the calendar year. The excess over \$1,000,000 is subject to withholding at 35%, regardless of the withholding rate called for by the employee's Form W-4.

On the other hand, if the supplemental wages paid to the employee during the calendar year are less than or equal to \$1,000,000, the following rules apply in determining the amount of income tax to be withheld. There are only two possibilities. First, if the supplemental wages are COMBINED with regular wages in a single payment, without identifying the amount of each, income tax is withheld as if the total were a single payment for a regular payroll period.

Alternatively, if the supplemental wages are PAID SEPARATELY (or combined in a single payment, but the amount of each is specified), the income tax withholding method depends partly on a second question: whether income tax is being withheld specifically from the regular wages.

---- Where income tax IS WITHHELD from the regular wages, then one uses either of the following methods for the supplemental wages:

- a.) withhold at a flat rate of 25.0%; no other flat rate is allowed, **OR**
- b.) add the supplemental to the regular wages for the most recent payroll period this year. Figure the income tax withholding as if the total were a single payment. Subtract the tax already withheld for the regular wages. Withhold the remaining tax from the supplemental wages.

--- Where income tax was NOT WITHHELD from the employee's regular wages, income tax is withheld as if the total were a single payment for a regular payroll period.

Regardless of the method used to withhold income tax on supplemental wages, Social Security, Medicare and FUTA taxes apply to such payments.

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### STATE DISABILITY INSURANCE UPDATE

Laws in five states and Puerto Rico provide benefits for workers temporarily disabled by injuries or illnesses NOT related to their employment. Temporary disability benefits provide some salary continuation for persons who are unable to work because of illness or injury, but who do not qualify for benefits under workers' compensation or unemployment compensation laws. Workers' compensation laws cover only work-related injuries or illnesses, while unemployment laws require that claimants be able and available to work.

Temporary disability benefits may be financed in three ways: 1.) employee contributions withheld by employers, 2.) employer contributions, or 3.) by a combination of the two. Noted below are the EMPLOYEE contribution requirements for the six jurisdictions which have temporary disability benefit laws:

--**California:** For 2006, the employee contributes 0.08% on the first \$79,418 of annual earnings. The 2006 rate includes 0.00% for Paid Family Leave (compared to 0.08% in 2004 and 2005). Employers may substitute comparable private plan coverage.

--**Hawaii:** Half the cost of providing benefits is contributed by the employee. For 2006, however, no more than 0.5% of an employee's wages up to \$791.70 weekly may be deducted (maximum weekly contribution of \$3.96).

--**New Jersey:** For 2006, employees contribute 0.5% of their first \$25,800 of annual earnings (was \$24,900 for 2005). Employers are not required to participate in the state plan if they provide comparable private plan coverage.

--**New York:** Unchanged from 2005, the employee may contribute 0.5% of year 2006 wages, up to \$0.60 per week. While the employer MUST provide disability insurance, it is the employer's decision whether to be reimbursed through employee deductions.

--**Puerto Rico:** Again in year 2006, the employee will contribute 0.3% on the first \$9,000 in wages.

--**Rhode Island:** For year 2006, the employee contributes 1.4% (1.4% in 2005) on taxable wages up to \$50,600 (\$49,000 in 2005).

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### MICHIGAN MINIMUM WAGE INCREASE

In the May, 2006 TAX RESEARCHER we correctly reported that Michigan will increase the state minimum wage rate in three steps, beginning 10/1/2006. However, the minimum wage rate changes for **tipped employees** were incorrectly explained. Following is a recap of the correct information.

Beginning on 10/1/2006, Michigan will make the first of three increases to the state minimum wage rate.

- effective **10/1/2006:**  
the regular rate increases from \$5.15 to \$6.95 per hour.
- effective **7/01/2007:**  
the regular rate increases from \$6.95 to \$7.15 per hour.
- effective **7/01/2008:**  
the regular rate increases from \$7.15 to \$7.40 per hour.

However, for tipped employees in Michigan there will be **no change** in the minimum cash wage amount of \$2.65 when the regular minimum wage rate is changed. Therefore, on the above dates, the maximum tip credit for tipped employees will increase from \$2.50 to \$4.30, \$4.50 and \$4.75, respectively. Regardless of the foregoing changes in the regular minimum wage rate, the Training/Youth rate will remain unchanged at \$4.25 per hour.

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(July, 2005 through June, 2006)

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