

BARATZ & ASSOCIATES, P.A.

Accountants and Consultants

Brian D. Baratz, CPA • Mark H. Wander, CPA**[∞] • Raymond M. Giunta, CPA*

Clifford Simmons, CPA • Francis M. Mulroy, CPA • John R. Fekete, CPA

*Accredited in Business Valuations – *Personal Financial Specialist – [∞]Certified in Financial Forensics

December 2010

To Our Valued Business Clients,

Re: Calendar 2010 Employer Reporting Responsibilities

There is significant responsibility placed on employers to comply with the numerous regulations and requirements as set forth by the Internal Revenue Service and state taxing agencies. In an effort to both inform and educate our business taxpayers, we are writing to discuss some of the key compliance and recordkeeping issues for the upcoming employer calendar 2010 reporting season. We strongly encourage you to take the time to read and understand the topics presented in advance of the December 31, 2010 calendar year end and determine if these issues may be applicable to your business.

1. Employee vs. Independent Contractor Status

For federal tax purposes, there is an important distinction made between an employee and independent contractor. Generally speaking, when determining whether a worker is an employee or independent contractor, the IRS will consider ALL evidence as to the degree of control and degree of independence of the worker. Recent IRS guidance, however, has divided evidence to the degree of control and independence into three main categories: behavioral control, financial control, and relationship of the parties. Below is a brief definition and example of each category of control:

- **Behavioral Control** – Facts that show whether the business has the right to direct or control how the worker does the work. For example, if you receive extensive instructions on how work is to be done, this suggests that you may be an employee.
- **Financial Control** – Facts that show whether the business has a right to control the business aspects of the worker's job. For example, if you can realize a profit or incur a loss, this suggests that you may be an independent contractor.
- **Relationship of the Parties** – Facts that show how the business and the worker perceive their relationship. For example, if you receive benefits, such as insurance, pension, or paid leave, this suggests that you may be an employee.

No single fact provides the answer to whether a worker is an employee or independent contractor. It is important to understand the business and the relationship of the parties

when determining worker classification as improper classification can have significant tax consequences to both the worker and the business.

2. Personal Use of Employer-Provided Vehicles

Business use of an employer-provided vehicle can include traveling from one work location to another work location within your tax home area; visiting customers; attending a business meeting away from the regular workplace; and traveling from home to a temporary workplace if you have one or more regular places of work. An employee with an employer-provided vehicle is required to substantiate the business use of the car by maintaining a contemporaneous written log of all business mileage during the year.

The costs of travel between home and a regular place of work (“commuting”) is personal usage. Obviously, personal usage would also include non-business mileage accumulated while off duty from work (nights, weekends, holidays, vacation, etc.).

An employer provided vehicle is a fringe benefit that is generally taxable to the employee. The exception to this rule is when the vehicle is used by the employee almost exclusively for employer business purposes.

The employer is required to calculate the value of personal usage and include it in the employee’s Form W-2 as taxable wages. This is generally done by using the Annual Lease Value (“ALV”) method.

A personal usage percentage is calculated based upon the ratio of personal mileage (including commuting miles) divided by total mileage for the vehicle.

For Company-owned Vehicles:

The IRS prescribed “ALV” table (see attached **Exhibit A**) is used to determine the annual lease value “ALV” of *company-owned vehicles*. The proper ALV amount is selected based upon the company’s original cost to purchase the vehicle during the first four years of company ownership. The ALV amount is re-determined in year 5 based upon the vehicle’s current fair value as a “used” car. The ALV table takes into account the fair market value of insuring and maintaining the vehicle but not the value of fuel. If an employer provides an employee with the use of a vehicle for less than an entire calendar year, the employer may treat the automobile’s prorated ALV amount as the fair market value of the benefit.

The personal usage percentage is applied to the proper ALV amount for the vehicle to arrive at the value of personal usage that is taxable to the employee.

Where an employer provides fuel to an employee in connection with the employee’s use of an automobile—whether in kind, by means of a reimbursement arrangement, or by directly charging the cost of fuel to the employer—the fair market value of the fuel

is an additional fringe benefit to the employee which must be included in his or her W-2 gross income.

For Company-leased Vehicles:

The personal usage percentage can be applied to the company's actual cost for the vehicle (including annual lease cost, insurance, maintenance, fuel, etc.) to arrive at the value of the personal usage that is taxable to the employee. However, this may result in a significantly higher value for personal usage. Alternatively, the "annual lease value" can be determined from the ALV table based upon what the original cost would have been if the company had purchased the vehicle rather than leased it at date of lease origination.

3. Employee Expense Allowances for Auto/Travel, etc.

An employee doesn't pay tax on an advance, reimbursement or other expense allowance received from his employer under an "accountable plan." An advance, etc., is treated as made under an "**accountable plan**" if:

- (1) The employee receives the advance, etc., for a deductible business expense that he paid or incurred while performing services as an employee of his employer.
- (2) The employee must adequately substantiate and account to his employer for the expense within a reasonable period of time, and
- (3) The employee must return any excess reimbursement or allowance within a reasonable period of time.

An advance, etc., *that doesn't satisfy all three conditions* is treated as paid under a "non-accountable" plan. Advances under a "*non-accountable plan*" are taxed to the employee and are subject to FICA and income tax withholding and must be reported in the employee's W-2. If an employee does not timely return advances or reimbursements in excess of those that are substantiated, only the excess is treated as made under a non-accountable plan.

4. Medical Insurance Premiums of S Corporation Shareholders

The health and accident insurance premiums paid on behalf of 2% (or more) S corporation shareholder-employees are deductible by S corporations as fringe benefits and are reportable as wages for income tax withholding purposes on the shareholder-employee's Form W-2. This additional compensation is not subject to Social Security or Medicare (FICA) or Unemployment (FUTA) taxes. It should however, be included in Box 1 (Wages) of the Form W-2, Wages and Tax Statement, issued to the shareholder, but is not included in Boxes 3 or 5 of Form W-2. For New Jersey and Delaware residents this amount should also be included in Box 16 (State Wages). Pennsylvania residents should not include shareholder health insurance premiums in Box 16 (State Wages).

A 2% shareholder-employee is eligible for a deduction against adjusted gross income for amounts paid during the year for medical care premiums if the medical care coverage is established by the S corporation. For a medical care plan to be considered "established by the S corporation" it can be in the name of the S corporation or in the name of the 2% shareholder. In addition, medical care plans in the name of the 2% shareholder must either be paid by the S corporation directly or reimbursed if paid by the 2% shareholder. In either instance the premium payment or the reimbursement should be added as wages on the 2% shareholder's Form W-2.

5. Group Term Life Insurance

You should exclude the cost of up to \$50,000 of group-term life insurance from the wages of an insured employee. You also exclude the same amount from the employee's wages when figuring social security and Medicare taxes. In addition, you do not have to withhold federal income tax or pay FUTA tax on any group-term life insurance you provide to an employee.

You must include in your employee's wages subject to social security and Medicare taxes the cost of group-term life insurance in excess of \$50,000 coverage, reduced by the amount the employee paid toward the insurance. Report it as wages in boxes 1, 3, and 5 of the employee's Form W-2. Also, show it in box 12 with code "C."

Figure the monthly cost of the insurance to include in the employee's wages by multiplying the number of thousands of dollars of insurance coverage over \$50,000 (figured to the nearest \$100) by the cost shown in the IRS prescribed table (see **Exhibit B** attached). For all coverage provided within the calendar year, use the employee's age on December 31. You must prorate the cost from the table if less than a full month of coverage is involved.

You figure the total cost to include in the employee's wages by multiplying the monthly cost by the number of full months' coverage at that cost.

Example

You provide Tom, an employee, with group-term life insurance coverage of \$200,000. Tom is 45 years old, is not a key employee, and pays \$100 per year toward the cost of the insurance. You must include \$170 in his wages calculated as follows:

The \$200,000 of insurance coverage is reduced by \$50,000. The yearly cost of \$150,000 of coverage is \$270 $\{ \$15 \text{ (per thousand per month at age 45)} \times 150 \text{ (thousand)} \times 12 \text{ (months)} \}$. This amount is reduced by the \$100 Tom pays for the insurance. You must include \$170 in boxes 1, 3, and 5 of Tom's Form W-2. You must also enter \$170 in box 12 with code "C."

There is no \$50,000 group-term life insurance exclusion for 2% (or more) S corporation shareholder-employees. The entire value of life insurance coverage provided to a 2% (or more) S corporation shareholder-employee is reportable as W-2 wages.

6. Business Use of Cell Phones

Effective retroactive to January, 01 2010, cell phones and similar telecommunications equipment (including PDA's and Blackberry devices) have been removed from "listed property". This means that cell phones can be deducted or depreciated like other business property, without onerous recordkeeping and substantiation requirements. As with other property, you still must be able to demonstrate the business use of the cell phone. For employee use of company provided cell phones, currently there is no specific fringe benefit exclusion for personal usage. However, the IRS may allow an exclusion for employee use of company provided cell phones *that are used primarily for business purposes* as a tax free "de minimis" fringe benefit.

7. "De Minimis" Fringe Benefits

"De minimis" or minimal fringe benefits are excluded from the employee's gross income. A de minimis fringe benefit is any property or service whose value is so small that accounting for it is unreasonable or administratively impracticable, taking into account the frequency with which similar fringe benefits are provided by the employer to its employees.

Examples of De minimis fringe benefits include: occasional meals, supper money, or local transportation provided because of overtime work; transportation (e.g., taxi fare) where other available means of transportation are unsafe, occasional cocktail parties or picnics; traditional holiday gifts of property (not cash) with a low fair value; flowers, fruit, etc., provided under special circumstances, such as sickness or outstanding performance.

Conclusion:

All employers have the responsibility to understand and comply with the requirements as set forth by the Internal Revenue Service and state taxing agencies. It should be noted that the topics discussed in this letter and the requirements set forth by the federal and state taxing agencies have already been in place. We believe that it is important to review these issues regularly as any improper application of the topics discussed could substantially increase your risk of audit by taxing authorities or significantly impact your tax liability. As your accountants and tax preparers we are providing this information for you as it is important that you understand the growing support and documentation requirements of the Internal Revenue Service and state taxing agencies. If you do not understand or you need further clarification on any of the issues discussed in this letter, please contact your Baratz & Associates representative.

EXHIBIT A

IRS Table- Annual Lease Value for Company-Provided Vehicles

If an employer provides an employee with the use of an automobile as a fringe benefit for an entire calendar year, the automobile's annual lease value is used to compute the value of that benefit (i.e., the amount taxed to the employee). The following table (from Reg § 1.61-21(d)(iii)) provides the annual lease value to be used in this computation.

Annual Lease Value Table for Automobiles

(1) Automobile Fair Market Value	(2) Annual Lease Value
\$0 - 999	\$ 600
1,000 - 1,999	850
2,000 - 2,999	1,100
3,000 - 3,999	1,350
4,000 - 4,999	1,600
5,000 - 5,999	1,850
6,000 - 6,999	2,100
7,000 - 7,999	2,350
8,000 - 8,999	2,600
9,000 - 9,999	2,850
10,000 - 10,999	3,100
11,000 - 11,999	3,350
12,000 - 12,999	3,600
13,000 - 13,999	3,850
14,000 - 14,999	4,100
15,000 - 15,999	4,350
16,000 - 16,999	4,600
17,000 - 17,999	4,850
18,000 - 18,999	5,100
19,000 - 19,999	5,350
20,000 - 20,999	5,600
21,000 - 21,999	5,850
22,000 - 22,999	6,100
23,000 - 23,999	6,350
24,000 - 24,999	6,600
25,000 - 25,999	6,850
26,000 - 27,999	7,250
28,000 - 29,999	7,750
30,000 - 31,999	8,250
32,000 - 33,999	8,750
34,000 - 35,999	9,250
36,000 - 37,999	9,750
38,000 - 39,999	10,250
40,000 - 41,999	10,750
42,000 - 43,999	11,250
44,000 - 45,999	11,750
46,000 - 47,999	12,250
48,000 - 49,999	12,750
50,000 - 51,999	13,250
52,000 - 53,999	13,750
54,000 - 55,999	14,250
56,000 - 57,999	14,750
58,000 - 59,999	15,250

EXHIBIT B

Computing the value of taxable group-term life insurance.

The value of group-term life insurance is determined on the basis of uniform premiums (computed on the basis of five-year age brackets) prescribed by IRS.

The cost of \$1,000 of group-term life insurance provided for one month is determined under the following table:

Age	Cost per \$1,000 for one-month period
Under 25.....	\$.05
25 to 29.....	\$.06
30 to 34.....	\$.08
35 to 39.....	\$.09
40 to 44.....	\$.10
45 to 49.....	\$.15
50 to 54.....	\$.23
55 to 59.....	\$.43
60 to 64.....	\$.66
65 to 69.....	\$1.27
70 and above....	\$2.06