Chapter 4
Employee Compensation

Key Concepts

- Most forms of employee compensation are fully taxable to the employee as income and fully deductible by the employer as a business expense.
- Fringe benefits are taxable as income to employees unless they fit into one of the specific categories of tax-exempt fringe benefits. Tax-exempt fringe benefits are deductible by the employer even though they are not taxable income to the employee.
- Most tax-exempt fringe benefits have some dollar limit. Benefits paid in excess of these limits are compensation, taxable to the employee and deductible by the employer.
- Qualified stock options allow employees to defer income recognition and require no cash outlay by the employer.
- Qualified deferred compensation is deductible by the employer when the contribution is made to the trust fund, but employees are not taxed until they receive the funds. Income on the contributed funds accrues tax free until it is withdrawn.
- Employers can offer unlimited deferred compensation to key and highly paid employees through nonqualified deferred compensation plans.

1. Employee Compensation

a. Tax consequences

Employers can deduct wage expense.
Employers can deduct payroll taxes on employee wages.
Taxes include FICA, FUTA and SUTA.
FICA has 2 components.
    SS is 6.2% of wages up to $87,900 for 2004.
    Medicare is 1.45% of total compensation.
Employees must pay a matching but nondeductible FICA tax.
Employers withhold these taxes from their employees' compensation.
Employers pay FUTA and SUTA. FUTA is 6.2% on the first $7,000 of covered wages paid during the year to each employee.
Employers must file W-2s on employees.

b. Employee versus independent contractor (IC)

An IC is a worker who is subject to the direction of another only as to the result of the work accomplished, not the means to accomplish it. An IC is self-employed.

Nanny tax threshold is $1,400 or more for 2004.

Revenue Ruling 87-41-factors for determining work status
Instructions
Payment
Tools and materials
Significant investment
Realization of profit or loss

c. Timing of compensation deduction
If a corporation accrues an obligation to pay compensation, the payment must be made within 2 1/2 months after the close of the corporation's tax year or it cannot be deducted until the year of payment.

If an accrual basis corporation accrues a payment to a related cash-basis TP, the deduction for the payment is deferred until the related party recognizes the income in year of payment.

d. Reasonable compensation is the amount that a similar business would pay for services under similar circumstances. Because dividends are not deductible by a corporation, the business has an incentive to inflate SH-employee salaries instead of paying dividends.

IRC limits the amount of deductible compensation paid to top executives of publicly traded companies to $1M annually.
Compensation subject to the limitation includes all cash and non-cash benefits except:

Compensation based on performance goals
Compensation paid on a commission basis
Employer contributions to a qualified retirement plan
Tax-free employee benefits

When an individual is a controlling SH-employee of an S Corp, IRS auditors look for unreasonably low salary because salaries are subject to payroll taxes while distributions of profits are not.

Closely held business owners can hire family members as employees and shift income within the family. Owners who hire their own children under 18 are not subject to payroll taxes if the business is not a corporation.

Foreign earned income exclusion is $80,000
US citizen must be a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year, or
must be physically present in a foreign country/countries for at least 330 full days during any 12 month period.
May take a foreign tax credit rather than the exclusion.

2. Employee fringe benefits – deductible by payor and not taxable to recipient.
Study Table 4.1

a. Group term life insurance premiums up to $50,000 (face)
Life insurance premiums in excess of $50,000 of coverage paid by the employer are income to the employee.
Exclusion only applies to employee.
Let's look at Table 4.2.

b. Health and accident insurance premiums – All employees can exclude from income the value of both employer – paid premiums and benefits received from their health and accident plans, even if the plans discriminate in favor of key employees. Applies to employee's children and spouse too.
Self-insurance plans.

c. Child and dependent care programs
Employee can exclude up to $5,000. Provided at either on-site or off-site facility. Excluded benefits cannot exceed the employee's EI for the year or, if less, the EI of a spouse.

d. Cafeteria plans are an exception to Doctrine of Constructive Receipt.
Nondiscriminatory, written plan that allows employees to choose from a menu of options up to a certain dollar amount or take cash.
Flexible spending arrangement

e. Meals and lodging
Meals are excluded if provided on employer's premises for employer's convenience.
Lodging if on employer's premises for employer's convenience and a condition of employment.
Cash allowances for meals or lodging are usually included in employee's GI.

f. No-additional-cost-services
Employer provides free "excess capacity" services to employees without incurring substantial additional costs, employee excludes the value of the services from GI.

g. Employee purchase discounts on property or services, excluding real estate and investment property, must be offered to customers in ordinary course of business. Does not apply to real estate or investment property. Employee must pay an amount equal to employer's cost of property to receive the full discount on property. Excludable discount for services cannot exceed 20% of the price normally charged for the services.

h. Employee achievement awards for length of service or safety achievement. Award must be tangible personal property under a non-discriminatory plan, a single award can be valued as high as $1,600 in any year, if the value for all achievement awards does not exceed $400.

i. De minimas fringe
Coffee & doughnuts (Krispy Kreme)
Personal use of photocopy machine or computer
Non-cash holiday gifts
Company picnic
Tickets to cultural or sporting events
Employer provided qualified transportation benefits
Employer provided athletic facilities on employer's premises

j. Working condition fringe – Key is whether employee would have a tax deduction if she paid the expense herself.
Job related education
Professional membership dues
Subscriptions to professional journals
Bodyguards
Use of company car/plane for business
    Personal use of a company car is taxable as compensation.
    Lease value method
    Cents-per-mile method – 37.5 cents/mile. FMV ≤ $15,200.
    Commuting method - $1.50 per one-way commute.

k. Employee relocation expenses/Moving
HH goods, vehicles, pets from old home to new home
30 days of storage and insurance while in transit and before delivery to new home.
Travel expenses for all family members from old to new
Distance between old residence and new principal place of work must be at least 50 miles greater than the distance between the old place of work and the old residence.

Time
39 weeks during 12 months following the move
78 weeks during 24 months
If not reimbursed – Deduction for AGI

l. Education expenses
Employees can exclude up to $5,250 in educational assistance plan reimbursements annually.
Reimbursement for tuition, fees, books, supplies, and equipment qualify and the education does not have to relate directly to employment.

OR to maintain or improve skills required in TP's business – exclusion is unlimited
CPE – Yes
CPA Exam – No CPA Review – No

m. Substantiating business expenses
Employer's accountable plan
Need a receipt for lodging
Need a receipt for any other expenditure in excess of $75
Reimburse = bus ex
Reimburse > bus ex
If bus ex > reimbursement

If nonaccountable plan, employee includes reimbursement in income and deducts expenses as miscellaneous itemized.

Per diem

3. Employee stock options

   a. Section 83 – In general, employee recognizes no income until the stock becomes freely transferable and not subject to a substantial risk of forfeiture. The employer takes a deduction in the year the employee recognizes income.

   b. Non-qualified stock options (NQSO)

   c. Incentive stock options (ISO)
   Employee recognizes LTCG at sale.
   Employee cannot sell the stock for one year after exercising the option or two years after the grant date, whichever is later. Employer receives no compensation deduction for the option. Untaxed bargain element of ISO is an AMT adjustment.

   d. Phantom stock – does not require cash. Employee's deferred compensation is hypothetically invested in shares of the company's stock. At the end of the deferral period, the employer pays the employee the FMV of the phantom shares.

   e. Stock appreciation rights (SAR) plan – employees receive cash equal to appreciation of employer's stock over a certain period of time. Employee has income. Employer has a deduction.

4. Deferred compensation and retirement planning

   a. Qualified retirement plans
   Employer deducts contributions as they are made
   Earnings on contributions accumulate tax free
   Employee is not taxed on benefits until they are received
   Nondiscrimination rules
   Employees must fully vest after no more than 7 years
   Premature withdrawals are hit with an extra 10% penalty
   Lump sum distribution may be rolled over in 60 days
   20% W/H unless a direct rollover

   b. Types of retirement plans
   Defined benefit plan provides for a fixed benefit at retirement based on employee's years of service and compensation. Employer bears risk of investment G/L.

Defined contribution plan provides for specified contribution but the future benefit to be paid is not specified. Employee bears risk.

Money purchase plan – company and employee contribute a fixed % of employee's salary to the plan.
Profit-sharing plan – employer contributions are based on earnings.
401K (CODA)
403 (b) – tax sheltered or tax-deferred annuity
ESOP
Simplified employee pension plan (SEP)
Savings incentive match plan for employees (SIMPLE)
SIMPLE 401 (k) plans

c. Contribution limits

Defined benefit plan – max pension benefit that a plan can fund is 100% for a participating employee's average compensation for the three highest paid years, subject to a $160,000 cap.

Defined contribution plan

Max contribution to each participant's account is 100% of compensation up to a maximum of $40,000. Max deductible contribution is 25% of compensation paid to all employees covered by the plan.

401 (k) – 2003 the max pretax compensation that can be deferred is $12,000. If employer matches, the max deduction is 25% of covered employee compensation. Catch up for 50 or older; 2003 $2,000.

d. Nonqualified deferred compensation plans

Employer can defer an unlimited amount of compensation for highly compensated executives without extending plan benefits to other employees.
Employer accrues liability but sets aside no assets.
Employer has no tax deduction until year in which deferred compensation is actually paid to the employee.

e. Individual retirement accounts – personal retirement plans available to anyone with earned income during the year.

Max contribution is lesser of $3,000 ($3,500 if 50 or older) or EI.
Married TP can contribute a max of an additional $3,000 to a spousal IRA for a nonworking spouse or a spouse whose EI is < $3,000, if together they have at least $6,000 of EI.

If not an active participant in another qualified plan, contribution is a FOR.

Table 4.4 Phase out range for active participants

TPs who are not covered by an employer's plan but whose spouse is, may make fully deductible contributions to an IRA if AGI is $150,000 or less. Deduction phases out between $150,000 - 160,000.

f. Roth IRAs – contribute after-tax dollars and withdrawals are tax free
   5 years
   Phase out
   No minimum distribution requirements during the owner's lifetime

5. Self-employed individuals ALERT!!! THIS IS VERY IMPORTANT FOR YOUR TAX PROJECT
   a. Employment tax consequences
      12.4 % SS
      2.9 % Medicare
      15.3% FICA

      92.35% of net earnings from self-employment is subject to SET
      50% of SET is a FOR

      Any FICA taxes paid as an employee reduce the ceiling for FICA taxes imposed on SE earnings.

   b. Fringe benefits limited
      Self-employed cannot participate in fringe benefits provided to employees.
      Cost of health insurance is a FOR and fully deductible for someone who is self-employed.

   c. Retirement plans
      Keogh (HR 10) – most are defined contribution either money purchase or profit-sharing.
      Max contribution is lesser of $41,000 or 100% of net earning from self-employment, calculated after subtracting the deduction for SET.
      Deduction FOR
      Self-employed individual may also contribute to an IRA.

Let's look at Example 45