Payroll Tax Update

2016 Edition

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CERTIFIED PUBLIC ACCOUNTANTS

Payroll Tax Update

2016 Edition

Dear Clients and Friends of ORBA:

Each year, business owners are faced with complex payroll tax procedures that are constantly changing. As the Internal Revenue Service and the Illinois Department of Revenue revise the laws on a regular basis, owners are forced to learn the new rules regarding payroll taxes and reporting requirements. Owners must be certain that they understand the new rules or incur the expense of penalty and interest charges.

To keep you informed about these issues, we have compiled the 2016 Edition Payroll Tax Update. The update includes descriptions of new payroll tax rules and requirements, which are highlighted on the next page, as well as reviews of unchanged items and explanations of other important issues.

We hope this information helps you to hold on to some of your hard-earned profits by reducing payroll taxes and eliminating penalties and interest. Please call us at (312) 670-7444 if you have any questions about payroll tax or any other tax or business issues, or if you know someone else who might want a copy of this booklet.

Sincerely,

Ostrow Reisin Berk & Abrams, Ltd.

Key Information and What's New for 2016

- The Social Security rate (6.2%) and Medicare rate (1.45%) to be withheld from wages and matched by the employer remain unchanged in 2016. Also, the 0.9% surcharge assessed on wages over $200,000 remains unchanged. This surcharge is not imposed on the employer.

- The maximum annual earnings subject to the OASDI portion of Social Security is $118,500, unchanged from 2015.

- The standard business mileage rate set by the IRS has decreased from 57.5 cents in 2015 to 54.0 cents in 2016.

- The 401(k) elective deferral limitation remains at $18,000 for 2016.

- The Illinois unemployment tax (SUTA) wage base remains unchanged at $12,960 for 2016.

- The Federal minimum wage of $7.25 per hour remains unchanged in 2016.

- In Illinois (except for the City of Chicago), the minimum wage of $8.25 per hour remains unchanged 2016.

- Effective July 1, 2015, the minimum wage in the City of Chicago increased to $10.00 per hour. Effective July 1, 2016, the minimum wage in the City of Chicago will increase to $10.50 per hour. The City of Chicago minimum wage is scheduled to continue to increase each year until it reaches $13.00 in July, 2019.

- Effective January 1, 2016, the Illinois withholding rate holds at 3.75% for 2016. This rate may be subject to change per legislative order.

- Applicable large employers (50 or more employees in the prior year) are required to report 2015 health insurance coverage information to the IRS and to their employees. Due dates for these forms have been extended. Beginning in 2016, applicable large employers may face penalties if they don't make affordable minimum health insurance coverage available to their employees.

- The Affordable Care Act requires that the value of employer-provided health coverage be reported on the employee's W-2. However, reporting remains optional for small employers (employer's filing fewer than 250 W-2's in the prior year). Reporting is required for employers filing 250 or more W-2's.

- There will be a new filing due date for BOTH paper and electronically filed 2016 Forms W-2, W-3, and 1099-Misc. These 2016 forms must be filed with the IRS (Forms W-2 and W-3) or the Social Security Administration (Forms 1099-Misc) by January 31, 2017. The filing deadline for these 2015 forms is February 29, 2016 for paper filing and March 31, 2016 for electronic filing.

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Federal Rules

A thorough review of the payroll tax rules and requirements will enable business owners to determine whether they have properly complied with the 2016 Federal payroll tax requirements and are fully informed of the new payroll rules. Business owners can begin to review these rules by familiarizing themselves with the wage base and tax rate information as well as the deposit rules for Federal payroll taxes. Some of the highlights are presented in this booklet.

Each quarter, employers who pay wages subject to income tax withholding or social security and Medicare taxes must file Form 941, *Employer's Quarterly Federal Tax Return*. The return is due by the last day of the month that follows the end of the quarter.

- **Federal Income Tax Withholding (FITW)**

The current edition of Circular E, *Employer's Tax Guide* (www.irs.gov/pub/irs-pdf/p15.pdf), is the best place for business owners to look to calculate 2016 employee withholding. The IRS also issues Publication 15-A, *Employer's Supplemental Tax Guide* (www.irs.gov/pub/irs-pdf/p15a.pdf), which is directed at larger depositors and supplements the basic information provided in Circular E.

- **Federal Insurance Contributions Act (FICA)**

The Federal Insurance Contributions Act (FICA) provides for a two-part tax: 1) Old-Age, Survivor and Disability Insurance (OASDI), or Social Security tax, and 2) Hospital Insurance (HI), or Medicare tax. The total FICA tax rate is 15.3 percent. The Social Security tax rate is 12.4 percent and is applied to the maximum OASDI wage base. The Medicare tax rate is 2.9 percent, and there is no limit on the wage base to which it is applied. A 0.9% surcharge is charged on an employee's wages over $200,000. This surcharge must be withheld from the employee's wages, but is not matched by the employer.

The FICA tax is levied on both the employer and the employee. The employee and employer must each contribute 7.65 percent of the total tax: 6.2 percent of the OASDI tax and 1.45 percent of the HI tax. For 2016, the maximum OASDI wage is $118,500; maximum employer and employee portions of the OASDI tax will be $7,347. There is no maximum HI wage base limitation.

- **Federal Unemployment Tax Act (FUTA)**

The first $7,000 of wages paid to each employee in 2016 is subject to a 6.0 percent Federal Unemployment (FUTA) tax rate. Employers may be able to offset up to 5.4 percent of the 6.0 percent FUTA tax with state unemployment taxes. For 2015, Illinois employers received the full credit for Illinois state unemployment taxes paid and are therefore entitled to receive the full offset of 5.4 percent resulting in a FUTA tax rate of 0.6 percent. Check with us if you file in a state other than Illinois.

Federal Deposit Rules

- **FITW and FICA Tax Deposit Rules**

Under current federal tax deposit rules, employers are designated as either *monthly* or *semiweekly* depositors. By November of each year, the Internal Revenue Service will notify any employer it identifies as having a change in its deposit schedule for the following calendar year.

A four-quarter "look back" period beginning July 1 of the second preceding year and ending June 30 of the preceding year is used to determine *monthly* or *semiweekly* depositor status. Total payroll taxes reported on Forms 941 for the look back period determine the employer's classification. For 2016, the look back period includes the quarters beginning July 1, 2014 and ending June 30, 2015.

General Rule

Employers who reported Federal withholding and FICA taxes of $50,000 or less for the specified look back period will be required to make *monthly* tax deposits for the current calendar period; employers who reported more than $50,000 will be required to make *semiweekly* tax deposits.

EXCEPTIONS:

- *$100,000 One-Day Deposit Rule*

  An employer who accumulates a payroll tax liability of $100,000 or more during a deposit period must make payroll tax deposits by the next banking day. This rule applies whether the employer is a *monthly* or *semiweekly* depositor. Once a *monthly* depositor becomes subject to the one-day rule, the depositor is classified as a *semiweekly* depositor for the remainder of the current calendar year and subsequent calendar year.

- *New Employer*

  New employers have no look back period. Therefore, the Internal Revenue Service deems new employers to be *monthly* depositors for their first calendar year, unless the one-day deposit rule is triggered.

- *Less than $2,500 Deposit Rule*
  Employers that have less than a $2,500 quarterly payroll tax liability are not required to make deposits. Instead, they may choose to pay their payroll tax liability with the Form 941, *Employer's Quarterly Federal Tax Return*. An employer who accumulates a quarterly payroll tax liability of $2,500 or more and fails to make the required monthly or semiweekly deposits will be subject to a failure to deposit penalty. Employers uncertain as to whether the total quarterly payroll tax liability will be less than $2,500 should make deposits under the appropriate monthly or semiweekly deposit rules.

Deposit Due Dates
Monthly depositors must deposit payroll taxes withheld during the calendar month by the 15th day of the following month. *Semiweekly* depositors must deposit payroll taxes withheld as follows:

Semiweekly Deposits

Payment Days	*Deposit By*
Wednesday, Thursday, and/or Friday	Following Wednesday
Saturday, Sunday, Monday, and/or Tuesday	Following Friday

Semiweekly depositors are guaranteed a minimum of three banking days after the end of the semiweekly period to deposit their taxes. If a holiday falls within the three banking days after the end of a semiweekly period, an extra banking day is allowed to meet the requirements. For example, if an employer has a Friday payroll and the following Monday, Tuesday, or Wednesday is a holiday and banks are closed, the employer will have until the following Thursday to deposit taxes. Generally, non-banking days include local bank holidays, Saturdays, Sundays and legal holidays.

The 98 Percent/Shortfall Rule
If a timely deposit is at least 98 percent of the employer's actual deposit obligation (or within $100 of the actual obligation), no failure-to-deposit penalty will be imposed, provided the shortfall or balance of employment taxes owed is deposited by the "shortfall make-up date."

- Monthly Depositor Shortfall Make-Up Date
  The "shortfall make-up date" is the due date for the Form 941 covering the period in which the shortfall occurred. For example, a shortfall on a May deposit obligation must be paid by July 31, the Form 941 due date for the 2nd quarter.

- Semiweekly Depositor Make-Up Date
  The "shortfall make-up date" is the earlier of the first Wednesday or Friday on or after the 15th day of the month following the month in which the deposit was required or the due date of the return for the period of the tax liability.

Holiday Deposit Rules
If a due date that is set by law falls on a Saturday, Sunday, or legal holiday, the due date is delayed until the next day that is not a Saturday, Sunday or legal holiday. A statewide legal holiday delays a due date only if the IRS office where an employer is required to file is located in that state. When a federal holiday occurs on a Sunday, the following Monday is a federal holiday. When a federal holiday falls on a Saturday, the preceding Friday is a federal holiday.

- **FUTA Tax Deposit Rules**

Employers are required to report Federal unemployment taxes annually on Form 940, *Employer's Annual Federal Unemployment Tax Return*. Federal unemployment tax deposits for quarterly liability exceeding $500 are required to be made using the Electronic Federal Tax Payment System (EFTPS).

Quarterly deposit requirements are determined by multiplying the taxable wages for the quarter by the applicable FUTA tax rate. If the result is more than $500, deposits must be made by the last day of the month after the close of the quarter. If the result is less than $500, no deposits are required for the quarter. The undeposited amount is simply added to the calculation for the following quarter. For the last calendar quarter, employers must calculate the entire year's tax liability. Unpaid balances of more than $500 must be deposited by February 1. Unpaid balances of $500 or less (and state credit reduction amounts, if applicable) can be made via EFTPS deposit, credit or debit card or may be remitted with Form 940 by its due date. Form 940 is due by February 1, 2016.

- **Electronic Funds Transfer (EFT)**

Federal tax deposits must be made by electronic funds transfer. Generally, an EFT is made using the Electronic Federal Tax Payment System (EFTPS). If you do not want to use EFTPS, you can arrange for your financial institution, payroll service, or other trusted third party to make deposits on your behalf. Also, you may arrange for your financial institution to initiate a same-day tax wire payment on your behalf. EFTPS is a free service provided by the Department of the Treasury. Services provided by your financial institution, payroll service, or other third party may have a fee. To enroll in EFTPS, visit www.eftps.gov or call 1-800-555-4477.

Illinois Withholding and Deposit Rules

◆ Illinois State Income Tax Withholding

The Illinois individual income tax rate for 2016 is 3.75 percent. Employers should use Booklet IL-700-T, *Illinois Withholding Income Tax Tables*, to calculate state withholding amounts. The exemption amount increased to $2,175 for 2016 from $2,150 in 2015. The amount of additional exemptions allowed for taxpayers age 65 or older or who are blind remains at $1,000 for 2015 and 2016. Business owners who have not received Booklet IL-700-T should download a copy at www.ILtax.com.

Each year, Illinois will assign employers to one of three deposit due date schedules: *semiweekly*, *monthly* or *annual*. Employers must use the assigned due date schedule. Employers are also required to file Form IL-941, *Illinois Withholding Income Tax Return*, quarterly or annually as assigned by Illinois.

The payment due dates are determined by the total tax withheld during the "look-back" period, which is the one-year period ending on June 30 of the immediately preceding calendar year. For 2016, the look-back period is July 1, 2014 through June 30, 2015.

General Rule

Employers who reported Illinois withholding of more than $12,000 for the specified look back period will be assigned to the *semiweekly* due date schedule; employers who reported $12,000 or less, but more than $1,000 are assigned to the *monthly* due date schedule; employers that reported $1,000 or less are assigned to the *annual* due date schedule.

EXCEPTIONS:

- *Annual or Monthly employers exceeding $12,000 withholdings*
  An annual or monthly employer who exceeds $12,000 in withholding during any quarter must begin to use the semiweekly due date schedule for the following quarter, the remainder of the year and the subsequent year.

- *New Employer*
  New employers are automatically assigned to the *monthly* due date schedule.

Payment and Filing Requirements

Annual filers have three payment options:

1) Make a single payment with Form IL-941, by January 31 of the following year;
2) Make multiple payments throughout the year electronically or with Payment Coupon Form IL-501 and file IL-941 annually, by January 31 of the following year;
3) Make monthly payments and file Form IL-941 quarterly.

Monthly payers must make payments of amounts withheld during the calendar month by the 15th day of the following month electronically or using Payment Coupon Form IL-501. *Semi-weekly* payers are required to remit payroll tax deposits withheld electronically. The *semiweekly* deposit schedule is as follows:

Semiweekly Deposits

Payment Days	*Deposit By*
Wednesday, Thursday, and/or Friday	Following Wednesday
Saturday, Sunday, Monday, and/or Tuesday	Following Friday

Monthly and *semiweekly* taxpayers file Form IL-941 quarterly by the last day of April, July, October and January. No annual return is filed.

Electronic Funds Transfer

Taxpayers are encouraged to file and pay electronically using MyTax Illinois. Taxpayers assigned to the *semiweekly* schedule are required to make all payments electronically. MyTax Illinois is a free service provided by the Illinois Department of Revenue to file, to pay, and to monitor your Illinois tax accounts. To activate or access your MyTax Illinois account, visit www.tax.illinois.gov for additional information.

◆ State Unemployment Tax (SUTA)

The state unemployment tax (SUTA) wage base remains at $12,960 in 2016. Illinois is a benefit-ratio state. This means that an employer's state unemployment contribution tax rate is the product of its benefit ratio for the calendar year and the adjusted state experience factor for that year. If you use a third party payroll provider, please be sure to notify them of your correct SUI rate for the current year.
Employers are required to file Form UI-1*, Report to Determine Liability under the Illinois Unemployment Insurance Act*, with the Illinois Department of Employment Security within 30 days of commencing business within the state. A successor employer who succeeds to substantially all of a predecessor's business must notify the Department by filing Form UI-1 S&P, *Report to Determine Succession*, within 120 days of the succession.

Contribution and Wage Reports, Form UI-3/40, must be filed quarterly, on or before the last day of the month following the quarter for which the contributions are due. Contribution payments must be paid at that time. Employers who have paid zero wages during the quarter should file a signed Form UI-3/40 and indicate "no wages this quarter" on the form, OR employers may also telefile at 1-800-793-6860. Employers with 25 or more employees during the prior calendar year are required to file their Quarterly Contribution and Wage Report (UI-3/40) electronically. Employers not required to electronically file may do so with prior approval. Employers with 25 or more employees in the prior calendar year are also required to submit electronic monthly wage reports. These employers will continue to submit quarterly contribution and wages reports, but they will also submit eight additional monthly wage reports. Employers should be aware that there will NOT be manual entry for the monthly reports. Employers will have to create an electronic submission file and upload it at https://taxnet.ides.state.il.us.

Form W-2 Highlights

According to the Internal Revenue Service, the estimated average time to complete Form W-2, *Wage and Tax Statement*, is 30 minutes. Frequently, it takes employers nearly twice as long to read the W-2 instructions. Determining which items constitute taxable compensation, whether income is pre-tax or post-tax, which fringe benefits are taxable or nontaxable, and what type of taxes, if any, are required to be withheld can be both time consuming and confusing for employers. In an effort to reduce W-2 preparation time, we have highlighted some of the more frequently encountered items:

- **Compensation**

Wages, tips and other compensation must be reported on Form W-2. Wages include all compensation paid to an employee during the year, whether in the form of cash or property. Non-cash remuneration includes items such as the taxable cost of group term life insurance in excess of $50,000, the personal use of an employer automobile and certain other fringe benefits.

- **FICA Tax**

The two-part FICA tax withheld in 2015 consists of the 6.2 percent Old-Age, Survivor and Disability Insurance (OASDI) or Social Security tax rate and the 1.45 percent Hospital Insurance (HI) or Medicare rate. Each must be separately identified on Form W-2.

Wages subject to the OASDI or Social Security tax should be reported in Box 3; tips subject to the Social Security tax, should be recorded in Box 7. Boxes 3 and 7 combined should not exceed the 2015 maximum Social Security wage base of $118,500. The employee portion of the Social Security tax withheld should be reported in Box 4, and that amount should not exceed the 2015 maximum Social Security tax of $7,347.

Wages and *tips* subject to the HI or Medicare tax should be reported in Box 5. The employee portion of the Medicare tax withheld should be recorded in Box 6. Please note that the additional 0.9% withholding on wages in excess of $200,000 should also be reported in Box 6. No maximum wage base or withholding tax limitation exists for purposes of Medicare wages and withholding requirements for 2015.

- **Family Employee's Earnings**

Generally, sole proprietors who employ family members are required to withhold Federal income tax on earnings paid to a spouse or child. Earnings that a spouse receives while in the employ of his or her spouse are subject to FICA taxes, but not FUTA taxes. The earnings that a son or daughter under the age of 18 receives while in the employ of his or her parent are exempt from FICA taxes. Further, if the services provided by the son or daughter are not in the parent's trade or business (e.g. babysitting), these earnings are FICA tax exempt if the son or daughter is under the age of 21. Additionally, FUTA tax is not required to be withheld on earnings a son or daughter under age 21 receives while in the employ of his or her parent.

- **Group Term Life Insurance**

Employer contributions to the cost of group term life insurance provided to employees in excess of $50,000 of coverage are includible in an employee's or a retiree's gross income. The cost of group term life insurance is generally computed using the IRS uniform premium cost table 2-2 in section 2 of Publication 15-B. Employer contributions in excess of $50,000 should be reported in Box 12 of Form W-2, coded "C", and reported as compensation in Boxes 1, 3 and 5. Retired or former employees must pay their portion of Social Security and Medicare taxes on the cost of group term life insurance in excess of $50,000 on their individual income tax return, Form 1040. Employers are not required to collect this tax, but employers are required to report the "uncollected" Social Security and Medicare taxes in Box 12 of Form W-2. Uncollected social security tax should be identified with code "M"; uncollected Medicare tax should be identified with code "N."

◆ Accountable and Nonaccountable Employee Reimbursement Plans

Payments made to an employee under an *accountable* reimbursement plan are generally excludable from an employee's gross income and are not required to be reported on Form W-2. An *accountable* plan requires an employee to establish the business purpose of each expenditure and to return all excess reimbursements to the employer. Payments made under *nonaccountable* plans can produce taxable compensation. Employer payments to employees in excess of certain "deemed" IRS standard excludable amounts are taxable and subject to FITW, FICA and FUTA taxes. Employers must report these nonexcludable amounts as taxable compensation on Form W-2, Boxes 1, 3 and 5. Excludable (substantiated) amounts should be reported in Box 12 with the code "L." Employers only have to use Box 12 with code "L" when a nonexcludable amount exists.

◆ Employer-Provided Automobiles

The personal use of employer-provided automobiles is taxable to employees. The general valuation method based on fair market value, or one of three special valuation methods: cents-per-mile rule, commuting rule or lease value rule – may be used to determine the amount includible as taxable employee compensation for the tax year. A special valuation method may be used as long as the employer demonstrates a good faith effort to correctly report the benefit.

Employers can *elect* to withhold federal income tax on the value of the personal use of the company car on an employee-by-employee basis. If an employer elects to withhold, he or she may do so on a per-pay period, quarterly, semiannual or annual basis. However, an employer *must* withhold the employee's share of FICA taxes.

Employers may choose from one of two methods of reporting the personal use of employer-provided automobiles: 1) they may separate the personal portion of the automobile use from the business portion, and report only the personal portion as taxable wages to the employee; or 2) they may choose to report 100 percent of the automobile use and have the employee file Form 2106, *Employee Business Expense,* with his or her individual income tax return to deduct the business use of the automobile. However, the deductibility of the automobile expenses may be limited depending on the employee's tax situation.

The amount determined to be taxable compensation under the employer's method of reporting the personal use of employer-provided automobiles should be reported in Boxes 1, 3 and 5 of Form W-2. If 100 percent of the automobile use value is included in the employee's income in Box 1, then it must also be reported separately in Box 14 or on a separate statement.

◆ Employer-Provided Educational Assistance

The value of up to $5,250 in educational benefits provided to employees annually under a qualified educational assistance program is excludable from an employee's taxable wages for undergraduate and graduate coursework. Job-related educational assistance, even in excess of $5,250, is treated as a nontaxable working condition fringe benefit. Job-related education maintains or improves skills that an employee is required to have. Job-related education may also be expressly required for employment. If educational assistance is not job-related, then the value of the assistance above $5,250 is treated as taxable wages.

◆ Dependent Care Assistance

The total amount paid or incurred under a Section 129 dependent care assistance program, and the fair market value of employer-provided or employer-sponsored day care under a Section 125 plan, should be reported in Box 10 of Form W-2. Amounts in excess of the $5,000 ($2,500 for a married individual filing separately) exclusion of a dependent care assistance program should be included as compensation in Boxes 1, 3 and 5 of Form W-2.

◆ Pretax Contributions

An employee may make an elective deferral to contribute pretax dollars to a 401(k) or 403(b) pension plan. The deferral amount should be entered in Box 12 and coded "D" for Section 401(k) plan contributions or coded "E" for Section 403(b) plan contributions. The *Retirement Plan* check-box in Box 13 of Form W-2 should also be marked. Employee contributions to 401(k) and 403(b) plans are subject to Social Security and Medicare tax and should be included in Boxes 3 and 5 of Form W-2.

◆ Salary Reduction Simplified Employee Pension (SEP) Contributions

Salary reductions for Salary Reduction Simplified Employee Pension Plan (SEP) contributions should not be reported in Box 1 (wages, tips and other compensation). Instead, employers should report these contributions in Box 12 and place a code "F" next to the contribution amount. Additionally, employers should check the box for *Retirement Plan* included in Box 13 of Form W-2. Employee contributions to SEP plans are subject to Social Security and Medicare tax and should be included in Boxes 3 and 5 of Form W-2.

- **Savings Incentive Match Plan for Employees (SIMPLE) of Small Employers Contributions**

Salary reductions for Savings Incentive Match Plan (SIMPLE) contributions should not be reported in Box 1 (wages, tips and other compensation). Instead, employers should report these contributions in Box 12 and place a code "S" next to the contribution amount for a SIMPLE IRA contribution and place a code "D" next to the amount for a SIMPLE 401(k) contribution. Additionally, employers should check the box for *Retirement Plan* included in Box 13 of Form W-2. Employee contributions to SIMPLE plans are subject to Social Security and Medicare tax and should be included in Boxes 3 and 5 of Form W-2.

- **Active Participant Status in a Pension Plan**

Box 13, *Retirement Plan*, should be checked if an employee "actively participated" in an employer maintained retirement plan for any part of 2015. In a defined benefit plan, an active participant is defined as any employee eligible to participate in the plan. An active participant in a defined contribution plan is one who has contributions or forfeitures allocated to his or her account during the plan year. Employees who are classified as active participants are subject to the deductibility limitations on IRA contributions.

- **Designated Roth Contributions**

An employee may make designated Roth contributions to a 401(k) or 403(b) pension plan. The designated Roth contributions should be entered in Box 12 and coded "AA" for Section 401(k) plan contributions or coded "BB" for Section 403(b) plan contributions. The *Retirement Plan* check-box in Box 13 of Form W-2 should also be marked. Designated Roth contributions to 401(k) and 403(b) plans are subject to federal income tax withholding, Social Security and Medicare tax and should be included in Boxes 1, 3 and 5 of Form W-2.

- **Earned Income Credit (EIC) Notification**

Employees reporting no income tax withholding should be notified by their employers of the availability of the earned income credit (EIC). Even though no income tax has been withheld, certain employees still may be eligible for an income tax refund due to the EIC. Employers can accomplish such notification simply by issuing a Form W-2. The reverse side of Copy B of Form W-2 contains an EIC notification statement. Otherwise, business owners must provide IRS Notice 797, *Possible Federal Tax Refund Due to the Earned Income Credit* (EIC), to their employees.

- **Accident and Health Insurance for More-Than-Two-Percent Shareholders/Owners**

Accident and health insurance premiums paid by an S Corporation on behalf of its more-than-two-percent shareholder-employees are deductible by the corporation as an ordinary and necessary business expense. However, more-than-two-percent owners are required to include the cost of the employer-provided insurance premiums in gross income. Form W-2 includes the cost of the insurance premiums as additional wages and should be issued to the more-than-two-percent shareholder-employees.

Employer-provided fringe benefits such as accident and health insurance premiums furnished by an S Corporation to its shareholders are wages for purposes of income tax withholding. More-than-two-percent owners are not subject to FICA tax if the premium payments are made under a plan or system for employees and their dependents which satisfies certain nondiscrimination requirements. If these nondiscrimination requirements are not met, amounts paid by the qualified organization for accident and health insurance covering a more-than-two-percent shareholder must be includible in wages for FICA tax purposes as well as for income tax purposes.

If a partnership or limited liability company provides for accident and health insurance premiums for any partner or member, the premiums are includible in the recipient's income. The premium payments are not included on a Form W-2, but they are included on the partner's Schedule K-1. The premium payments are treated as guaranteed payments and may be subject to self-employment tax.

Although more-than-two-percent owners must include accident and health insurance premiums in their income and pay income tax (and in some instances, FICA tax), certain related tax benefits do exist. For federal purposes, these individuals may deduct 100 percent of the premium cost as an adjustment to gross income. However, special rules and limitations do apply.

- **Health Savings Account**

An employer's contribution (including an employee's contribution through a cafeteria plan) to an employee's Health Savings Account (HSA) is not subject to either federal income tax withholding or Social Security, Medicare, or FUTA tax. You must report all employer contributions (including an employee's contribution through a cafeteria plan) to an HSA in box 12 of Form W-2 with code "W".

An employee's contributions to an HSA through payroll deductions not part of a cafeteria plan are includible in income as wages and are subject to federal income tax withholding and Social Security and Medicare taxes.

◆ Nonqualified Deferred Compensation Plans

A nonqualified deferred compensation (NQDC) plan is used as a way to compensate certain key employees. Since the plan is nonqualified, it is subject to limited ERISA requirements and is not subject to IRS discrimination rules or limits on employer contributions.

FIT withholding does not apply at the time of contribution or deferral, provided a decision to defer is made before employment services are performed and the employer's promise to pay in the future is not secured by an irrevocable trust. Rather, federal income taxes are due when benefits are paid or become payable. The employer may not take a tax deduction for contributions and deferrals to a nonqualified plan until such time as the benefits are taxable income to the employee.

FICA taxes, however, apply to contributions and deferrals as of the later of (a) when services are performed or (b) when there is no substantial risk of forfeiture. Therefore, once an employee is vested, FICA taxes are applicable each year that contributions and/or deferrals are made. Since most employees eligible for nonqualified deferred compensation plans earn more than the Social Security wage base ($118,500 in 2016), the practical result is that OASDI taxes do not have to be paid for these amounts; only the Medicare tax would apply. Therefore, these amounts should be included in Box 5 of the W-2 (and Box 3 if under the wage base). When the employee eventually receives the benefits, FICA taxes are not due because they were paid at the time of contribution and/or deferral.

Also IRS section 409A requires deferrals under a NQDC plan to be included in gross income, unless certain requirements are met.

◆ Cost of Employer-Sponsored Health Coverage

The employer's cost of health insurance premiums paid on behalf of the employee should be reported in Box 12 using code "DD". The amount reported with code "DD" is not taxable. This reporting is optional for small employers (filing fewer than 250 W-2's for the previous year).

◆ Other Information

Employers may use Box 14 of Form W-2 to provide other information to employees such as union dues, moving expenses reimbursed or paid on the employee's behalf or employer matching contributions to a pension plan. Each item should be appropriately identified.

Preparation and Mailing

◆ Federal Form W-2 Preparation and Mailing Rules

The Social Security Administration encourages all employers to file forms W-2 electronically. If paper filing, the SSA requires that the entire first page of the six-part Form W-2 (Copy A) be sent, even if one of the two forms on the first page is blank or void. No erasures, white-outs, or strikeovers may appear on the originals (Copy A). To void a form or to indicate an error was made, an "X" should be placed in the "void" box.

DO NOT mail completed W-2 forms to the Internal Revenue Service. Copy A of Form W-2, with the entire first page of Form W-3, should be filed with the Social Security Administration on or before February 29, 2016 at the following address:

Social Security Administration
Data Operations Center
Wilkes-Barre, PA 18769-0001

If "Certified Mail" is used to file, change the ZIP code to 18769-0002. If an IRS approved private delivery service is used, add "ATTN: W-2 Process, 1150 E. Mountain Dr." to the address and change the ZIP code to 18702-7997.

If 250 or more forms are to be submitted, Electronic Filing must be used unless an employer has been granted a waiver. The due date for electronic filers is extended to March 31, 2016.
The employees' copies (Copies B, C and 2) of Form W-2 must be distributed to the employees on or before February 1, 2016.

Other Payroll Items

◆ Form W-4

To know how much federal income tax to withhold from employees' wages, a Form W-4, *Employee's Withholding Allowance Certificate*, should be on file for each employee. Advise employees to use the Withholding Calculator on the IRS website at www.irs.gov/individuals for help in determining how many withholding allowances to claim on their Forms W-4.

All new employees should prepare and submit a signed Form W-4 when they start work. Make the form effective with the first wage payment. If a new employee does not submit a completed Form W-4, withhold income tax as if he or she is single, with no withholding allowances.

- **Form 1099 Requirements and Penalties**

Federal Form 1099 is used to report many payments including interest, dividends, retirement plan distributions, unemployment compensation and other similar miscellaneous income items. Generally, these forms must be filed with the Internal Revenue Service by February 29, 2016 or March 31, 2016, if filing electronically. The recipient's copy, however, must be issued to the recipient by February 1, 2016.

Taxpayers are subject to certain IRS penalties if Forms 1099 are incomplete or incorrect, filed past the due date, or not filed at all. The penalty is based on when the correct information return is filed and ranges from $30 to $100 for each failure. The maximum penalty ranges from $250,000 to $1,500,000 ($75,000 to $500,000 for small businesses).

Generally, payments to a corporation need not be reported on Form 1099. However, this exemption does not apply to payments made to corporations for legal services or to payments for medical or health care services provided by corporations or professional corporations. Attorneys' fees of $600 or more paid in the course of trade or business should continue to be reported in Box 7. Also, gross attorney proceeds should be reflected in Box 14.

Taxpayers that file 250 or more 1099 forms must file electronically unless they receive a hardship waiver. This threshold applies separately to each type of form (i.e., do not add Forms 1099-MISC and Forms 1099-R together when applying this threshold).

- **Truncating Payee Identification Numbers**

Filers of series Forms 1098, 1099 and 5498 who meet certain requirements may truncate a payee's social security number for calendar year 2015. The requirements are met when (1) the payee's identifying number is a social security number, IRS adoption taxpayer identification number, an IRS individual taxpayer identification number or an employer identification number; (2) the payee's identifying number is truncated by replacing the first 5 digits of the 9 digit number with either an asterisk ("*") or the letter "X"; and (3) the truncated identifying number appears on a paper or electronically provided payee statement in the series Forms 1098, 1099 or 5498 for the 2015 calendar year. A filer may not truncate an identification number on any form filed with the IRS.

- **Backup Withholding System**

Information returns filed with missing or incorrect taxpayer identification numbers (TIN) subject the payee to the Backup Withholding System. The TIN is a social security number for individuals or an employer identification number for other tax entities. Forms 1099-MISC, 1099-INT, 1099-DIV, 1099-PATR, 1099-G, 1099-OID and 1099-B may include backup withholding at a rate of 28 percent in 2016.

If the TIN is *missing*, the payer will receive an IRS CP2100A notice. The payer must then 1) begin backup withholding at 28 percent, 2) request that the payee provide a certified TIN by completing and signing Form W-9, *Request for Taxpayer Identification Number and Certification*, and 3) continue backup withholding until the payee provides a certified TIN.

If the TIN is *incorrect*, the payer will receive an IRS CP2100A notice, which requires that the payer issue the payee a "B" notice (which is sent by the IRS with the CP2100A) and Form W-9 within 15 days of the date of the CP2100A notice. If the payee does not respond to the "B" notice within 30 business days of the date of the CP2100A notice, the payer must begin backup withholding, and it continues until the payee provides a TIN that is certified as correct (Form W-9). Upon receipt of such certification, the payer must discontinue backup withholding within 30 calendar days. Backup withholding must be reported on Form 945, *Annual Return of Withheld Federal Income Tax*, which is due by February 1, 2016, or by February 10, 2016, if timely deposits in full payment of the taxes have been made.

- **Withholding Rules For Retirement Plan Distributions**

Employers are required to withhold 20 percent of distributions paid from retirement plans when an employee leaves an employer. These rules, summarized below, continue to apply for 2016.

1. Employers MUST allow an employee to choose between having retirement funds fully distributed or transferred directly to an IRA or another qualified plan (a rollover). Most distributions are now eligible for rollover treatment. Exceptions include life annuities, payments made over at least 10 years, and payments of required minimum distributions after age 70½.

2. If an employee chooses to have the funds distributed, the employer must withhold 20 percent of the distribution. To avoid withholding, the employee must elect to have the distribution directly rolled over to another eligible retirement plan.

3. Employers MUST provide an employee with written notification of his or her distribution choices, as well as an explanation of the 20 percent withholding requirements. The IRS has issued a sample safe harbor notice which may be used by employers to meet this requirement. A copy of this sample notice is available from ORBA.

4. Employers MUST provide such written notification to an employee within a reasonable time period (at least 30 days but not more than 90 days prior to the actual distribution of funds). The reasonable time period requirement will not be violated if an employee makes his or her decision within 30 days, provided the employee knew that he or she had the opportunity to consider the decision for 30 days after the notification was provided.

- **Form 945**

Form 945, *Annual Return of Withheld Federal Income Tax,* is used to report all "non-payroll" withholdings, including the 20 percent withholding on lump sum distributions from retirement plans. Form 945-A, *Annual Record of Federal Tax Liability,* should be used to report non-payroll withholding on a daily basis. This form is used by the IRS to match an employer's tax liability reported via EFTPS. Employers should clearly indicate "Form 945" when depositing these non-payroll taxes.

- **Social Security Benefits Annual Earning Limitations**

There is a limit on the maximum amount of earnings retirees may receive without forfeiting any of their Social Security benefits. Earnings, for this purpose, include wages and self-employment income. The earnings limit for Social Security beneficiaries under full retirement age (see below) is $15,720 for 2016. For every $2 earned in excess of the 2016 earnings limit of $15,720, retirees will lose $1 of their Social Security benefits. Remember, the earliest age that you can receive Social Security retirement benefits remains 62 even though the full retirement age is rising.

In the year you reach full retirement age (see below), $1 in benefits will be deducted for each $3 you earn above a different limit, but only counting earnings for months prior to reaching the full benefit retirement age. For 2016 this limit is $41,880. Starting with the month you reach full retirement age, there is no earnings limit.

What is Your Full Retirement Age?

Year of Birth	Full Retirement Age
1937 or earlier	65
1938	65 and 2 months
1939	65 and 4 months
1940	65 and 6 months
1941	65 and 8 months
1942	65 and 10 months
1943-1954	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 and later	67

- **Self-Employment Tax Deduction**

Self-employed individuals are allowed a 50 percent deduction for self-employment taxes. The deduction is allowed as an adjustment to gross income on page one of Form 1040. The maximum Social Security tax base remains at $118,500 in 2016. The maximum Medicare wage base remains unlimited for 2016.

- **Dependent's Social Security Number**

Taxpayers are allowed to claim a dependency exemption for their dependent if a social security number is supplied. Also, other tax benefits which are conditioned on the dependency exemption (head of household filing status, earned income credit) may be denied if no social security number is supplied. The IRS no longer needs to issue a deficiency notice in order to assess the additional tax due. A parent can obtain a Social Security number for a dependent child by submitting Form SS-5, *Application for a Social Security Card,* to the local Social Security office with a copy of the child's birth certificate.

- **FICA Tax Credit For Tipped Employees**

Restauranteurs, and other food and beverage business owners, typically employ individuals that receive a base wage, plus tip income. The Fair Labor Standards Act (FLSA) contains certain provisions which require employees of such establishments to report their regular base pay plus tip income, as "wage income" equal to at least the minimum wage amount. Employers are responsible for FICA taxes on all reported tip income. This includes tip income treated as wages for purposes of satisfying the FLSA minimum wage provision.

Tax relief in the form of a business tax credit is available to food business owners for FICA taxes paid on employee tips. The amount of the credit is equal to 7.65% of total tips received by employees in excess of the tips used to make up the minimum wage. Wage expense must be reduced by the amount of the credit. Currently the tax credit may offset Alternative Minimum Tax (AMT).

The FICA tip credit will continue to be based on the old minimum wage of $5.15 per hour, rather than the current federal minimum wage of $7.25 per hour. As a result, even though the minimum wage has increased, the amount of the tip credit will not change.

- **Form I-9, Employment Eligibility Verification Form**

The Immigration Reform and Control Act of 1986 was enacted to preserve jobs for individuals who are legally entitled to work in the U.S. Employers must verify employment eligibility for employees hired after November 6, 1986. Consequently, Form I-9, *Employment Eligibility Verification Form*, must be completed and retained by the employer.

An employee must, under penalties of perjury, attest on Form I-9 that he or she is a citizen, permanent resident alien, or otherwise authorized to be employed in the U.S. Employers must examine the employee's documentation, and complete the verification form within three working days from the date of hire. If the employee is hired for less than three days, the employer must complete the verification at the time of hiring.

The Immigrant Act of 1990 provides that an employer cannot engage in unfair immigration-related employment practices and request that an employee present more or different documents than are required or refuse to honor documents which appear to be genuine.

Completed Forms I-9 must be retained by the employer for three years after the date of hire or one year after the date the employment is terminated, whichever is later.

- **New Hire Reporting Law**

The New Hire Reporting law is part of federal welfare reform and is intended to help child support officials track down parents who fail to pay child support payments. The information also will be used to reduce fraud and abuse of unemployment insurance, food stamps, temporary assistance and Medicaid. The directory is organized from information required to be supplied by each employer. This information includes the name, address, and Social Security number of each new employee. In Illinois, the report should be made either online or by completing the IDES New Hire Form within 20 days of the new employee's hiring. Failure to file the report will result in a penalty of no more than $15, but $500 if there is intent to withhold the information. The Directory will be compared to the state's list of individuals with outstanding child-support obligations. If directed, the employer must withhold the child support from the employee's pay.

Household Employment Tax

- **Federal Rules**

For 2016, domestic service in a private home is subject to FICA taxes when the employee is paid $2,000 or more, up $100 from 2015. Private household employers are required to report annually on Form 1040 any FICA tax obligations for private domestic workers.

Wages paid to an employer's child under the age of 21, a spouse, or a parent, generally are exempt from FICA tax. If the household service provided is the principal occupation of the employee, the wages are not exempt.

In any calendar quarter of 2016, household employers who paid total wages of $1,000 or more to a domestic worker (other than a spouse, a parent or a child under age 21) also must pay federal unemployment tax (FUTA).

- **Forms**

- *Schedule H*
  Individuals with household employees must report and pay FICA tax, FUTA tax, and, if applicable, federal withholding tax on Form 1040, Schedule H. This filing is included as part of the individual employer's personal tax return due on April 18, 2016.

- *W-2*
  Household employers must also file a separate 2015 Form W-2, *Wage and Tax Statement,* for each domestic employee for whom Social Security and Medicare wages of $1,900 or more are paid or from which federal income tax is withheld. This form must be completed and Copies B, C and 2 given to each employee by February 1, 2016. Copy A, as well as Form W-3, must be sent to the Social Security Administration by February 29, 2016 or March 31, 2016 if filing electronically.

- *SS-4*
  Household employers will need to obtain an employer identification number (EIN) by February 1, 2016. Employers may apply for an EIN by mailing or faxing Form SS-4 to the IRS.

Employers may also file online by going to www.irs.gov and entering "EIN" in the search box.

- **Extras**

- The threshold for FICA tax purposes ($2,000 for 2016 and $1,900 for 2015) applies separately to each household worker. Therefore, an employer can avoid FICA tax liability by hiring a different worker to prevent amounts paid to one worker from reaching the threshold. The threshold applies to cash payments. Reimbursements up to $250 per month for public transportation in 2016 ($130 in 2015), reimbursements up to $250 per month for parking for 2016 and 2015, and the value of food, clothing, and other noncash items (such as gifts) are not counted as wages.

- A household employer who owns a business, as a sole proprietor, and who pays federal employment taxes for business employees has two choices: 1) pay the employment taxes of its domestic employees with its federal income tax; *or* 2) pay the employment taxes with deposits or other payments of the taxes for its business using Forms 940 and 941.

- A household employer that compensates an employee wages in excess of $200,000 must withhold an additional 0.9% Medicare surcharge on these excess wages. The effective Medicare rate on wages over $200,000 is 2.35%. The household employer is not required to "match" this additional 0.9% Medicare tax.

- Additional information can be found in IRS Publication 926, *The Household Employer's Tax Guide (*www.irs.gov/pub/irs-pdf/p926.pdf).

- **State Rules**

Household employers generally must withhold Illinois Income Tax from employee's wages if the household employer withholds federal income tax or enters into a voluntary agreement to withhold tax with the employee. The way a household employer registers as a withholding agent depends on which option is chosen to file and pay withholding income tax for their household employee. The option chosen determines how they must pay and file for the entire period they are a household employer.

Option 1 – Annual Payment and Filing
This option allows a household employer to file and pay withholding income tax and unemployment insurance contributions once a year. For withholding income tax, no registration is required with the Illinois Department of Revenue. The employer simply reports and pays the Illinois withholding income tax with the filing of his or her Form IL-1040, *Illinois Individual Income Tax Return*, Line 22. This form is due April 18, 2016.

For annual unemployment contribution payment and filing, household employers must register with the Illinois Department of Employment Security before April 15 of the year following the year of employment by filing Form UI-1 DOM, *Report to Determine Liability for Domestic Employment*. In addition, household employers must check a box on the UI-1 DOM form to elect to pay annually. Once this election is made, form UI-HA, *Return for Household Employers Unemployment Insurance Contributions*, must be filed separately with the Illinois Department of Employment Security by April 18, 2016. This return may be filed and payments may be made electronically at www.household.illinois.gov.

Option 2 – Quarterly Payment and Filing
Instead of paying and filing annually, household employers can file quarterly. If an employer wants to file quarterly, they need to register with the Illinois Department of Revenue by filing a Form REG-1, *Illinois Business Registration*. For new registrants, Form IL-941 is required to be filed quarterly and IL-501 payments are required monthly. Based on historical compliance and annual withholding amounts, Illinois Department of Revenue may assign different filing and payment schedules in future years. Household employers may access the forms or apply on-line at www.tax.illinois.gov.

For quarterly unemployment contribution payment and filing, household employers must register separately with the Illinois Department of Employment Security by filing Form UI-1 DOM, *Report to Determine Liability for Domestic Employment*. To file quarterly instead of annually, household employers must check a box "no" on the UI-1 DOM form when asked if they elect to pay annually. Household employers will then have to file Form UI-3/40, *Employers Contribution and Wage Report* quarterly and pay quarterly with this form.

If currently registered as a household employer using Option 2, household employers wishing to convert to the annual IL-1040 reporting option **must** notify the Illinois Department of Revenue by calling (217)785-3707. The Illinois Department of Revenue encourages employers to use their My Tax Illinois programs which are detailed at www.tax.illinois.gov.

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