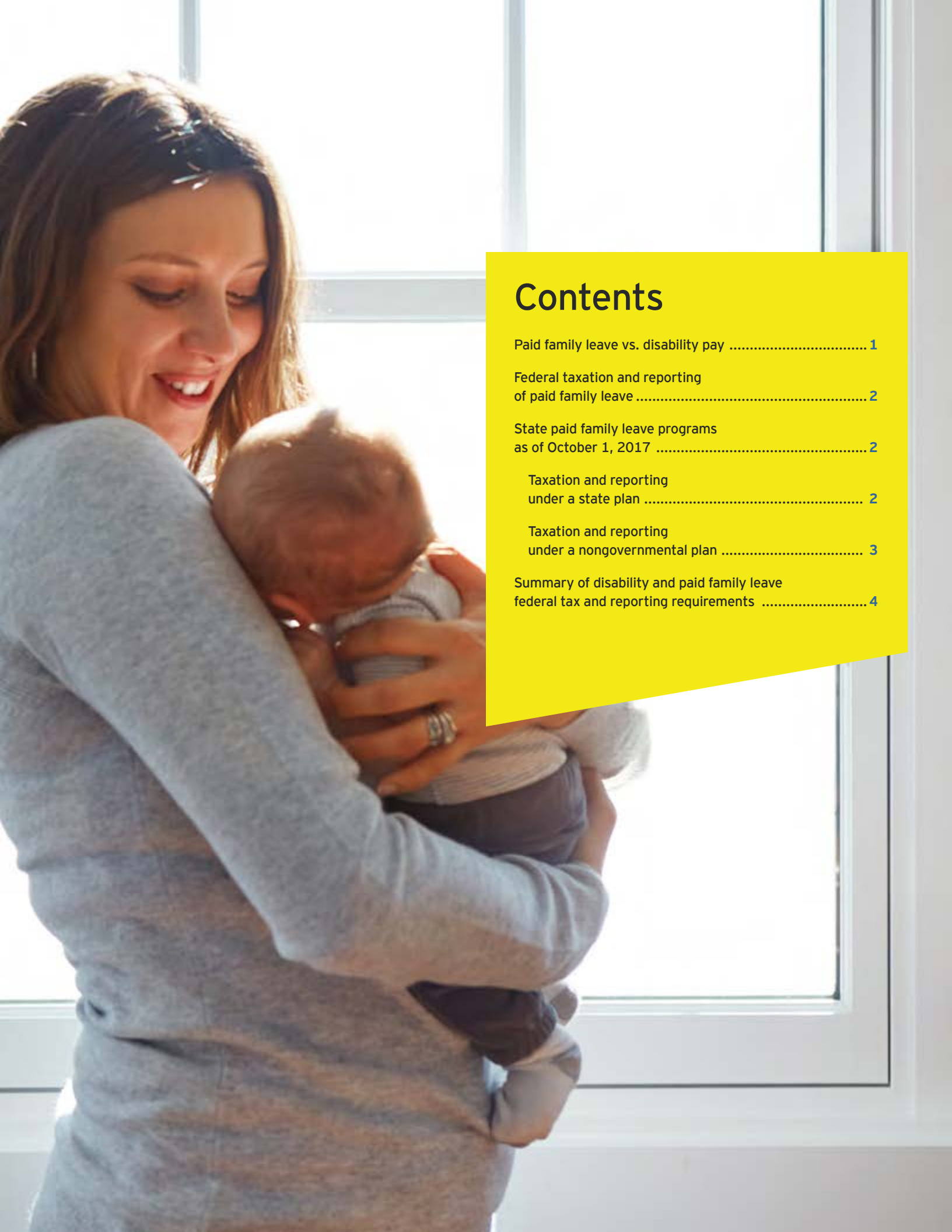


# **Paid family leave**

The federal tax and reporting requirements



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# Paid family leave: the federal requirements for taxation and reporting

The provision that employers provide paid family leave (PFL) insurance has enjoyed significant momentum in recent years with six states having adopted the program, four of them since 2013. In all of the six states except Rhode Island, employers have the choice of providing PFL insurance to their employees through the state fund or a private insurance plan. (See the chart on page 2.)

Employers, too, have adapted to the changing needs of the workforce by expanding their paid leave programs to include time off to bond with a newborn or to care for other family members.

The result is a PFL system that pays benefits through three possible sources – the state, a private insurance company or an employer’s plan or policy.

Understandably, confusion now exists as to the federal employment tax and reporting requirements that apply to PFL, in particular, when those benefits are paid by the employer.

Here we will explain how states have historically dealt with PFL, the federal guidance (or lack thereof) and the prudent path forward pertaining to benefits provided by nongovernmental organizations.

## Paid family leave vs. disability pay

Although PFL and state disability insurance (SDI) are generally administered by the same state agency, they are different in one important aspect. Disability insurance provides wage replacement for an employee’s illness, while PFL insurance covers lost wages for the time the employee is caring for a family member.

Federal law specifies that amounts received through accident or health insurance for an employee’s personal illness or injury (i.e., disability pay or third-party sick pay) are included in wages subject to federal income tax only to the extent the employer pays for the insurance. (*IRC §105(a)*; *IRS Reg. §1.104-1(d)*; *IRC §3401*.)

The portion of the benefit attributable to the employer portion of the insurance premium payment is subject to Social Security, Medicare and federal unemployment insurance only in the first six-month coverage period. (*IRC §3121aX4*; *IRC 3306(bX4)*.) Federal income tax withholding is required if paid by an employer from a self-insured plan, but income tax withholding is voluntary when paid by a third-party. *Form W-4S* is used for this purpose. (*IRC §3402(oX2XC)*.) Finally, as a qualified benefit under a cafeteria plan, employees may be allowed to pay their portion of the disability insurance premium with pretax contributions. (*IRC §125(fX1)*.)

See our special report on third-party sick pay [here](#).

Because PFL provides wage replacement for other than the employee’s personal illness, it does not meet the definition of disability pay. Accordingly, the federal employment tax and reporting requirements for disability pay do not necessarily apply to PFL benefits.

A comparative chart of the federal tax treatment of disability and paid family leave benefits is available on page 4.



# Paid family leave: the federal requirements for taxation and reporting

Continued

## State paid family leave programs as of October 1, 2017

State	Effective date	Citation	Administered by	Employer contribution	Employee contribution	Private insurer allowed
California	2004	<a href="#">AB908</a>	Unemployment agency	None	0.9% on wages up to \$110,902 for the year (included in SDI tax)	Yes
District of Columbia	2020	<a href="#">B21-0415</a>	Unemployment agency	0.62% of covered wages	None	Regulations pending
New Jersey	2008	<a href="#">N.J.S.A. § 43:21-38</a>	Unemployment agency	None	0.001000% on wages up to \$33,500 for the year	Yes
New York	2018	<a href="#">A9006C PART SS</a>	Workers' compensation insurance board	In excess of maximum when provided by a private plan	0.126% up to maximum weekly of \$1,305.92	Yes
Rhode Island	2014	<a href="#">RI Gen L § 28-41-35 (2013)</a>	Unemployment agency	None	1.2% on wages up to \$68,100 for the year (included in SDI tax)	No
Washington	2019	<a href="#">SB 5975</a>	Unemployment agency	0.4% with employers required to pay 37%, and employees 63%, of the premium	0.4% will be in effect, with employers required to pay 37%, and employees 63%, of the premium	Yes

## Federal taxation and reporting of paid family leave

### Paid family leave provided by a state fund

Unlike disability pay for which there is specific federal statute and ample IRS administrative guidance, there is little federal authority that definitely addresses PFL benefits under all of the possible scenarios. What definitive authority currently exists applies only to PFL benefits paid directly by state agencies.

Added to the Internal Revenue Code prior to the advent of any state PFL program, IRC §85 states that unemployment compensation is included in gross income and defines unemployment compensation as any amount received under a law of the United States or of a state which is **in the nature of unemployment**.

IRS Reg. §1.85 further explains that amounts in the nature of unemployment compensation also include **cash** disability **payments** made pursuant to a governmental program as a substitute for case unemployment **payments** to an unemployed **taxpayer** who is ineligible for such **payments** solely because of the disability.

The IRS explains on its [website](#) that recipients of unemployment compensation can voluntarily request federal income tax withholding by completing [Form W-4V](#) and that such payments are reported by the recipient as "other income" on (line 19) of the Form 1040. The [instructions](#) for Form 1040, line 19 state:

*You should receive a Form 1099-G showing in box 1 the total unemployment compensation paid to you in 2016. Report this amount on line 19. However, if you made contributions to a governmental unemployment compensation program or to a **governmental paid family leave program** and you aren't itemizing deductions, reduce the amount you report on line 19 by those contributions. If you are itemizing deductions, see the instructions on Form 1099-G.*

It is important to note that [Form 1099-G](#) clearly states that this form is used only by federal, state or local governments to report unemployment compensation (including payments in the nature of unemployment compensation).

## Paid family leave provided by a private fund

In response to questions raised by California's PFL program that took effect in 2004, IRS Chief Counsel issued a technical memo in 2005 to address if amounts paid to an individual under the California PFL program are included in gross income under IRC §85 under two scenarios (the employee itemizes or does not itemize deductions on Form 1040). The IRS held in both cases that California's PFL benefits are included in gross income according to the statutory authority of IRC §85; however, the fact pattern addressed in the IRS technical memo was specific – the PFL payments will be paid from the state disability fund, will be funded entirely by employee contributions and the payroll deductions are mandatory. ([CCA 200630017](#).)

For PFL benefits paid by a private insurance company or the self-insured plan of the employer, there is, unfortunately, no definitive guidance available. Accordingly, employers and plan benefit providers should consider a conservative protocol for taxing and reporting benefits not specifically exempt under federal statute, IRS authority or a private letter ruling they may have secured from the IRS.

Following is what the statute says about compensation and benefits that are not specifically exempt.

- ▶ **Gross income.** [IRC §61](#) states that compensation or benefits provided in consideration of services rendered is included in federal gross income unless otherwise exempted. Gross income in this context is defined as 100% of the benefit provided, without regard to the portion of the insurance paid by the employee. The employee may be able to claim a deduction for any insurance premiums they paid on the Form 1040 according to the guidelines in [CCA 200630017](#).
- ▶ **Federal wages subject to income tax.** [IRC §3401\(a\)](#) defines wages for federal income tax purposes as all remuneration (other than fees paid to a public official) for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash. There is no specific exemption provided for paid family leave benefits.
- ▶ **Federal wages subject to income tax withholding.** [IRC §3402\(a\)](#) requires that employers withhold income tax on all federal taxable wages. There is no exception provided for paid family leave benefits.
- ▶ **Social Security and Medicare wages.** [IRC 3121\(a\)](#) defines wages subject to Social Security and Medicare tax as all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash. There is no specific exemption provided for paid family leave benefits.
- ▶ **Federal unemployment insurance wages.** [IRC §3306\(b\)](#) defines taxable wages as all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash. There is no specific exemption provided for paid family leave benefits.
- ▶ **Form W-2 reporting.** [IRC §6051\(a\)](#) requires that every person required to deduct and withhold federal income tax or Social Security/Medicare tax must provide a Form W-2 to the employee. [IRC §6071](#) requires that employers file Form W-2 with the SSA to report taxable wages and taxes withheld. Note also in the instructions for 1099-MISC, there is no instruction to report paid family and leave benefits in box 3 (other compensation).
- ▶ **Pretax deductions.** In [IRS notice 2005-42](#), paid family leave is not listed as qualified benefit within a cafeteria plan; accordingly, pretax deductions for PFL insurance are not allowed.



# Paid family leave: the federal requirements for taxation and reporting

Continued

## Summary of disability and paid family leave federal tax and reporting requirements

Provision	Disability insurance benefits	Paid family leave insurance benefits not paid from state fund*	Paid family leave benefits paid by state fund
Federal income tax	Subject to extent employer pays for the insurance. Exempt if employee elects to treat employer-paid premium as included in taxable wages	Subject regardless of who pays for the insurance	Subject regardless of who pays for the insurance
Federal income tax withholding	Voluntary, Form W-4S	Mandatory, Form W-4	Voluntary, Form W-4V
Social Security/Medicare	Subject to extent employer pays for the insurance and for only the first six-month coverage period	Subject regardless of who pays for the insurance and for the entire benefit period	Exempt
Federal unemployment insurance	Subject to extent employer pays for the insurance and for only the first six-month coverage period	Subject regardless of who pays for the insurance and for the entire benefit period	Exempt
Pretax deduction for employee portion of premium	Allowed if included in employer's cafeteria plan	Not allowed	Not allowed
Information reporting	Form W-2	Form W-2	Form 1099-G

\*This is a conservative conclusion in the absence of definitive statutory authority or IRS administrative guidance.

### Ernst & Young LLP insights

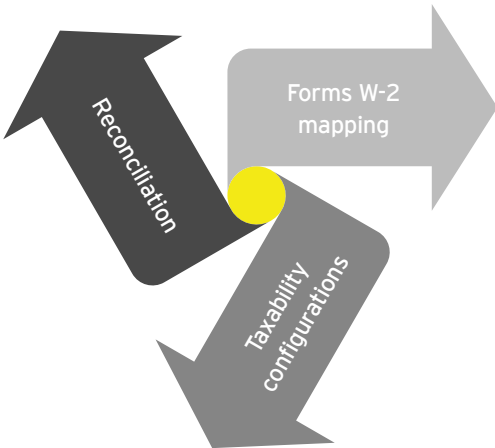
As more states adopt PFL programs, it is certain that Congress and/or the IRS will specifically address the tax and reporting requirements of this benefit under the various possible payment scenarios. In the meantime, employers and private insurance companies will need to carefully consider that absent definitive guidance excluding the benefit from Social Security covered wages, employees could seek litigation for the recovery of any Social Security benefits potentially lost as a result of the reporting position taken by the benefit provider.

Particularly where employers offer PFL benefits that supplement a private insurance plan, they should coordinate concerning how the private insurance company will report benefit payments. For instance, the employer and insurance provider may agree that benefit payments will be turned over to the employer to offset benefits paid directly to employees by the employer. In this case, the insurance provider would not issue information statements or returns reporting the payments to the individual recipients.

Organizations paying PFL benefits might consider obtaining a private letter ruling (PLR) from the IRS on the federal tax treatment of the benefits under their specific facts and circumstances. Instructions for obtaining a PLR from the IRS are available [here](#).



# Don't wait until year-end



Gaps in your payroll system or employment tax processes can easily go undetected and may result in costly errors on Forms W-2 and other employment tax returns.

## Get the support you need for 2017!

Take a look at how Ernst & Young LLP's employment tax professionals are [assisting](#) businesses in meeting their 2017 employment tax requirements.

Access our free essential resources [here](#).

Tax process review*	
Through staff interviews, data analysis and random sampling, our team identifies areas of opportunities and risk involving:	
<ul style="list-style-type: none"> <li>▶ Cash management</li> <li>▶ Employee master file and pay/deduction transactions</li> <li>▶ Recordkeeping, data management and reporting</li> <li>▶ Federal, state, local and provincial tax reporting</li> <li>▶ Efficiency/accuracy safeguards</li> <li>▶ Reconciliation and third-party oversight</li> </ul>	
Employment Tax (ET) Rapid Assessment™	Tax configuration review
With our ET Rapid Assessment™, businesses can access our secure web-based portal, or schedule an on-location meeting to complete our assessment questionnaire and receive a report highlighting potential risks and opportunities within their employment tax operations. Our team of qualified tax professionals supports the process by reviewing the flags, ranking their priority and codeveloping any follow-up action plans.	Employment tax processes are driven by configuration tables, payroll codes and attributes that direct the tax treatment of compensation and how it is ultimately mapped to returns and information statements. Our employment tax team reviews these data elements and assists businesses in designing and managing workflows to maintain their integrity.
System implementation support*	Co-sourcing*
Adding our skilled resources to the system implementation team adds integrity to the employment tax processes while freeing staff resources to focus on their routine responsibilities. Implementation support is available in all phases, including:	Our qualified professionals are available to meet your employment tax operational needs, whether they be staffing, training or responding to one-off questions.
<ul style="list-style-type: none"> <li>▶ Data migration planning and implementation</li> <li>▶ Design and specifications</li> <li>▶ Testing and data sampling</li> </ul>	

\*The scope of these services may be limited for Ernst & Young LLP SEC registrant audit clients.

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