



Third-party sick pay

What employers should know



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Third-party sick pay: the 10 most frequently asked questions

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Third-party sick pay describes payments received by employees through private insurers or state disability insurance funds for wage continuation during a qualified non-work-related disability-related leave. Some businesses fund their own disability leave benefits and may outsource administration of the plan to a third party. Regardless of who bears the insurance risk for disability leave benefits, special tax and reporting requirements apply. Additionally, employers and third-party payers share responsibility for taxing and reporting disability leave benefits, and it is precisely this shared obligation that frequently leads to confusion and reporting errors.

Here, we answer the 10 most frequently asked questions (FAQs) about third-party sick pay.

- FAQ 1:** When are employer-paid disability insurance premiums included in federal taxable wages?
- FAQ 2:** When are disability leave benefits included in wages subject to federal income tax?
- FAQ 3:** How is federal income tax withholding computed on taxable benefits?
- FAQ 4:** When are disability leave benefits included in wages subject to FICA?
- FAQ 5:** Are disability leave benefits included in unemployment insurance taxable wages?
- FAQ 6:** What exactly is meant by the six-month coverage period?
- FAQ 7:** What if the employer changes the amount it pays toward the cost of disability insurance?
- FAQ 8:** Who files the Form W-2: the employer or the third-party payer?
- FAQ 9:** What are the tax and reporting obligations of the third-party payer?
- FAQ 10:** What are the employer's tax and reporting obligations?

FAQ 1

When are employer-paid disability insurance premiums included in federal taxable wages?

Premiums paid by employers for disability insurance are excluded from wages subject to federal income tax (FIT), federal income tax withholding (FITW), Social Security/Medicare (FICA) and federal unemployment insurance (FUTA). (*IRC §106(a).*)

FAQ 2

When are disability leave benefits included in wages subject to FIT?

Generally, disability pay is included in federal taxable wages to the extent the employer pays for the cost of the insurance. If the employee contributes to the premium cost, that portion of benefits is exempt from FIT.

Unlike FICA and FUTA, taxable disability benefits are included in FIT wages for the duration they are paid. In contrast, FICA and FUTA taxes apply only for the first six-month coverage period. See FAQ 4. (*IRC §104(a)(3); IRS Publication 15-A.*)

Example 1: Employee Sally pays 100% of the disability insurance premium. She receives disability benefits of \$500. The \$500 is exempt from FIT.

Example 2: Randy's employer pays 100% of the disability insurance premium. He receives disability benefits of \$700. The \$700 is subject to FIT.

Example 3: Rebecca's employer pays 60% of the premium, and Rebecca pays 40%. She receives disability benefits of \$1,000. \$600 is subject to FIT, and \$400 is exempt.

Watch this. If the employer pays 100% of the disability insurance premium and the employee makes an irrevocable election at the beginning of the plan year to include the employer-paid premium in wages subject to FIT, any disability leave benefits received by the employee at a future date are exempt from FIT. This exclusion applies only to FIT. Taxable disability benefits continue to be subject to FICA and FUTA for the six-month coverage period. See FAQ 4 and FAQ 5. (*IRS Reg. §1.104(d)-1(d); Rev. Rul. 2004-55, 2004-26 CB 1081.*)

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FAQ 3

How is FITW computed on taxable benefits?

Whether federal income tax withholding is required depends on which entity bears the insurance risk – the employer or a third party.

- ▶ **Self-insured plan and plans administered by a third party** – if the employer bears the insurance risk, FIT is computed using the employee's Federal [Form W-4, Withholding Allowance Certificate](#), and the method of FITW that applies to regular wages.

If the payments are made by an agent of the employer (e.g., a third-party plan administrator), the federal supplemental withholding rate of 25% may be used in lieu of the Federal Form W-4 and the regular withholding tables.

- ▶ **Third-party insured plan** – if a public (state) or private third party bears the insurance risk, FIT is withheld only if the employee files a [Form W-4S, Request for Income Tax Withholding From Sick Pay](#), with the third party. (*T.D. 9276; Rev. Rul. 90-29, 1990-1 CB 11.*)

FAQ 4

When are disability leave benefits included in wages subject to FICA?

Disability leave benefits are included in wages subject to FICA to the extent the employer contributed toward the premium cost (see FAQ 2) and only for the six-month coverage period. Benefits received after the six-month coverage period are exempt from FICA (see FAQ 6). ([§31.3121\(a\)\(4\)-1](#).)

Watch out for this exemption. Disability leave benefits that are paid under a plan exclusively for employees who are terminated because of disability retirement are exempt from FICA, including benefits paid in the six-month coverage period. ([IRC 3121\(a\)\(13\)](#).)

FAQ 5

Are disability leave benefits included in unemployment insurance taxable wages?

For federal purposes, the amount that is subject to FICA tax (see FAQ 4) is also subject to FUTA. ([IRC §3306\(b\)\(4\)](#).)

Watch out for state exceptions. The state unemployment insurance (SUI) rules vary. For example, Alaska, Delaware and numerous other states exclude all disability leave benefits from wages subject to SUI, including benefits received in the first six-month coverage period. Failure to consider a state's SUI exclusion for disability benefits could result in substantial overpayment of SUI taxes when you consider that employees on disability leave are likely not to reach the SUI wage limit in the year.

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FAQ 6

What exactly is meant by the six-month coverage period?

The six-month coverage period is defined as the six months following the last day of the month that the employee last worked. (*IRC §3121(a)(4), §3306(b)(4).*)

This period starts over if the employee returns to disability leave for the same illness or injury – even if the employee worked only one day between leave periods.

Example 4: Employee Mike was injured in a car accident on January 2 and was on disability leave until August 31. Mike's employer pays 100% of the disability premium. Disability pay received from January 2 through July 31 (the six months following January 31) is subject to FICA and FUTA; however, disability pay received in August is exempt from FICA and FUTA (but continues to be subject to FIT).

Example 5: Assume the same facts as in Example 4 except that because of a processing error, Mike didn't receive any of his disability pay until August for the period of January through July. The entire amount is exempt from FICA and FUTA (but subject to FIT) because the benefits weren't paid to Mike until after the six-month coverage period.

Caution: The IRS and Social Security Administration discourage intentionally delaying payments to avoid FICA and FUTA.

FAQ 7

What if the employer changes the amount it pays toward the cost of disability insurance?

Clearly, a change in the amount that employers and employees contribute toward disability insurance also changes the amount that is subject to FIT, FICA and FUTA. What is surprising is that the IRS requires a three-year look-back each time the employer's contribution ratio changes. (*IRS Reg. §1.105-1(d)(2).*)

Specifically, when the employee-employer contribution ratio changes, the IRS requires using a three-year weighted average to determine the contribution ratio for purposes of computing taxable disability pay. For each of the three years, the weighted average of the previous three years' contribution history is used. (Special rules apply when the plan doesn't have a three-year history.)

Computing the weighted average requires the following information at the plan level for the previous three years:

- ▶ Total disability insurance premiums paid
- ▶ Total employer contribution
- ▶ The contribution ratio of A and B

Example 6: For 2010, 2011 and 2012, Widget, Inc. paid 100% of the cost of its group disability insurance plan, which for the biweekly period was \$3.06. Widget determined that for 2013, employees would contribute 39.2%, or \$1.20 each biweekly period, and Widget would contribute 60.8%, or \$1.86 each biweekly period. See Figures 1.a through 1.f for an illustration of how Widget's contribution ratio is determined for calendar years 2013 through 2016.

Third-party sick pay: the 10 most frequently asked questions

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Figure 1.a:
Widget's disability premium contributions – 2010 to 2016

Policy year	Total premium	Widget's contribution	Widget's contribution %
2010	\$100,000	\$100,000	100%
2011	\$150,000	\$150,000	100%
2012	\$140,000	\$140,000	100%
2013	\$140,000	\$85,120	100% (see Fig. 1.c)
2014	\$150,000	\$91,200	87.24% (see Fig. 1.d)
2015	\$200,000	\$121,600	73.56% (see Fig. 1.e)
2016	\$200,000	\$121,600	60.8% (see Fig. 1.f)

Figure 1.b: determining Widget's contribution ratio – 2013 to 2016

2013	First policy year after contribution change takes effect. Prior three-year weighted average is 100%.
2014	Second policy year after contribution change takes effect. One year (2013) of the contribution change is reflected in the three-year weighted average.
2015	Third policy year after contribution change takes effect. Two years (2013 and 2014) of the contribution change are reflected in the three-year weighted average.
2016	Fourth policy year after contribution ratio takes effect. Three years (2013 through 2015) of the contribution change are reflected in the three-year weighted average; therefore, the contribution ratio is now equal to 60.8%, the ratio intended by the policy change made in 2013.

Figure 1.c:
Weighted-average computation for the 2013 contribution ratio

Policy year	Total premium	Widget's contribution
2010	\$100,000	\$100,000
2011	\$150,000	\$150,000
2012	\$140,000	\$140,000
Total:	\$390,000	\$390,000

Weighted average: $\$390,000 \div \$390,000 = 100\%$

Figure 1.d:
Weighted-average computation for the 2014 contribution ratio

Policy year	Total premium	Widget's contribution
2011	\$150,000	\$150,000
2012	\$140,000	\$140,000
2013	\$140,000	\$85,120
Total:	\$430,000	\$375,120

Weighted average: $\$375,120 \div \$430,000 = 87.24\%$

Figure 1.e:
Weighted-average computation for the 2015 contribution ratio

Policy year	Total premium	Widget's contribution
2012	\$140,000	\$140,000
2013	\$140,000	\$85,120
2014	\$150,000	\$91,200
Total:	\$430,000	\$316,320

Weighted average: $\$316,320 \div \$430,000 = 73.56\%$

Figure 1.f:
Weighted-average computation for the 2016 contribution ratio

Policy year	Total premium	Widget's contribution
2013	\$140,000	\$85,120
2014	\$150,000	\$91,200
2015	\$200,000	\$121,600
Total:	\$490,000	\$297,920

Weighted average: $\$297,920 \div \$490,000 = 60.8\%$

Caution: The contribution ratio that was in effect in the year the employee first became disabled will be used for all years the employee receives pay pursuant to the same disability event. In Example 6 on page 4, assume an employee's disability period began on December 15, 2013, and ended on March 31, 2014. The contribution ratio for the entire period is the 2013 weighted average of 100%.

FAQ 8

Who files the Form W-2: the employer or the third-party payer?

The employer is obligated to file the Form W-2 reporting taxable (boxes 1, 3 and 5) and nontaxable (box 12, code J) disability leave benefits. The third-party payer is required to issue Forms W-2 under its Employer Identification Number (EIN) only if:

- ▶ An agency agreement specifies the third party will file Forms W-2 under its EIN.
- Or
- ▶ The third party has failed to meet the requirements for transferring liability for employment tax and reporting to the employer (see FAQ 9).

Watch this. Unless the third-party payer has agreed to pay the employer portion of FICA, FUTA and SUI (which is generally never the case), the employer's EIN should be used on Forms W-2, not the third party's EIN. Use of the third party's EIN on Forms W-2 when the employer bears the employment tax responsibility can cause imbalances in federal and state unemployment insurance returns and lead to time-consuming reporting and collection notices from the IRS and state unemployment insurance agencies. If the third-party payer or plan administrator has agreed to issue Forms W-2, employers should confirm which EIN is being used.

Use of the third party's EIN on Forms W-2 when the employer bears the employment tax responsibility can cause imbalances in federal and state unemployment insurance returns and lead to time-consuming reporting and collection notices from the IRS and state unemployment insurance agencies.

FAQ 9

What are the tax and reporting obligations of the third-party payer?

The third-party payer (including a state disability insurance fund) is required to withhold federal income and FICA taxes from taxable disability pay and make timely IRS deposits of these withholding taxes under its EIN. (*IRC §6051(f); IRS Reg. §31.6051-3*.)

The third-party payer is also required to report on Form 941 federal income tax withheld, Social Security wages, Social Security tax withheld, Medicare wages and Medicare tax withheld. A credit for the employer portion of Social Security and Medicare tax is reported on Form 941 if liability was properly transferred to the client-employer.

The third-party payer may transfer liability for the employer portion of FICA, FUTA and Form W-2 reporting to the client employer by providing regular statements and, no later than January 15, an annual statement to the client-employer that includes:

- ▶ Employee name
- ▶ Employee Social Security Number
- ▶ Total amount of sick payments made to the employee in the tax year
- ▶ FIT and FICA taxable payments made to the employee in the tax year
- ▶ Amount of FITW, if any
- ▶ Any employee FICA withheld

The third-party payer must also file [Form 8922, Third-Party Sick Pay Recap](#), if it has transferred liability for FICA and FUTA taxes to the client-employer.

FAQ 10

What are the employer's tax and reporting obligations?

Provided the third-party payer has properly transferred liability for employer FICA and FUTA (see FAQ 9), the employer is obligated to make timely IRS deposits of employer FICA, FUTA and SUI and report the taxable sick payments on Forms 941 and W-2.

For reconciliation purposes, the employer makes special entries on Forms 941, W-2 and W-3 as follows:

- ▶ **Form 941** – show a credit for the employee portion of FICA
- ▶ **Form W-2** – in box 12, code J, show the nontaxable portion of the third-party sick pay
- ▶ **Form W-3** – in box 14, enter the federal income tax withheld, if any, by the third-party payer
- ▶ **Form 940** – report the total third-party sick pay and the portion subject to FUTA and pay the tax owed
- ▶ **State unemployment insurance** – report and pay as required under state unemployment insurance law

Third-party sick pay and workers' compensation insurance



Is the employee receiving benefits for a work-related sickness or injury? This is an important question because the taxes owed on the benefits hinge on the answer.

When benefits are provided to employees for personal sickness or injury under an employer-paid disability insurance plan, they are included in wages subject to FIT, FITW, FICA and FUTA. (See page 4.) On the other hand, when benefits are paid for work-related sickness or injuries under a workers' compensation act or similar law, they are excluded from these taxes. (*Publication 907, Tax Highlights for Persons with Disabilities.*)

From a payroll perspective, it is plain to see why properly classifying disability benefits is important. Improperly treating a workers' compensation benefit as disability or third-party sick pay results in the overpayment of tax by both the employee (e.g., FIT, FICA) and the employer (e.g., FICA, FUTA).

Retroactive workers' compensation offsets are time-consuming and costly to account for and can result in the denial of some or all of the federal income tax refund available to benefit recipients under IRC §1341.

Classification errors typically occur because an employee who is on leave for a work-related sickness or injury initially receives benefits under the disability insurance plan and is later provided retroactive pay under the workers' compensation policy. Clearly, information returns and statements must be adjusted to reflect the correct nature of the payment (workers' compensation vs. disability pay), and this is no simple task, particularly if the error is discovered in subsequent tax years.

Assume an employee receives short-term disability of \$1,000 through the employer's disability insurance plan in 2015. In 2016, it is determined the leave was work-related and – as such – the employee is owed workers' compensation insurance benefits of \$500.



Tax concerns

As previously explained, disability pay under a definite plan or system is taxable to the extent the employer paid the insurance cost. In our example, the employer paid 60% of the premium; therefore, \$600 of the \$1,000 benefit is generally subject to FIT, FITW, FICA and FUTA. (Note that there may be an exception for state and local purposes.) In this example, the employee's taxable wages should have been only \$100 (taxable disability pay of \$600 less the workers' compensation benefit of \$500), resulting in a taxable wage overstatement of \$500.

Resolution of tax overpayments due to workers' compensation offsets

To resolve tax overpayments that arise when benefits are reclassified from disability to workers' compensation, the workers' compensation insurance provider will often remit the workers' compensation benefit to the employer. Once the employer receives that payment, the employee's wage and tax records must be adjusted. How this adjustment is made depends on the tax year the disability insurance benefits were originally paid.

- ▶ **Current year.** If the workers' compensation offset is made in the same year as the disability payment, simply reduce FIT and FICA taxable wages by the amount of the workers' compensation benefit, but to not less than zero. A corresponding reduction in FICA taxes should also be made for the employer and the employee. Federal and state unemployment insurance wages should likewise be corrected.
- ▶ **Subsequent years.** If the offset is made in a year subsequent to the disability payment, the rule for prior-year wage overpayments applies (also known as the claim-of-right doctrine). Under the rule, a [Form W-2c](#) is issued for the year the disability benefit was originally paid. On the Form W-2c, a reduction is shown in Social Security and Medicare wages and taxes, but no adjustment is shown in box 1, *Wages, tips, other compensation*. Employees can obtain a refund of federal income tax, if applicable, on their federal income tax return according to the methods explained in [Publication 525](#) (the "Repayments" section). (*IRC §1341.*)

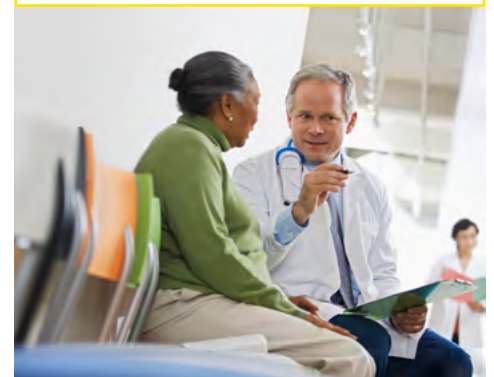
Watch out for this exception. The tax adjustment described above would not apply if by law or judgment it is determined that the workers' compensation benefits are not due and payable. In this case, because no workers' compensation is payable to the employee, the employee was properly in receipt of disability benefits only, and no adjustment to taxable wages applies.

When disability benefits are reclassified as workers' compensation benefits, payroll professionals should verify that adjustments are properly made to taxable earnings in accordance with the claim-of-right doctrine.

Ernst & Young LLP insights

Retroactive workers' compensation offsets are time-consuming and costly to account for and can result in the denial of some or all of the federal income tax refund available to benefit recipients under IRC §1341. For these reasons, employees should be required to timely indicate whether their sickness or disability is work-related. Human resources should also confirm that disability and workers' compensation insurance claims are routinely reviewed and classification errors remedied immediately.

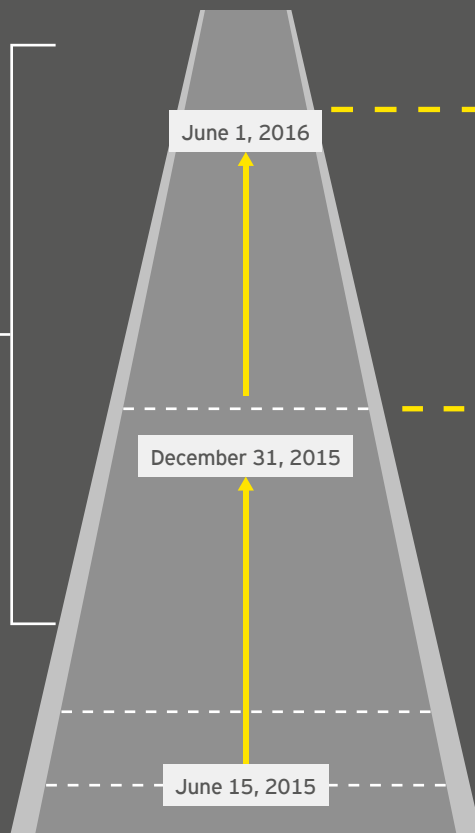
Payroll departments should confirm that earnings codes are configured for both workers' compensation and disability benefits and that the tax settings are correct for federal, state and local taxes. When disability benefits are reclassified as workers' compensation benefits, payroll professionals should verify that adjustments are properly made to taxable earnings in accordance with the claim-of-right doctrine.



Overview of third-party sick pay

Assumes third-party transfers liability to employer

- ▶ What percentage of the premium is paid by the employer? *This percentage is taxable; the remaining is nontaxable.*
- ▶ Employee submits Form W-4S to third party if federal income tax withholding (FITW) desired. If a self-insured plan, Form W-4 is needed and income tax withholding is mandatory.
- ▶ Third party withholds FICA and FITW. Generally, employer must pay the employer share of FICA and federal/state unemployment insurance.
- ▶ Employer and third party file Form 941.
- ▶ If third party provides annual statement to employer by January 15, employer issues and files Form W-2 – nontaxable portion is reported in box 12, code J.
- ▶ Employer is responsible for Form 940 and state unemployment insurance return.



▶ Employee returns to work

Taxable portion of disability pay is subject only to federal income tax.

Long-term disability (LTD)

"Six-month" coverage period, or short-term disability (STD)

Taxable portion of disability pay is subject to Social Security, Medicare, unemployment insurance and federal income tax.

- ▶ Employer liability for FICA tax deposit is triggered with each disability payment
- ▶ Employee takes first day of disability leave

How the IRS defines short-term and long-term disability

Third-party sick pay employer checklist

- ☑ Notify third party of the percentage of the disability insurance premium paid by the employer.
- ☑ When employee makes initial claim for disability benefits, provide the third party with the employee's year-to-date earnings, including Social Security earnings. Also provide work and resident state information for income tax withholding compliance, if applicable.
- ☑ Each payroll period, confirm that the third party has provided you with a statement of disability payments made and taxes withheld for those employees on disability leave and make the required deposits for Social Security/Medicare and unemployment insurance according to their due dates.
- ☑ By January 15, obtain annual statement from third party and verify that Forms W-2 are accurately generated for prior-year disability benefit recipients.

Source: IRS Publication 15-A



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SCORE No. 02738-161US
CSG No. 1608-2035769 SW
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