

The W-2 as Roadmap for Tennessee Child Support Guideline Income

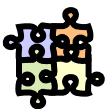
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The IRS form W-2, Wage and Tax Statement, can often prove to be a simple roadmap for determining an employee's income for Tennessee Child Support Guidelines purposes. However, don't be fooled by its apparent simplicity. The W-2, if not read correctly, does not always reveal the unknown *and known* sources of employment "income" as defined by the Guidelines. Per the Guidelines, the definition of "income" is:

Gross income shall include all income from any source (before taxes and other deductions), whether earned or unearned, and includes but is not limited to, the following: wages, salaries, commissions, bonuses, overtime payments, dividends, severance pay, pensions, interest, trust income, annuities, capital gains, benefits received from the Social Security Administration, i.e., Title II Social Security benefits, workers' compensation benefits whether temporary or permanent, judgments recovered for personal injuries, unemployment insurance benefits, gifts, prizes, lottery winnings, alimony or maintenance and income from self-employment. Income from self-employment includes income from business operations and rental properties, etc., less reasonable expenses necessary to produce such income. Depreciation, home offices, excessive promotional, excessive travel, excessive car expenses, or excessive personal expenses, etc., should not be considered reasonable expenses. "In kind" remuneration must also be imputed as income, i.e., fringe benefits such as a company car, the value of on-base lodging and meals in lieu of BAQ and BAS for a military member, etc.¹

"All income from any source (before taxes and other deductions)," would seem to be a no-brainer - an all-encompassing definition of a person's cash inflow. But, the term "income" can mean one thing to a CPA and W-2 preparer and another to an attorney trying to interpret the document in order to set child support. Income is conventionally thought by CPAs to be taxable compensation or earnings of some type. Attorneys and the Guidelines generally consider the term "income" to be cash flows available to the employee regardless of the purpose for payment. W-2's report gross income in one of its boxes, and can document other payments made to the employee for items like business expense reimbursements and moving costs.

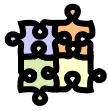


Practice Tip -Because the W-2 is a much more complex reporting document than it appears, understand that employers or their accountants in preparation make many unintentional errors. Do not necessarily rely upon the form as presented. For employees with a more complex compensation structure, an attorney should discover the expense reimbursement policies and retirement plans available to the employee, then trace those items to the W-2.

Start your analysis with the most commonly used items on the W-2 – Boxes 1, 3 and 5, Wages Tips and Other Compensation, Social Security Wages and Medicare Wages, respectively. Box 1 reports the taxable wages, salary, commissions, certain expense reimbursements, etc. (hereinafter wages) the employee will be required to report on his form 1040 as income for that year. It will not include any amounts for *elective salary deferrals*, (i.e. pre-tax deductions.) The most common examples of elective salary deferrals are contributions to 401(k) or Simple IRA plans. Note that most companies match some percentage of an employee's pay or contribution to a retirement plan and deposits the cash or company stock into the employee's separate account. This type of fringe benefit does not have to be

¹ Rules of Tennessee Department of Human Services Child Support Services Division, Chapter 1240-2-4 Child Support Guidelines, ¶1240-2-4-.03 (3)(a), Oct. 1989 (Revised)

reported on the W-2, although it may appear in Box 14. The match could also be considered Guideline income since it is a monetary balance the employee can access usually after a vesting period.



Practice Tip – Social Security Tax (6.2% rate) and Medicare Tax (1.45% rate) are **collectively** known as FICA (total rate of 7.65%), not one or the other separately. These taxes are deducted from an employee’s pay at these rates, subject to certain limits as explained below. An employer matches the withheld tax dollar-for-dollar for a total tax paid in of 15.3%. The W-2 will only report the employee’s withheld portion.

Box 3 reports the wages subject to Social Security Tax withholding at the 6.2% rate, up to the maximum wage base. For 2001, the wage base is \$80,400 for a maximum tax of \$4,984.80; for 2002, the base is \$84,900 for a maximum tax of \$5,263.80. Generally, Box 3 reports all of the items found in Box 1, but does not deduct the elective salary deferrals. Note that certain government employees and clergy are not subject to Social Security tax and will not have an amount reported in Box 3.

Box 5 reports the wages subject to Medicare Tax withholding, which are generally the same as those in Box 3, without the maximum wage base. The elective salary deferrals are not deducted from Box 5 and, since there is no maximum Medicare wage base, **Box 5 is the most accurate of the three boxes in determining the employee’s gross income from employment.** An employee’s Box 5 will be higher than Box 3 and possibly Box 1 if his wages exceed the maximum wage base and he participates in a 401(k)-type plan.

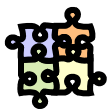
A simple example will illustrate all of these points. An employee, Joseph Jones, earned \$140,000 in 2002 and elects to have \$5,000 deducted and contributed to his 401(k) plan. He has no federal tax withheld (he lives dangerously.) No fringe benefits.

The W-2 reporting is as follows:

a. Control number 22222		For Official Use Only - OMB No. 1545-0047	
b. Employer identification number 12-3456789		1. Wages, tips, other compensation \$ 135000.00	2. Federal income tax withheld \$ 0.00
c. Employer's name, address, and ZIP code SAMPLE COMPANY, INC. 4321 MAIN STREET MEMPHIS TN 38103		3. Social security wages \$ 84900.00	4. Social security tax withheld \$ 5263.80
d. Employer's social security number 987-65-4321		5. Medicare wages and tips \$ 140000.00	6. Medicare tax withheld \$ 2030.00
e. Employee's first name and initial JOSEPH		7. Social security tips \$	8. Allocated tips \$
Last name JONES		9. Advance EIC payment \$	10. Dependent care benefits \$
f. Employee's address and ZIP code 321 MAPLE ROAD MEMPHIS TN 38103		11. Nonqualified plan \$	12a. See instructions for Box 12 D \$ 5000.00
g. State of residence TN		13. State income tax \$	13b. \$
h. State wages, tips, etc. \$		14. Other \$	13c. \$
i. State income tax \$		15. Local wages, tips, etc. \$	13d. \$
j. Local income tax \$		16. Local wages, tips, etc. \$	13e. \$
k. Local income tax \$		17. Local wages, tips, etc. \$	13f. \$
l. Local income tax \$		18. Local wages, tips, etc. \$	13g. \$

- Box 1 \$135,000.00 (Wages)
- Box 3 \$84,900.00 (Soc. Sec. Base)
- Box 4 \$5,263.80 (Soc. Sec. Tax)
- Box 5 \$140,000.00 (Micare Wages)
- Box 6 \$2030.00 (Medicare Tax)
- Box 12 \$5,000.00 (401(k) code D)

In this example, Joseph’s net “take home” pay is \$127,706.20 (\$140,000.00-5,263.80-2,030.00-5,000.00); the Guideline income is \$140,000. The elective salary deferrals should be considered part of Mr. Jones’ gross income since the deduction was *elective* and would have been included in gross taxable income if Congress had not decided to make this particular paycheck deduction a pre-tax item.

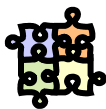


Practice Tip –Photocopy both sides of a W-2. The backside may include instructions and explanations of any codes that might appear in Box 12. These codes can provide a wealth of information about income, reimbursements, deductions and fringe benefits that may or may not be included in Boxes 1, 3 and 5.

The Trouble with Fringe Benefits and Expense Reimbursements

An employee fringe benefit increasing in popularity is the §125 “Cafeteria Plan.” This IRS-qualified paycheck deduction allows for a pre-tax deduction from income for particular personal expenses that would probably otherwise not be tax deductible to the employee. A typical cafeteria plan deduction is medical insurance, which could add up to several thousand dollars. The amount of the Plan deducted from pay will generally not be found in Boxes 1, 3 or 5, (or anywhere else for that matter) and could be considered Guideline income since it is also *elective*.

Employer expense reimbursements and allowances can also be a source of income for Guideline purposes. An employee’s out-of-pocket business expenses and employer paid moving expenses may be reported in Boxes 1, 3 and 5, however, the payments may qualify for non-reporting on the W-2 depending on the method of payment and documentation. In most circumstances, the obligee spouse will know if the obligor makes a “profit” on expense reimbursements.



Practice Tip-The reporting of expense reimbursements and allowances is a source of confusion, thus many employers fail to include them properly on the W-2. A quick call or a subpoena issued to the company’s benefits department will reveal their reimbursement and W-2 reporting policies.

Reimbursements could also satisfy the “all income from any source” Guideline criteria. Under certain conditions, the IRS considers these payments to be taxable income includable on the W-2 depending on the discretion the employee has over the use of the funds. Since the dollars are paid to the employee to reimburse him for ordinary and necessary business expenses or for moving, which could be quasi-business related, many practitioners might not consider them as income. To illustrate, a salesman may use her car to travel from customer to customer and she is reimbursed for the mileage costs, but does an attorney usually receive a stipend for his expensive business suits or commuting costs to and from home? All are necessary to conduct business. All persons that work incur some sort of personal expense as a condition of employment. Will the attorney be hit for support on income that he ultimately will use to buy a new suit and tie? Yes. Should the salesman be hit for support on reimbursed mileage payments she will ultimately use to buy gas? Perhaps.

The W-2 can be an effective roadmap that summarizes income for Tennessee Child Support Guideline purposes and other important measures in a divorce – but you can make a wrong turn and end up in a bad neighborhood if you read it incorrectly. Of course, there is no substitute for a thorough interview and full financial analysis of the subject, along with a little common sense. The W-2 is a roadmap that can lead the attorney to the right side of the tracks, but it also contains alleys and side streets just waiting for a missed turn.

Summary of W-2 Reporting

	Box 1	Box 3	Box 5
Includes	-Taxable Wages, Salary, Commissions -Certain Expense Reimbursements	-Income subject to Social Security Tax withholding -All items from Box 1 -Elective Salary Deferrals	-Income subject to Medicare Tax withholding -All items from Box 1 -Elective Salary Deferrals
Does Not Include	-Elective Salary Deferrals -Cafeteria Plan Deductions	-Income above maximum wage base; reporting "caps out" and does not report Guideline income over the maximum wage base -Cafeteria Plan Deductions	-No maximum wage base cap -Cafeteria Plan Deductions
Notes		-Some government employees and clergy are not subject to SS	Most accurate Box to use for Guideline income