

W-2s, Tax Returns, and Earnings

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When you need to determine an employee's income, do you rely on obtaining that information from W-2s? Do you look to Form 1040, line 7 of past tax returns? Do you use the net income reported on Schedule C for the self-employed person? Do you use the income listed on Schedule E for a partner or a shareholder of an S Corporation? If yes, do you truly have earnings? According to ORC 3119.05(a), the code section related to child support computations, "...earnings shall be verified by electronic means or with suitable documents, including, but not limited to, paystubs, employer statements, receipts and expense vouchers related to self-generated income, tax returns, and all supporting documentation and schedules for the tax returns." Here is why I believe you can't rely solely on W-2s and tax returns.

Tax Returns (Federal Form 1040):

If you are relying on line 7, of Form 1040, the amount of income reported here may be substantially lower or higher than the individual's actual earnings. Line 7 is the total of all W-2s, using the amount reported in Box 1. Box 1 reports the taxpayer's taxable wages, which is gross income adjusted for pre-tax contributions to 401k (or similar) plans, taxable fringe benefits, noncash payments, certain employee business expense reimbursements, and other items. I would recommend that you not rely on line 7 of Form 1040 as your only source document for determining earnings.

W-2's:

You have obtained W-2s and, after reading the preceding paragraph, you know that you don't want to rely on Box 1 for determining the earnings. So you look around and you see Box 3, Social security wages. Please note, the amount reported here is capped annually. For 2010, the maximum reported here will be \$106,800. Medicare wages, Box 5, will equal social security wages, except that the amount reported is not capped. Maybe this is a reliable source? Well, it depends on what you consider to be "earnings". In addition to wages paid, Medicare wages include: noncash payments, certain employee business expense reimbursements, signing bonuses, taxable cost of group-term life insurance over \$50,000, cost of health insurance premiums for a 2% or more shareholder, adoption benefits, and more. Again, I would not recommend that you rely solely on a W-2.

Pay Statements:

I recommend getting the final pay statement for each year that you are reviewing. Granted, some companies issue pay statements that have codes and other information that need clarification by the payroll department, but this is where the detail can be found. Many times, the pay statement is the only source for detail concerning: salary, bonus, commissions, over-time, shift-differential,

stock option exercise, gifts and awards, non-qualified deferred compensation, pre-tax deductions and taxable noncash compensation. Information regarding employer-paid benefits may also appear on the pay statement. If you compare the total gross compensation on the final pay statement to the amount reported on the W-2 for that year, most likely you will find that the two amounts don't agree. This is because of all the adjustments that are made to the total gross before it is reported in Box 1 of the W-2.

Schedule C for the Self-Employed:

A business owner is going to include Form Schedule C with the filed tax return, unless the business is a corporation (LLC may be filed on Schedule C) or an entity taxed as a partnership. The net income, gross receipts less expenses, is what gets taxed. Gross receipts will typically be cash collected. Expenses will typically be cash expended, except for a few notable exceptions. Depreciation and Section 179 expense is a noncash item. Section 179 is a special deduction that allows business owners to deduct immediately (subject to limitations), as an expense, the cost of acquiring property that would otherwise be required to be expensed over time. The amount reported for deductible meals and entertainment is typically only 50% of the actual amount expended. Wages are shown as total paid to all employees. Who are the employees? Deductions for the use of one's home would include a percentage of the mortgage interest, real estate taxes, insurance, utilities, etc of the home. Actual earnings may not be as simple as what is reported.

Schedule E for Partners and Shareholders:

Partners and shareholders of S Corporations report net income from business activity on page 2 of Schedule E, which is attached to their tax return. The net income reported is not necessarily the amount of cash received by the partner or shareholder. For partners, the cash distributed is referred to as draws or guaranteed payments. Guaranteed payments are reported as income, but draws are not. The draws are reported on Schedule K-1, which the partner receives but does not attach to the return.

Shareholders of S Corporations typically receive two types of income. They may receive wages, which are reported on a W-2, and they may also receive distributions or draws, which only appear on the Schedule K-1. The distributions or draws are not taxable income (unless in excess of basis) to the shareholder and may not agree with the amount reported on the Schedule E as income from the S Corporation.

Determining earnings may not be as straightforward as it seems. Having the appropriate documents is critical when determining "earnings".

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