

# Paid family and medical leave insurance benefits

Taxation and reporting

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# Paid family and medical leave insurance benefits: taxation and reporting

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The state requirement that employers provide paid family and medical leave (PFML) insurance has gained momentum in recent years with 10 states having adopted legislation for the program, eight of them since 2013. In all of the 10 states except the District of Columbia and Rhode Island, employers have the choice of providing PFML benefits to their employees through the state fund or a private insurance plan. (See *the chart of states with PFML programs 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 PFML 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 when PFML benefits are paid by the employer or a private insurance company.

Here we will explain how states have historically dealt with the taxation of PFML, the lack of federal guidance concerning the tax treatment of benefits provided by nongovernment organizations, and the prudent approach to taxation and reporting.

# Paid family and medical leave insurance benefits: taxation and reporting

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## PFML leave vs. disability pay

Although PFML 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 PFML 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 own 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(oX2X(C))*.)

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)*.)

Because PFML provides wage replacement for other than the employee's own 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 PFML benefits.

A comparative chart of the federal tax treatment of disability is available on page 6.

## State PMFL benefit programs as of September 1, 2021

State	Effective date	Citation	Administered by	Employer contribution	Employee contribution	Private insurer allowed
California	2004	<a href="#">AB908</a>	Unemployment agency	None	Included in SDI tax	Yes
Colorado	2023	<a href="#">Proposition 118</a>	Unemployment agency	0.45% of covered wages	0.45% of covered wages	Yes
Connecticut	2021	<a href="#">Public Act 19-25</a>	Unemployment agency	None	0.5% up to the Social Security wage limit	Yes
District of Columbia	2020	<a href="#">D.C. Law 31-264</a>	Unemployment agency	0.62% of covered wages	None	No
Massachusetts	2019	<a href="#">Chapter 121 Acts of 2018</a>	Department of Family and Medical Leave	For employers of 25 or more employees, 60% of medical insurance portion of rate, otherwise employees pay 100%	0.75% up to the Social Security wage base (employees pay 100% of family leave portion).  If employer of 25 or more employees, 40% of medical insurance portion; otherwise employee pays 100%.	Yes

State	Effective date	Citation	Administered by	Employer contribution	Employee contribution	Private insurer allowed
New Hampshire	2023	<a href="#">H.B. 2</a>	Granite State Paid Family Leave Fund	Employers with 50 or more employees must make payroll deductions available to employees.	Employees may voluntarily opt in.	Yes
New Jersey	2008	<a href="#">N.J.S.A. § 43:21-38</a>	Unemployment agency	None	0.028% on wages up to \$138,200 for the year up to a maximum of \$386.96 per year	Yes
New York	2018	<a href="#">A9006C PART SS</a>	Workers' compensation insurance board	In excess of the maximum employee contribution when provided by a private plan	0.511% of maximum weekly of wages of \$1,450.17 up to a maximum of \$385.35 per year	Yes
Rhode Island	2014	<a href="#">RI Gen L § 28-41-35</a>	Unemployment agency	None	Included in SDI tax	No
Washington	2019	<a href="#">SB 5975</a>	Unemployment agency	0.4% up to the Social Security wage base, with employers required to pay the excess over 63.333%	0.4% up to the Social Security wage base, with employers paying 63.33%	Yes

## Federal taxation and reporting of PFML benefits

### PFML benefits 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 definitively addresses the federal payroll tax treatment of PFML benefits under all of the possible scenarios. What definitive authority currently exists applies only to PFML benefits paid directly by state agencies.

As added to the Internal Revenue Code prior to the advent of any state PFML 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 that 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 7) of the Form 1040.

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# Paid family and medical leave insurance benefits: taxation and reporting

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The [instructions](#) for Form 1040, line 7 state:

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 7 by those contributions. If you are itemizing deductions, see the instructions on Form 1099-G.

It is important to note that [Form 1099-G](#) instructions clearly state that Form 1099-G is used only by federal, state or local governments to report unemployment compensation (including payments in the nature of unemployment compensation, such as governmental paid family leave program payments).

## PFML benefits provided by a private fund

In response to questions raised by California's PFML 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 its 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 PFML benefits are included in gross income under the statutory authority of IRC §85; however, the fact pattern addressed in the IRS technical memo was specific – the PFML 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 PFML benefits paid by a private insurance company or the self-insured plan of the employer, there is, unfortunately, no definitive guidance available. Accordingly, absent the specific authority under federal law, IRS guidance or a private letter ruling issued to the taxpayer, employers and plan benefit providers should consider a conservative protocol for taxing and reporting PFML benefits.

Following is what federal law states about the tax treatment of compensation that is not specifically tax-exempt by statute or other substantial authority.

- ▶ **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 PFML 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 PFML 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 PFML 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 PFML 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 PFML 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 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/1099-NEC, there is no directive to report PFML benefits. An exception applies only to PFML benefits paid by a state agency, which are reported on Form 1099-G.
- ▶ **Pretax deductions.** In [IRS notice 2005-42](#), PFML is not listed as qualified benefit within a cafeteria plan; accordingly, pretax deductions for PFML insurance are not allowed.



# Paid family and medical leave insurance benefits: taxation and reporting

Continued

## Summary of disability and PFML federal tax and reporting requirements

Provision	Disability insurance benefits paid by a third-party insurance provider	Paid family leave insurance benefits not paid from a state fund*	Paid family leave benefits paid by a state fund
Federal income tax	Subject to the 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 the 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 the 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 PFML programs, Congress and/or the IRS will likely 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 PFML benefits 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 by the benefit provider to exclude these amounts from the Form W-2.

Particularly where employers offer PFML 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 employer will report PFML benefits on Form W-2 and the insurance provider does not issue Forms 1099 reporting the payments to the individual recipients.

Organizations paying PFML 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](#).



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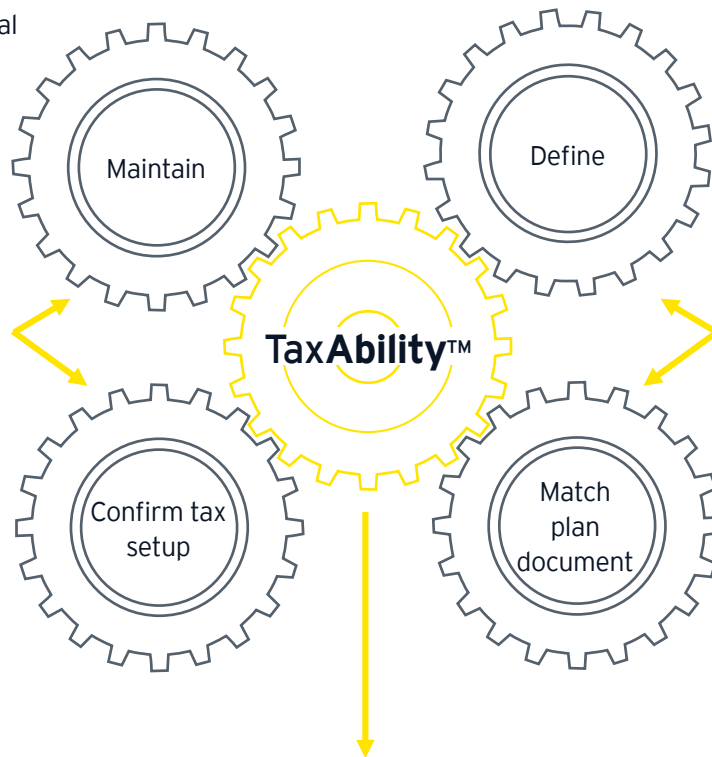
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