

BULKY DOCUMENTS

(Exceeds 100 pages)

Proceeding/Serial No: 91162330

Filed: 10-24-05

Title: Motion to Dismiss

Opposer's Opposition

Part 2 of 2

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E. Davis .

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take a play on something to make an interesting article on somebody. This could be faulty reporting here. It might be Tony, you know, making a statement without giving a lot of thought. I don't think that Tony trying to win a bet is really the way that ENYCE was developed. The way I stated before, Mr. Felix coming into the room and writing five letters down, was the way that name was started.

Q. Again, you were not here for yesterday's deposition, but Mr. Felix did state that to a certain degree -- and I don't have the exact words -- the letters N-Y-C did stand for New York City.

Did some portion of it, being the initials of N-Y-C, stand for New York City? Do you have any knowledge of that?

A. Of what?

MS. KLINGER: I am going to object to the form of the question.

Mr. Felix's testimony speaks for itself. You can answer the question.

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E. Davis

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A. I am not going to speculate what Lando was thinking, but I do know that one of the things he was excited about was that it did present -- was that it presented phonetic spelling of N-Y-C. But with that we decided to take it in a different direction and create it on its own word onto itself.

Q. Let me be more specific with the question because I don't think you understand the question.

Prior to the day that Mr. Felix presented this --

A. To me?

Q. -- to you, as you previously stated, was there any conversation regarding the use of the letters N-Y-C in this brand that you generally were trying to put together?

A. No, I don't believe so. I can't say we kicked around a lot of names. I can't recall what happened nine years ago.

I know that the goal in starting a new brand name was to take things from

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E. Davis

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2 the opposite end of the spectrum of Mecca
3 USA, which had a lot of meaning behind it.
4 The goal was to have something a little bit
5 more, you know, obscure and more of a blank
6 canvass. Trying to create a new word was
7 one of the goals of it. I don't recall
8 there being this marriage towards New York
9 City.

10 But, I think once it was
11 developed and that's what was come up with,
12 we felt that, you know -- yeah, we're in
13 New York City. We did have a company
14 called Mecca, which Madison Square Garden
15 is the mecca of, you know, basketball, and
16 you know, we saw that this new word had a
17 few different meanings to it. It can be
18 interpreted in different ways.

19 Q. Do you have any knowledge of why
20 we're here today?

21 MS. KLINGER: I'm just going
22 to caution the witness not to reveal
23 any attorney/client privilege
24 communications in answering the
25 question, but you can go ahead and

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answer.

A. Yeah. I've heard that yourself -- you have wanted to use the name E-N -- not the name, rather the likeness of ENYCE or E-N-Y-C-E to use that as your company name for auto products and electronics that relate to auto products.

Is that correct?

Q. I'm taking the deposition.

A. I just wanted to flip it for a second.

Is that --

Q. Yeah, that's correct.

Did you ever have any thoughts about using these letters on automobile products?

A. Yeah. We -- as a matter of fact, we've, you know, come across all different licensing or different venture opportunities. Coincidentally, some of the -- you know, when you break down the demographics, our consumer, a lot of the interest that's had for a discretionary income right now -- the most important

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E. Davis

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2 things are anything to deal with MP3's and
3 electronics, car accessories and clothing.
4 So it is not unfamiliar for us to realize
5 that a lot of those things, speaking from
6 discretionary income, go together and take
7 up the market share for teens and people
8 out of college.

9 So we've, you know, we've thought
10 of things like rims and we've had
11 discussions. We haven't done any of these
12 ventures, but they have been topics of
13 conversation. We've actually advertised in
14 an advertisement called "Dub," which is --
15 are you familiar with that?

16 Q. (No verbal response.)

17 A. "Dub" is a magazine. It stands
18 for dubs, meaning twenties, rims, devoted
19 to rims. So we've been approached by
20 people and had, you know, very minute
21 discussions about it, but I can't say the
22 thought hasn't been there.

23 Q. Are you aware of the fact that
24 there is actually a trademark that has been
25 issued?

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MS. KLINGER: Objection to the
characterization of the terms issued.

Q. There's a trademark that has been
issued and it is now being opposed.

Are you aware of that?

MS. KLINGER: I believe that
it's been allowed -- I'm sorry, yes,
it's been allowed. It's been
published. It's not been allowed.
It's been published. It's not been
issued.

Q. The exact terminologies you can
go back and talk to your counsel and you
can look at the paperwork. We don't have
to go into that anymore.

MS. KLINGER: Can we go off
the record for a second.

(Discussion held of the
record.)

Q. Do you currently have a position
with any company?

MS. KLINGER: Objection to the
form of the question.

Q. Let me apologize again.

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Yesterday there were some issues with respect to what these different corporate entities are actually called.

So my question is, are you currently employed by one of these various corporate entities that control this E-N-Y-C-E line of --

A. I'm employed by ENYCE, which is a division of Liz Claiborne.

Q. Is it a division or is it a subsidiary?

A. I'm not sure.

Q. Do you know the corporate name that pays you?

A. Yes.

Q. Could you please tell us that corporate name?

A. ENYCE.

Q. ENYCE, Incorporated, ENYCE, LLC?

A. I don't.

Q. ENYCE what?

A. I have direct deposit. Honestly, I don't really don't know.

Q. You must receive some fact

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information to file your taxes?

A. As you said, and as you stated in your opening statements, you said if I wasn't sure of something that I don't have to answer. So I'm telling you that I can find out the information for you, but if I say even LLC or whatever it is and it's wrong, I probably won't be doing justice what this exercise is, so I don't know the answer to that.

Q. What is your job title?

A. President.

Q. So you're president of a company that you don't know the name of; is that correct?

MS. KLINGER: Objection to the question.

It's argumentative.

A. I do know the name of the company. I don't know the exact title. There is something called direct deposit. Honestly, I have not received a pay stub since I've been employed with Liz Claiborne. Everything is direct

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E. Davis

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2 deposited.

3 My taxes I get and I send it to
4 my accountant. I don't even open it. They
5 give me my 1099 or my W-2, whatever it may
6 be, you know. I just get it, put it in a
7 pile and send it to my accountant. I put
8 it in a pile and I don't even know what it
9 is. I send it to him.

10 As I said before, I am not a
11 hundred percent positive. I can provide
12 the information to you. It will be
13 correct. I could speculate right now, but
14 I wouldn't be -- I wouldn't be a hundred
15 percent sure of my answer.

16 Q. Do you ever write a letter to a
17 customer or to any corporation that you do
18 business with?

19 A. For a company, I usually e-mail.

20 Q. Have you ever written a letter on
21 behalf of your company?

22 A. In the past five years, no.
23 Maybe a quick hand jotted note "nice
24 meeting," but anything in the business
25 format has been done via e-mail.

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2 Is that the same as writing a
3 letter or is that a different --

4 Q. When you send an e-mail, are you
5 listing your job title in your e-mail?

6 A. No.

7 Q. Are you similarly signing your
8 name?

9 A. Regards Evan.

10 Q. Does this entity have a bank
11 account?

12 A. I'm sure it does, yeah.

13 Q. Would you agree that if you
14 received direct deposit, you must be
15 receiving direct deposit via some bank
16 account?

17 A. I would agree.

18 Q. Did you sign bank papers to open
19 this bank account?

20 A. No.

21 Q. Forgive me, but corporate
22 officers usually have to sign bank papers
23 to open up a bank account.

24 Did other corporate officers --

25 A. At Fila, I signed many slips. At

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E. Davis

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2 Liz Claiborne that was not required of me

3 Q. Do you have a business card?

4 A. Yes, I do.

5 Q. Do you have one with you today
6 sir?

7 A. No, I don't.

8 Q. Does the business card have a
9 corporate entity listed on the business
10 card?

11 A. Yes, it does.

12 Q. What is that, sir?

13 A. ENYCE.

14 Q. Does it say ENYCE Holdings?

15 A. No. Just says ENYCE.

16 Q. Does it say ENYCE, LLC?

17 A. No.

18 Q. Does it say Evan Davis?

19 A. Yes, it does.

20 Q. Does it say president?

21 A. Yes.

22 I'm sorry, I just don't know the
23 answer to the question. I am not trying to
24 frustrate you. It is like you are trying
25 to get something that I don't know the

1 E. Davis

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2 answer to.

3 MS. KLINGER: It is completely
4 appropriate not to guess.

5 Q. It's fine, sir. It's just not
6 what I'm used to. I don't -- I'm trying to
7 understand the corporate entity that has
8 all of these different --

9 MS. KLINGER: I think we
10 should move on.

11 MR. BERMAN: Yes.

12 A. I will be more than happy to
13 provide it if you want. I mean --

14 MS. KLINGER: Let's just move
15 on.

16 Q. I'd like to show you Exhibit
17 number 4.

18 MS. KLINGER: Applicant's
19 Exhibit 4.

20 A. I'm familiar with this one.

21 Q. Would you agree that this states
22 that when ENYCE was sold to Liz Claiborne,
23 it was sold for \$114 million.

24 A. Yes.

25 Q. Are you aware of the

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E. Davis

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circumstances surrounding this sale?

MS. KLINGER: Objection to the
form of the question as vague and
ambiguous.

You can answer the question if
you understand it.

A. You're asking me the -- can you
repeat the question?

Q. Prior to this sale --

A. Yes.

Q. -- what was your position --

A. President.

Q. -- with the company?

A. I was the president of ENYCE,
which was a wholly owned subsidiary of Fila
USA.

Q. And after this sale, what was
your position?

A. President of ENYCE.

Q. Which is --

A. A division of Liz Claiborne.

Q. You refer to a wholly subsidiary
of Fila, but a division of Liz Claiborne --

A. I don't know.

1 E. Davis

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2 Q. -- are you using the correct
3 terminology or are you guessing?

4 A. I am positive about the Fila
5 aspect.

6 Q. Okay.

7 A. As I've said, with the Liz
8 Claiborne, I'm just not positive of how
9 they set it up.

10 I know when I go in, there's
11 thirty-one plaques on the wall of the
12 companies that they own. I've only been
13 there a year. I don't know the actual
14 vernacular term, legal thing that would --
15 that I feel comfortable enough to speculate
16 on.

17 MS. KLINGER: Nobody is asking
18 you to speculate. If you don't know,
19 you don't know.

20 Q. Is there a date that you see on
21 here or can you refer to a date that this
22 occurred, this acquisition?

23 A. The date you have down here is
24 4/5/2005.

25 Q. That's when it was printed.

1 E. Davis 58

2 Do you recall when this
3 acquisition took place, approximately?

4 A. December 1st, 2003.

5 Q. Prior to December 1st, 2003 --

6 MS. KLINGER: Excuse me for a
7 second, I just want to clarify, was
8 that your recollection of when it
9 occurred or are you reading that from
10 the document?

11 THE WITNESS: No. I know.

12 MS. KLINGER: Thank you. I
13 was just clarifying.

14 Q. What were your job
15 responsibilities prior to this acquisition
16 on a day-to-day basis?

17 A. Prior to this acquisition, I was
18 responsible for the income statement and
19 the P&L statement, profit and loss
20 statement, for ENYCE, marketing design and
21 sales reported to me for both men's and
22 ladies. And my specific role was still of
23 a merchandiser in addition.

24 Q. After this acquisition, did you
25 have the same job responsibilities or have

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E. Davis

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2 they changed?

3 A. They are the same.

4 Q. Same?

5 A. (No verbal response.)

6 Q. So you are actually involved in
7 the preparation of your profit and loss
8 statement?

9 A. Of the preparation, no.
10 Actual -- what do you mean, as far as the
11 paperwork?

12 Q. I'm sorry, you said you were
13 involved in the income and P&L statement.

14 A. Well, I manage the business, so
15 I'm responsible for it, but I don't -- I
16 thought in terms of preparation, I thought
17 you meant like preparing the actual
18 statements.

19 Q. What are your responsibilities?
20 I'm sorry.

21 A. Well, if sales reports to me,
22 that's -- you know, I determine the amount
23 of sales when we have budgets and the
24 amount of sales in trying to keep the sales
25 up or down or whatever you're trying to do

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E. Davis

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with it. I'm responsible for the

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expenses. I'm responsible for, you know,

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the costs of goods sold. There's probably

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about thirty different things that go into

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the whole formula. I help manage that on a

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day-to-day or weekly basis.

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Q. Are these numbers reported to a

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parent company or the -- again, we don't

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know whether it's a subsidiary or

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division.

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A. No.

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Q. Are they presented to Liz

14

Claiborne?

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THE WITNESS: Is that a proper

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term so I can establish what it is?

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MS. KLINGER: Objection to the

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form of the question.

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Could we go off the record for

20

a second.

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(Discussion held off the

22

record.)

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Q. Are you reporting these financial

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statements, financial information to

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someone at Liz Claiborne?

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A. I have a finance person that was given to us by Liz Claiborne. His name is Jason Schmidt. We work the financials and P&L's together and those go to Liz Claiborne's financial people on a daily -- weekly basis.

Q. When this financial information is delivered to Jason Schmidt, are you signing off on these figures?

A. We work in conjunction. We have budgets that we establish in the beginning of the year. And when something becomes off budget, whether it's sales or expenses run to high, we analyze it together and we try to make corrections towards it. Some of which you can control, some of which you can't.

Q. Are you signing any document that's saying that you're representing these figures are correct?

A. No.

Q. Is someone signing these documents?

A. I'm not sure.

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Q. Okay, you stated that you're in charge of marketing design, sales and that you're still a merchandiser.

A. Yes.

Q. On a daily basis, who is working with you? Who's helping you run these departments?

MS. KLINGER: Objection to the form of the question.

A. You have -- Lando Felix is the Executive Vice President of Marketing. He reports to me. I have a national sales manager who is EVP of Sales. He reports then to me. We have a Vice President of Design who reports then to me. We have a Vice President of Production who reports then to me. So they control their separate entities and aspects of the business, but then report it to me.

Q. Does Mr. Shellman help you in these fields?

A. Mr. Shellman is an outside contractor and generally works mostly with Mr. Felix. Tony does a lot of events and

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marketing and independent marketing ventures
and ventures for the company. He directly
reports to Mr. Felix. But, there are times
when I speak directly with Tony and work
with Tony since we have a ten-year
relationship and history.

Q. Does Mr. Shellman have an office
within your offices?

A. Yes.

Q. Does he have an assistant at your
location?

A. I think there's a pool. I think
there's a few people that use the same
assistant. I think it's more of a
departmental assistant.

Q. Is Mr. Shellman there on a
regular basis at your offices?

A. Yeah, I would say so. He travels
a lot.

Q. Prior to the acquisition that we
are referring to in Applicant's Exhibit
number 4, that's just referenced in
Applicant's Exhibit number 4, was
Mr. Shellman an employee of the entity when

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it was owned by Fila?

A. No.

Q. Was there ever a time that
Mr. Shellman was an employee --

A. To the best of my --

MS. KLINGER: Objection to the
form of the question.

An employee of?

MR. BERMAN: Well, he had all
these different corporation names. I
would like be more specific.

MS. KLINGER: Are you talking
about post-acquisition?

Q. Well, we can talk any piece. I
want to hear about it all.

So was there ever a time that
Mr. Shellman was an employee -- let's start
from 1996 I believe is what you said you
started this venture --

A. No.

Q. -- through today?

A. No. No, I do not believe so to
the best of my knowledge.

Q. You stated that Mr. Shellman

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E. Davis

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2 along with yourself and Mr. Felix together
3 started this venture; is that correct?

4 A. (No verbal response.)

5 Q. Does Mr. Shellman receive regular
6 paychecks?

7 MS. KLINGER: Objection. Lack
8 of foundation.

9 You can answer if you know.

10 A. He doesn't receive a regular
11 paycheck. I believe he receives a
12 consulting fee that is paid in the form of
13 check.

14 Q. Is that paid on a weekly basis,
15 biweekly?

16 A. Monthly.

17 MS. KLINGER: Objection to the
18 form of the question.

19 Q. Do you know --

20 MS. KLINGER: Lack of
21 foundation.

22 You can answer the question if
23 you know the answer.

24 A. Monthly.

25 Q. Is it the same amount every

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month?

MS. KLINGER: Objection to

form of the question. Lack of
foundation.

You can answer the question

you know.

A. Yes.

Q. Does Mr. Shellman receive any
additional funds if the company has certain
sales levels?

MS. KLINGER: Objection to the

form of the question.

You can answer if you know.

A. I have more of -- when he was
Fila, I was privy to a lot more specifics.
I think Tony has been under renegotiation
of his contract. I am not sure of his
current status. I believe there are --
there were and I believe that there are
still bonus incentives for him.

Q. Let's back up then to Fila.

When this was part of Fila,
please describe what those bonus incentives
were?

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MS. KLINGER: Objection to the form of the question. Lack of foundation.

You can answer if you know.

A. He would receive a bonus based on sales and he would also get one based on budget, based on, say, not going over budget of the marketing and his expenditures and allotments of his events and projects that he worked on.

Q. Does Mr. Shellman provide you with any sort of reporting or any kind of information on a regular basis?

MS. KLINGER: Objection to the form of the question.

A. Not in a very structured matter, no.

Q. But he does give you reports on things in a non-structure --

A. Non-structure, yes.

Q. Such as what?

A. We did a event in Miami, it was good, this is what happened, this guy performed and we had about "X" hundred

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E. Davis

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2 people. It's more of an informal
3 conversation.

4 Q. When Mr. Shellman goes to these
5 events, does he turn in an expense report?

6 A. Yes.

7 Q. And the company pays his
8 expenses?

9 MS. KLINGER: Objection to the
10 form of the question.

11 You can answer it.

12 A. Yes.

13 Q. Have you ever been convicted of a
14 crime, sir?

15 A. No.

16 Q. Are you a party to any
17 litigation --

18 A. No.

19 Q. -- at this time that you know of?

20 A. No.

21 Q. Have you ever owned or applied
22 for a patent?

23 A. No.

24 Q. Have you ever owned or applied
25 for a trademark?

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A. Yes.

Q. What would that be, sir?

A. Evan T. Davis, Inc.

Q. I'm sorry, your name?

A. Yeah.

Q. Did you receive the trademark?

A. Yes.

Q. When was that, sir?

A. I believe it was '95 -- '94,

'95.

Q. For what products?

A. I am not -- actually, I am not sure. It was either late Mecca or -- how we were getting paid -- we were getting paid directly into -- we were paying into a corporation, so I established my own corporation. I am not sure if it was the end of Mecca or the beginning of ENYCE.

Q. I'd like to go back to Applicant's Exhibit number 4.

When this acquisition occurred, could you please describe the portion of this dollar amount that you received, sir?

MS. KLINGER: Objection to the

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form of the question. Lack of
foundation and vague and ambiguous.

A. Could you be more specific? From
who?

Q. Yes, whatever you could to
describe.

A. I'd just like you to be more
specific.

MR. BERMAN: I'd like to
introduce a new --

MS. KLINGER: Exhibit?

MR. BERMAN: -- exhibit.

(Two-page document was marked
as Applicant's Exhibit 7 for
identification as of this date.)

Q. Let's refer to Applicant's
Exhibit 7.

Is that okay, sir?

A. Certainly.

Q. Previously you referred to
various different corporate names and this
document here now refers to a name that
appears to not have been brought up, Sports
Brands International.

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E. Davis

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A. Yes.

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Q. Do you know who that is, sir?

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A. Certainly. I believe six months
5 to nine months prior to the sale of ENYCE
6 to Liz Claiborne, Fila based out of Biella,
7 Italy sold their interest or sold their
8 company to Sports Brands International,
9 which I guess is a division of Cerbus.

10

Q. So could you please describe --

11

A. For me, I still work for Fila
12 Sports Brand. International now owned
13 Fila, but we were still a wholly owned
14 subsidiary of Fila. So for me, there was
15 no change. The same people were there
16 before as there were after. There was no
17 change in the day-to-day business for me.

18

Q. So the sale that we're referring
19 to in Applicant's Exhibit number 4, is it
20 the same sale that we're looking at that's
21 described here in Applicant's number 7,
22 sir?

23

A. No. It's two different sales --
24 I'm sorry, I apologize. Okay, yes. You're
25 correct. They're discussing the same sale,

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E. Davis

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2 but prior to that, there was a different
3 sale. A lot of selling going on.

4 Q. Do you know the terms and
5 conditions of the prior sale that took
6 place that you just referred to,
7 Fila/Sports Brand International sale?

8 A. Just hearsay.

9 Q. Please describe that hearsay,
10 sir.

11 A. \$225 million.

12 Q. \$225 million?

13 A. Yeah, they bought Fila, ENYCE and
14 I believe Ciesse, three separate entities
15 of Fila.

16 Q. So for clarification, Sports
17 International, therefore, owned other
18 things other than this E-N-Y-C-E; is that
19 what you're saying?

20 MS. KLINGER: Objection to the
21 form of the question. Lack of
22 foundation.

23 You can answer it if you
24 know.

25 A. I believe they owned Fila, which

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E. Davis

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owned ENYCE and Ciesse.

Q. Okay, when that sale occurred, were you involved in the due diligence of that sale?

A. No.

Q. When that sale occurred, did you receive any funds associated with that sale personally?

A. No.

Q. Now, let's go to the following sale that's referred to in these two exhibits.

MS. KLINGER: What two

exhibits?

MR. BERMAN: Exhibit number 7

and Exhibit number 4.

Q. Again, let me just clarify because you made a previous statement that I believe you retracted.

These two exhibits are referring to the same sale; is that correct, sir?

A. Yes.

Q. I understand how confusing this can be.

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E. Davis

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A. There is a lot of sales, a lot of different companies, a lot of different entities.

Q. Right. This sale did occur; is that correct, sir?

A. Yes.

MS. KLINGER: What sale?

MR. BERMAN: The sale that's in Exhibit 7 and --

A. Yes.

MR. BERMAN: -- and Exhibit 4.

Q. Let's talk about --

A. Liz Claiborne --

Q. -- this sale.

A. -- purchased ENYCE from SBI.

Q. Okay. Was there a period of time that there was due diligence that occurred? Are you familiar with the term "due diligence," sir?

A. Yes, I am.

Q. Was there a period of time where there was a certain due diligence that occurred in order to complete this sale?

A. Yes.

1 E. Davis

75

2 Q. Were you involved in this due
3 diligence process?

4 A. Yes.

5 Q. Please describe your
6 involvement.

7 A. They asked me questions and I
8 answered.

9 Q. Questions about what?

10 A. Various questions.

11 Q. Let's give some examples.

12 Were there questions about
13 inventory?

14 A. Yes.

15 Q. Were there questions about the
16 value of the inventory?

17 A. Yes.

18 Q. Was there a question about how
19 long the inventory may have been in
20 inventory?

21 A. Every business question you can
22 probably think of, I was probably asked.

23 MS. KLINGER: I'm just going
24 to caution the witness during this
25 line of questioning to be careful not

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E. Davis

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to divulge any attorney/client
communications.

THE WITNESS: Okay.

Q. Were you ever involved in the
production of the products that bear the
name E-N-Y-C-E?

A. Yes.

Q. You did actually decide on
production matters on behalf of the
E-N-Y-C-E?

MS. KLINGER: Objection to the
form of the question.

A. Yeah, we've established that
already.

Q. We didn't, so let's establish it.
Did you decide where the products
were to be manufactured?

A. In some cases, yes, but not all.

Q. Are you familiar with the term
"letter of credit"?

A. Yes.

Q. Was there ever a letter of credit
involved in the production of products that
carried the E-N-Y-C-E name?

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E. Davis

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MS. KLINGER: Objection to the
form of the question.

You can answer it if you
understand it.

A. I don't really understand it.

Q. Did you ever sign a production
order --

A. No.

Q. -- to cause products to be
produced?

A. No.

Q. Let's back up to this due
diligence process.

During the due diligence process,
were there other individuals that were
asked questions about the value of the
inventory?

MS. KLINGER: Objection to the
form of the question.

A. Not sure.

Q. Let's move on.

This acquisition, when it
occurred, did you personally receive a
portion of this acquisition fee?

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E. Davis

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A. From who, Liz Claiborne?

Q. Yes.

A. No.

Q. Did you receive a portion of the acquisition from Fila?

A. Yes.

Q. What did you receive, sir?

A. Why is my personal -- what's the relevancy?

Q. You can refuse to answer it.

A. I refuse to answer.

MS. KLINGER: Let's take a

break for a minute.

(Brief recess was taken.)

Q. You stated you had a middle initial. I forget what you said.

What's your middle initial?

A. T.

Q. T. I had an Evan E. Davis that I wanted to make sure -- I'm not looking at the same thing.

MR. BERMAN: I'm going to

introduce Applicant's Exhibit number

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E. Davis

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(One-page document was marked
Applicant's Exhibit 8 for
identification as of this date.)

Q. I would like to ask the witness
is this the information regarding the same
acquisition that is referred to in
Applicant's Exhibit number 4 and
Applicant's Exhibit number 7 as far as you
know?

A. Yes.

MR. BERMAN: I'd like to
introduce Applicant's Exhibit number
9.

(One-page document was marked
as Applicant's Exhibit number 9 for
identification as of this date.)

Q. Is this picture on Applicant's
Exhibit number 9 the picture of the same
Tony Shellman that we have been talking
about?

A. Yes.

Q. I'd like to get back into the
customer.

Who is the customer? Who are you

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E. Davis

80

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going after as far as demographics, as far

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as the customer for the product? Is that

4

okay, sir?

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A. Certainly.

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Q. You previously stated it was a

7

young men. I mean, I see where you've done

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some women's products as well in some of

9

these documents.

10

Can we be more specific?

11

A. At Mecca, we only did young

12

men's. While I was there at ENYCE, we did

13

young men's for the first two years and

14

then we launched a ladies' division, so it

15

is young men's and women's now.

16

Q. Now, yesterday your associate

17

talked about the fact that you are

18

advertising in certain magazines.

19

Are you familiar with the type of

20

advertising that your company does?

21

A. Yes.

22

Q. Would you name some of the

23

magazines that you're familiar with that

24

you would say would be substantial? Let me

25

back up, are there other areas of

1
2 advertising that you do other than magazine
3 advertising?

4 A. Yeah.

5 Q. Where would that be, sir?

6 A. We do buses. Most print
7 advertising is done in magazines, but we do
8 buses, we do billboards. I believe that's
9 all that comes to mind right now. I might
10 be leaving something out right now.

11 Q. Do you do any radio advertising?

12 A. Not very much. Sometimes.

13 Q. It's not worthy of speaking of;
14 is that what you're saying?

15 A. We'll do a co-op with a store
16 where you do something in conjunction with
17 the store, if you are having an event, but
18 it would be very minimal of the portion of
19 the allocated funds.

20 Q. Do you do any television
21 advertising?

22 A. No.

23 Q. So let's get back to the
24 magazines.

25 What would you say would be two,

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E. Davis

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three, four of the largest magazines? You referred to some magazine earlier.

A. DUB I referred to earlier.

Q. Okay. What other magazines?

A. We do "Vibe," we do "Source," we do "Fader," "XXL" I believe, and some various other youth-related magazines.

Q. Now, you know, when it comes to advertising, I know that you're very specific with respect to demographics. I mentioned to your associate yesterday when I read the papers, they talk about the television shows and --

MS. KLINGER: Objection to the narrative.

Why don't you just ask him the question.

Q. I would like to know specifically who you're advertising to. And I believe that we could agree that it's a little more specific than you're saying as far as young men.

MS. KLINGER: Objection to the form.

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E. Davis

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A. Is there a certain aspect that you would like to ask?

Q. You already talked about sex. You already talked about age.

Is there a race that you're advertising to?

A. No.

Off the record?

MS. KLINGER: Yes.

(Discussion held off the record.)

MS. KLINGER: Let the witness continue his answer.

Q. You were talking about your advertising, sir. Go ahead.

A. I think to an outsider, it seems very easy to say that we're totally being very specific to a certain -- whether, like you said, race inside a demographic. But, in our belief, it isn't. It's not targeted to a certain race. There are many kids in Franklin Lakes, New Jersey, where I live, that wear our products that are many races. And in the suburbs of America,

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there are many kids that are interested in this aspect of pop culture that we've tapped into, as there are on 125th Street or Fordham Road in the Bronx.

I think you're looking for something that is very general in approach but it's really not. And I think that, you know, I can understand why that is. But for me to have me say why I am being general is because I'm being specific when I'm being general.

Q. I don't mean to put you on the defensive.

A. I'm not on the defensive. I am not saying -- I'm trying to answer something that I don't believe -- I think you would like me to say it's targeted to a consumer of a certain race, and you are the one that mentioned the race word. I am not -- I don't believe we do that. I'm saying all types of people. We're a line of clothing. We are trying to target young ladies and young men tapped into pop culture. Yeah, I think there's many white

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E. Davis

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2 people, as many black people, as many as
3 Latins wearing our stuff. I don't think
4 it's broken down, and that's the beauty of
5 what our brand is. You know, that's what
6 lot of retailers -- that's their feedback
7 to us, that we are a brand that has a very
8 large demographic in terms of race and
9 ethnicity, so it's not very specific. In
10 age, it's about fourteen to twenty-four.
11 So I don't really like to get caught up
12 into all of that because I don't believe in
13 it and I don't think it's true.

14 Q. This is your deposition. This is
15 not my deposition. I had never heard of
16 your product before, so I went and tried to
17 find out what you're doing.

18 A. I agree with you. And you've
19 asked the demographic question three or
20 four times and I've answered it as best as
21 I possibly can. You think I'm being too
22 general.

23 MS. KLINGER: Objection.

24 Let's see if there's a
25 question pending.

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E. Davis

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Q. So I went and purchased a couple of these magazines that were referred to by your associate yesterday.

A. Right.

Q. I have the May 2005 issue of "Vibe" Magazine and I have the April 2005 issue of "Source" Magazine. I believe that the demographic that you're going after probably speaks for itself, if this is indicative of what you're doing. That's the only reason I asked the question.

A. I know, but I don't --

MS. KLINGER: I am going to object.

A. I don't agree with your question, so we can agree to disagree. I think what you are trying to say --

MS. KLINGER: Objection.

MR. BERMAN: I want to ask a question.

MS. KLINGER: Okay, fine, but I mean he's answered your question many times.

Q. Let me back up.

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E. Davis

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Did you and your two

3

associates -- let me be more specific --

4

Tony Shellman, Rolando Felix and yourself

5

get together to start this Mecca clothing

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line? Is that correct, sir?

7

A. Yes.

8

Q. Was that clothing line developed

9

to target the African-American market

10

place?

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A. No.

12

Q. Did it, in fact, end up targeting

13

the African-American market place?

14

MS. KLINGER: Objection to the

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form of the question.

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You can answer if you

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understand it.

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A. I understand it, and I'm

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trying -- still trying to say to you the

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answer is no. There's all type of

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consumers that like our products. You

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know, there's not -- we didn't go out there

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and say we want to create a clothing line

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specifically for African-Americans. We

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created a clothing line that would be

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E. Davis

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2 dialed into pop culture and youth culture
3 that was maybe influenced by pop, hip hop
4 and the music life-style, but I don't del
5 that into African-American. I know as much
6 about hip hop as Tony Shellman does and I'm
7 not African-American. Rolando Felix knows
8 more about it than both of us combined and
9 he's Asian.

10 The magazines that you bring up,
11 these are entertainment artists in the
12 community. But, if Eminem was on the cover
13 the previous two months, would that be a
14 different type of question you're asking?

15 Q. I don't know, sir. I'm just
16 asking the questions.

17 A. I am trying to respond. I
18 responded the best I can. I think you are
19 trying to get me to go with you on a point
20 that I don't agree with.

21 MS. KLINGER: I think we've
22 established that he's asked and
23 answered the question many times.
24 Let's move on.

25 Q. Is there anything further you

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want to add with this subject matter?

A. No.

Q. I'd like to refer to Applicant's Exhibit number 9 and Applicant's Exhibit number 8.

Just to complete this subject matter, these two documents were produced in the Network Journal of Black Professional and Small Business Magazine.

MS. KLINGER: I'm going to object to the characterization.

The documents speaks for themselves. They are what they are.

Do you want to ask him a question?

Q. Would you agree that the African-American market place --

A. I could only -- I'm sorry.

Q. -- is one, if not the main, certainly one, of the main consumers that you have for your current product as well as your previous Mecca product?

MS. KLINGER: Objection to the form of the question.

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A. I've already answered no.

And to speculate on this, which is speculation, I believe you found this on the network because Tony Shellman is African-American. There are also articles, you know, on Lando that appeared in A Magazine and articles on myself that didn't come up that way depending on what it is.

MR. BERMAN: I'd like to

identify this as Applicant's Exhibit number 10.

(Two-page document was marked as Applicant's Exhibit number 10 for identification as of this date.)

Q. Have you ever seen this before?

A. Yes.

Q. Again, referring to Applicant's number 10.

A. Yes, I have.

Q. Could you please describe what this is, sir?

A. I think this is a bio on our website.

Q. There's a picture of an

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E. Davis

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individual?

A. Yes.

Q. Is that you, sir?

A. Yes.

Q. Then there are three little pictures below the picture of you.

Who are they, sir?

A. There's myself, Tony and Lando.

Q. Tony Shellman?

A. Rolando Felix.

Q. Your name is listed and your title is listed as president?

A. (No verbal response.)

Q. Is that correct, sir?

A. Yes.

MR. BERMAN: Again, I'd like to introduce Applicant's Exhibit number 11.

(Two-page document was marked as Applicant's Exhibit 11 for identification as of this date.)

Q. I refer you to Applicant's Exhibit number 11.

Have you ever seen this before,

2 sir?

3 A. No.

4 Q. Do you know what it is now that
5 you're looking at it, sir?

6 A. Yes, I do.

7 Q. Can you please tell us what it
8 is?

9 A. I think it's Tony's bio on the
10 website considering it's the same structure
11 as mine.

12 Q. Are you ready to answer the next
13 question?

14 A. Certainly.

15 Q. I'm sorry, you were looking at
16 the document.

17 A. I was trying to read it in case
18 you asked me.

19 Q. Help me understand please why a
20 1099 contract employee is listed as one of
21 the three integral individuals on your
22 company's website, sir?

23 MS. KLINGER: Objection to the
24 form of the question. Lack of
25 foundation.

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You can answer the question
you know.

A. Because he's a cofounder.

Q. Would you please agree or
disagree that the date that this was pulled
off your website was 4/5/2005?

MS. KLINGER: Objection to the
form of the question.

I don't know that the witness
has any knowledge of when it was
pulled off the website. I believe he
testified that he thought that it was
the same, but I don't think that he is
ever even testified that he actually
knows that this actually came from
that website.

Q. Do you have any reason to
question the fact that this is currently on
your website?

A. I've never read this before. It
looks like it's in the same format, so I
would assume that it's probably on our
website.

MR. BERMAN: We can go off the

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E. Davis

record for one second.

(Discussion held off the record.)

Q. You just answered a question that the reason that Mr. Shellman's picture is currently on your website would be the fact that he is a cofounder.

A. I believe this is the title page. When you navigate this, that says founder and then they have -- you can pop on I believe.

Q. All right.

MR. BERMAN: I have no further questions.

MS. KLINGER: Okay, we're done.

(Whereupon, at 3:02 p.m. the examination of this witness was concluded.)

EVAN DAVIS

Subscribed and sworn to before me
this _____ day of _____, 2005

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NOTARY PUBLIC

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C E R T I F I C A T E

I, LESLIE M. PAGAN, a Shorthand Reporter and Notary Public within and for the State of New York, do hereby certify:

That the foregoing proceedings were taken down by me in shorthand and thereafter transcribed under my direction and supervision, and that the within transcript is a true record of such proceedings.

I further certify that I am not related to any of the parties to this action by blood or marriage, and that I am in no way interested in the outcome of this matter.

IN WITNESS WHEREOF, I have hereunto set my hand this 25th day of April, 2005.

Leslie M. Pagan
LESLIE M. PAGAN

A

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The 9th floor suite at the W Hotel in Atlanta is nothing short of luxurious. From the complimentary DVD player, to the extravagant view overlooking the skyscrapers on the Northwest side of the city giving way to Cumberland Mall; the exquisite quarters exude prominence and prosperity. The suite was fit to house a suit-and-tie-wearing CEO of a Fortune 500 company or a music mogul with an account balance that resembles a social security number. The couch was elegant enough to rest President Bush himself.

But that's where Tony Shellman sat upright, in blue jeans and an ENYCE golf shirt with his feet kicked up on the coffee table, juggling three artificial Granny Smith apples. His shoulder-length locks swung about as he performed the act with the skill of a seasoned Universoul Circus performer.

"Not exactly what you'd expect from a CEO, huh?," Shellman asked jokingly. His flawless act was disrupted by the chiming of his cell phone. Shellman sighed heavily before answering his state-of-the-art camera-phone, which seemed to ring annoyingly in two-minute intervals. But that's the life of a CEO whose company is expected to exceed \$100 million in sale in 2003. As co-founder of ENYCE Clothing, Shellman shoulders more responsibility than one could ever imagine. But you won't hear the 37-year-old entrepreneur utter a complaint. He's become what he's always wanted to be.

"Once I got to New York my goal was to learn the market and work with as many people as I could, so that one day I could start my own clothing company," Shellman said. "And here I am today."

Although Shellman's leisure consists of popping bubbly with P. Diddy, attending fashion shows with Tommy Hilfiger and teeing-it-up on golf courses in Miami with media mogul Keith Klingscales, his life hasn't always been a star-studded affair. Shellman started from ground zero paid his dues, and worked his way to the top. Shellman grew up in Seattle, establishing a formidable work ethic at an early age. As a high-school student, he bagged groceries at a local store to make ends meet. He went from saying "paper or plastic" to literally having the paper and plastic to buy anything his heart desires, because he never lost sight of his ultimate dream. He said that he always knew he wanted to work in the fashion industry, so he did whatever it took to get his foot in the door.

While attending Seattle Community College, Shellman modeled for Nordstrom department store in his spare time. The experience eventually led to an internship which turned into a job. But Shellman knew that in order to become the next Karl Kani he would have to elevate his knowledge of the fashion industry. He landed a job at the Zebra Club, a popular brand company in Seattle, working as a buyer and store manager.

"I wasn't the smartest guy on the block as far as books," Shellman said. "But I knew that my niche was fashion. I knew that I wanted to go a four-year school, but I wanted to go to the Harvard school of fashion, and that was Parsons School of Design in New York."

When Shellman was accepted into Parson School of Design, he was prepared to meet the challenge. Shellman said that being introduced to imaging and packaging at the Zebra Club gave him a jump on his peers.

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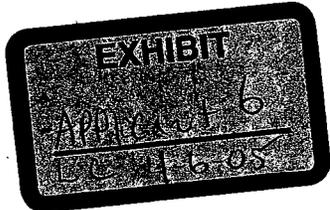
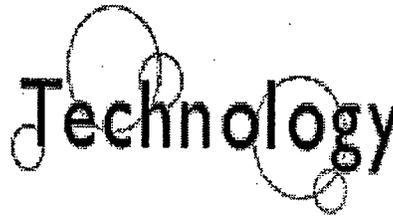
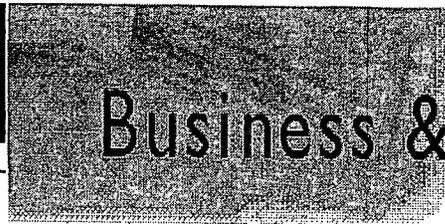


Exhibit 6



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"They (Zebra Club) were doing it big, so by the time I got to New York, I was already educated, Shellman said. "It was weird because when I got to college they were like 'man, you're a rocket scientist'. But I had just gotten exposure earlier in the game. It was like I got to hang around with pros, so when I went to play college ball it was like, 'this is easy'. But that's because when was scrimmaging with the pros, they let me get in the game."

When Shellman was given a chance to 'get in the game', he wasn't just taking up space. He performed. As a result of his effort, the Zebra Club, which owned International News Clothing Company in New York, hooked him up with a job there. The only problem was that Shellman's former boss, who is currently his business partner, told him that he wasn't going to pay him for his services. Although Shellman's bank account was on Slim Fast, he wasn't discouraged. He realized that the opportunity was more valuable than a paycheck.

"I said 'that's o.k., just make sure that I meet all of these buyers, so I can establish a personal relationship with them'", Shellman said. Shellman expected his experience-laden resume to boost him to the top of the company right away. But when he punched-in, he experienced a rude awakening. "I was thinking I was going to be the lead sales guy," Shellman said. "But they were like, 'no, that's your broom over there, start sweeping'. They wouldn't even let me fold the clothes."

Shellman was a broke college student who swept the floor of a department store that wouldn't let him fold any clothes or dollar bills. In addition to Shellman's rigorous class schedule, after working at the Zebra Club by day, Shellman had to work as a bartender by night to pay his bills.

"I could've just bartended at night, made mad loot, and took two or three classes a day," Shellman said. "But I worked in the showroom because I needed that experience."

Shellman's persistence eventually led to his promotion. After two years at Parson's School of Design, Shellman went from sweeping up dusty price tags at International News Clothing Company to traveling to Las Vegas with the sales staff to sale accounts.

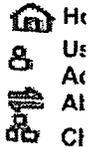
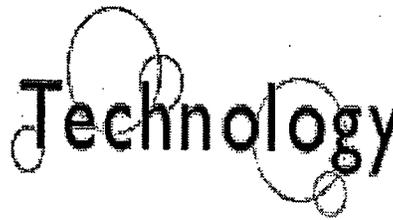
Shellman used his extensive knowledge of the fashion industry to co-found Mecca USA, an urban clothesline. Mecca USA took the industry by storm, growing from \$12 million in sales in its first year to \$25 million by its second year. As Shellman's company grew, so did his notoriety. Before long, larger clothing companies began to take notice of Shellman's creativity.

"With those kind of numbers people were like, 'what the hell are they doing?'" Shellman said.

The Mecca USA brand gained popularity with the hurry-upness. In fact, Shellman said that his partners wanted to put the brand on golf hats and lampshades.

Shellman disagreed with the direction his partners wanted to steer the company, so he split. He decided to bounce before he'd landed a job with another company. In essence, Shellman left a million dollar company that he helped start, for the unemployment line. But he never regretted his decision.

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"You've got to wear your own shoes," Shellman said. "Do you. If you don't believe in you, how will anyone else?"

Shellman's self-confidence led to more prosperous opportunities. Shortly after leaving Mecca USA, he found himself sitting in a chair outside of an office full of white men who owned the FIL Clothing Company. Shellman said that most of them walked by him on their way inside, assuming he was an intern. But they had no idea he was really the CEO of the company they would soon fund.

"When I walked in they were like 'who's he?'," Shellman said. "Now it's a whole different story."

Although he wouldn't disclose the terms of the deal, Shellman said that FILA made him an offer to start a new brand that he couldn't refuse.

"It was bananas," Shellman said.

Shellman didn't waste any time starting ENYCE, a sportswear company geared toward 14 to 34-year-olds. He said that the name ENYCE originated from a bet. While chilling with a group of friends, someone bet Shellman that he couldn't copyright the abbreviation NYC. After brainstorming, Shellman won the bet by wisely deciding to place an E on the front and end of the NYC. What started off as a bet amongst friends has since morphed into ENYCE - a \$100 million company.

"You've got to set small goals to do what it takes to reach your bigger goal," Shellman said. "You have to set a timeline and keep it aligned with your goals."

In spite of Shellman's success, he hasn't lost sight of where he came from. He relaxed on the couch in his suite at the W Hotel, holding his phone close to ear, discussing whether to purchase a silver or black Porsche. But he wasn't eating Grey Poupon. He was getting his locks re-twisted watching the hood classic "South Central" on DVD.

Although the digits in Shellman's bank account have changed, his plan to succeed has remained the same.

"If you don't know where you're going, how are you to get there,?" Shellman asked.

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Exhibit 7

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1. Who Are Employees?

Before you can know how to treat payments that you make to workers for services, you must first know the business relationship that exists between you and the person performing the services. The person performing the services may be:

- An independent contractor,
- A common-law employee,
- A statutory employee, or
- A statutory nonemployee.

This discussion explains these four categories. A later discussion, *Employee or Independent Contractor?* (section 2), points out the differences between an independent contractor and an employee and gives examples from various types of occupations. If an individual who works for you is not an employee under the common-law rules (see section 2), you generally do not have to withhold federal income tax from that individual's pay. However, in some cases you may be required to withhold under backup withholding requirements on these payments. See Publication 15 (Circular E) for information on backup withholding.

Independent Contractors

People such as lawyers, contractors, subcontractors, public stenographers, and auctioneers who follow an independent trade, business, or profession in which they offer their services to the public, are generally not employees. However, whether such people are employees or independent contractors depends on the facts in each case. The general rule is that an individual is an independent contractor if you, the person for whom the services are performed, have the right to control or direct only the result of the work and not the means and methods of accomplishing the result.

Common-Law Employees

Under common-law rules, anyone who performs services for you is your employee if you have the right to control what will be done and how it will be done. This is so even when you give the employee freedom of action. What matters is that you have the right to control the details of how the services are performed. For a discussion of facts that indicate whether an individual providing services is an independent contractor or employee, see *Employee or Independent Contractor?* (section 2).

If you have an employer-employee relationship, it makes no difference how it is labeled. The substance of the relationship, not the label, governs the worker's status. Nor does it matter whether the individual is employed full time or part time.

For employment tax purposes, no distinction is made between classes of employees. Superintendents, managers, and other supervisory personnel are all employees. An

officer of a corporation is generally an employee; however, an officer who performs no services or only minor services, and neither receives nor is entitled to receive any pay, is not considered an employee. A director of a corporation is not an employee with respect to services performed as a director.

You generally have to withhold and pay income, social security, and Medicare taxes on wages that you pay to common-law employees. However, the wages of certain employees may be exempt from one or more of these taxes. See *Employees of Exempt Organizations* (section 3) and *Religious Exemptions* (section 4).

Leased employees. Under certain circumstances, a corporation furnishing workers to various professional people and firms is the employer of those workers for employment tax purposes. For example, a professional service corporation may provide the services of secretaries, nurses, and other similarly trained workers to its subscribers.

The service corporation enters into contracts with the subscribers under which the subscribers specify the services to be provided and the fee to be paid to the service corporation for each individual furnished. The service corporation has the right to control and direct the worker's services for the subscriber, including the right to discharge or reassign the worker. The service corporation hires the workers, controls the payment of their wages, provides them with unemployment insurance and other benefits, and is the employer for employment tax purposes. For information on employee leasing as it relates to pension plan qualification requirements, see *Leased employees* in Publication 560, *Retirement Plans for Small Business* (SEP, SIMPLE, and Qualified Plans).

Additional information. For more information about the treatment of special types of employment, the treatment of special types of payments, and similar subjects, refer to Publication 15 (Circular E) or Publication 51 (Circular A) for agricultural employers.

Statutory Employees

If workers are independent contractors under the common law rules, such workers may nevertheless be treated as employees by statute ("statutory employees") for certain employment tax purposes if they fall within **any** one of the following four categories **and** meet the three conditions described under *Social security and Medicare taxes*, below.

1. A driver who distributes beverages (other than milk) or meat, vegetable, fruit, or bakery products; or who picks up and delivers laundry or dry cleaning, if the driver is your agent or is paid on commission.
2. A full-time life insurance sales agent whose principal business activity is selling life insurance or annuity contracts, or both, primarily for one life insurance company.
3. An individual who works at home on materials or goods that you supply and that must be returned to you or to a person you name, if you also furnish specifications for the work to be done.
4. A full-time traveling or city salesperson who works on your behalf and turns in orders to you from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments. The goods sold must be merchandise for resale or supplies for use in the buyer's business operation. The work performed for you must be the salesperson's principal business activity. See *Salesperson* in section 2.

Social security and Medicare taxes. Withhold social security and Medicare taxes from the wages of statutory employees if **all three** of the following conditions apply.

- The service contract states or implies that substantially all the services are to be performed personally by them.
- They do not have a substantial investment in the equipment and property used to perform the services (other than an investment in transportation facilities).
- The services are performed on a continuing basis for the same payer.

Federal unemployment (FUTA) tax. For FUTA tax, the term "employee" means the same as it does for social security and Medicare taxes, except that it does not include statutory employees in categories 2 and 3 above. Thus, any individual who is an employee under category 1 or 4 is also an employee for FUTA tax purposes and subject to FUTA tax.

Income tax. Do not withhold federal income tax from the wages of statutory employees.

Reporting payments to statutory employees. Furnish Form W-2 to a statutory employee, and check "Statutory employee" in box 13. Show your payments to the employee as "other compensation" in box 1. Also, show social security wages in box 3, social security tax withheld in box 4, Medicare wages in box 5, and Medicare tax withheld in box 6. The statutory employee can deduct his or her trade or business expenses from the payments shown on Form W-2. He or she reports earnings as a statutory employee on line 1 of Schedule C or C-EZ (Form 1040). (A statutory employee's business expenses are deductible on Schedule C or C-EZ (Form 1040) and are not subject to the reduction by 2% of his or her adjusted gross income that applies to common-law employees.)

Statutory Nonemployees

There are two categories of statutory nonemployees: direct sellers and licensed real estate agents. They are treated as self-employed for all federal tax purposes, including income and employment taxes, if:

- Substantially all payments for their services as direct sellers or real estate agents are directly related to sales or other output, rather than to the number of hours worked and
- Their services are performed under a written contract providing that they will not be treated as employees for federal tax purposes.

Direct sellers. Direct sellers include persons falling within any of the following three groups.

1. Persons engaged in selling (or soliciting the sale of) consumer products in the home or place of business other than in a permanent retail establishment.
2. Persons engaged in selling (or soliciting the sale of) consumer products to any buyer on a buy-sell basis, a deposit-commission basis, or any similar basis prescribed by regulations, for resale in the home or at a place of business other than in a permanent retail establishment.
3. Persons engaged in the trade or business of delivering or distributing newspapers or shopping news (including any services directly related to such delivery or distribution).

Direct selling includes activities of individuals who attempt to increase direct sales activities of their direct sellers and who earn income based on the productivity of their direct sellers. Such activities include providing motivation and encouragement;

imparting skills, knowledge, or experience; and recruiting. For more information on direct sellers, see Publication 911, Direct Sellers.

Licensed real estate agents. This category includes individuals engaged in appraisal activities for real estate sales if they earn income based on sales or other output.

Misclassification of Employees

Consequences of treating an employee as an independent contractor. If you classify an employee as an independent contractor and you have **no reasonable basis** for doing so, you may be held liable for employment taxes for that worker (the relief provisions, discussed below, will not apply). See Internal Revenue Code section 3509 for more information.

Relief provisions. If you have a reasonable basis for not treating a worker as an employee, you may be relieved from having to pay employment taxes for that worker. To get this relief, you must file all required federal information returns on a basis consistent with your treatment of the worker. You (or your predecessor) must not have treated any worker holding a substantially similar position as an employee for any periods beginning after 1977.

Technical service specialists. This relief provision does not apply for a technical services specialist you provide to another business under an arrangement between you and the other business. A technical service specialist is an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work.

This limit on the application of the rule does not affect the determination of whether such workers are employees under the common-law rules. The common-law rules control whether the specialist is treated as an employee or an independent contractor. However, if you directly contract with a technical service specialist to provide services for your business and not for another business, you may still be entitled to the relief provision.

2. Employee or Independent Contractor?

An employer must generally withhold federal income taxes, withhold and pay social security and Medicare taxes, and pay unemployment tax on wages paid to an employee. An employer does not generally have to withhold or pay any taxes on payments to independent contractors.

Common-Law Rules

To determine whether an individual is an employee or an independent contractor under the common law, the relationship of the worker and the business must be examined. In any employee-independent contractor determination, all information that provides evidence of the degree of control and the degree of independence must be considered.

Facts that provide evidence of the degree of control and independence fall into three categories: behavioral control, financial control, and the type of relationship of the parties. These facts are discussed below.

Behavioral control. Facts that show whether the business has a right to direct and control how the worker does the task for which the worker is hired include the type and degree of:

Instructions that the business gives to the worker. An employee is generally subject to the business' instructions about when, where, and how to work. All of the

following are examples of types of instructions about how to do work.

- When and where to do the work.
- What tools or equipment to use.
- What workers to hire or to assist with the work.
- Where to purchase supplies and services.
- What work must be performed by a specified individual.
- What order or sequence to follow.

The amount of instruction needed varies among different jobs. Even if no instructions are given, sufficient behavioral control may exist if the employer has the right to control how the work results are achieved. A business may lack the knowledge to instruct some highly specialized professionals; in other cases, the task may require little or no instruction. The key consideration is whether the business has retained the right to control the details of a worker's performance or instead has given up that right.

Training that the business gives to the worker. An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods.

Financial control. Facts that show whether the business has a right to control the business aspects of the worker's job include:

The extent to which the worker has unreimbursed business expenses.

Independent contractors are more likely to have unreimbursed expenses than are employees. Fixed ongoing costs that are incurred regardless of whether work is currently being performed are especially important. However, employees may also incur unreimbursed expenses in connection with the services that they perform for their business.

The extent of the worker's investment. An independent contractor often has a significant investment in the facilities he or she uses in performing services for someone else. However, a significant investment is not necessary for independent contractor status.

The extent to which the worker makes his or her services available to the relevant market. An independent contractor is generally free to seek out business opportunities. Independent contractors often advertise, maintain a visible business location, and are available to work in the relevant market.

How the business pays the worker. An employee is generally guaranteed a regular wage amount for an hourly, weekly, or other period of time. This usually indicates that a worker is an employee, even when the wage or salary is supplemented by a commission. An independent contractor is usually paid by a flat fee for the job. However, it is common in some professions, such as law, to pay independent contractors hourly.

The extent to which the worker can realize a profit or loss. An independent contractor can make a profit or loss.

Type of relationship. Facts that show the parties' type of relationship include:

Written contracts describing the relationship the parties intended to create.

Whether or not the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay.

The permanency of the relationship. If you engage a worker with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this is generally considered evidence that your intent was to create an employer-employee relationship.

The extent to which services performed by the worker are a key aspect of the regular business of the company. If a worker provides services that are a key aspect of your regular business activity, it is more likely that you will have the right to direct and control his or her activities. For example, if a law firm hires an attorney, it is likely that it will present the attorney's work as its own and would have the right to control or direct that work. This would indicate an employer-employee relationship.

IRS help. If you want the IRS to determine whether or not a worker is an employee, file Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding, with the IRS.

Industry Examples

The following examples may help you properly classify your workers:

Building and Construction Industry

Example 1.

Jerry Jones has an agreement with Wilma White to supervise the remodeling of her house. She did not advance funds to help him carry on the work. She makes direct payments to the suppliers for all necessary materials. She carries liability and workers' compensation insurance covering Jerry and others that he engaged to assist him. She pays them an hourly rate and exercises almost constant supervision over the work. Jerry is not free to transfer his assistants to other jobs. He may not work on other jobs while working for Wilma. He assumes no responsibility to complete the work and will incur no contractual liability if he fails to do so. He and his assistants perform personal services for hourly wages. Jerry Jones and his assistants are employees of Wilma White.

Example 2.

Milton Manning, an experienced tilesetter, orally agreed with a corporation to perform full-time services at construction sites. He uses his own tools and performs services in the order designated by the corporation and according to its specifications. The corporation supplies all materials, makes frequent inspections of his work, pays him on a piecework basis, and carries workers' compensation insurance on him. He does not have a place of business or hold himself out to perform similar services for others. Either party can end the services at any time. Milton Manning is an employee of the corporation.

Example 3.

Wallace Black agreed with the Sawdust Co. to supply the construction labor for a group of houses. The company agreed to pay all construction costs. However, he supplies all the tools and equipment. He performs personal services as a carpenter and mechanic for an hourly wage. He also acts as superintendent and foreman and engages other individuals to assist him. The company has the right to select, approve, or discharge any helper. A company representative makes frequent inspections of the construction site. When a house is finished, Wallace is paid a certain percentage of its costs. He is not responsible for faults, defects of construction, or wasteful operation. At the end of each week, he presents the company with a statement of the amount that he has spent, including the payroll. The

company gives him a check for that amount from which he pays the assistants, although he is not personally liable for their wages. Wallace Black and his assistants are employees of the Sawdust Co.

Example 4.

Bill Plum contracted with Elm Corporation to complete the roofing on a housing complex. A signed contract established a flat amount for the services rendered by Bill Plum. Bill is a licensed roofer and carries workers' compensation and liability insurance under the business name, Plum Roofing. He hires his own roofers who are treated as employees for federal employment tax purposes. If there is a problem with the roofing work, Plum Roofing is responsible for paying for any repairs. Bill Plum, doing business as Plum Roofing, is an independent contractor.

Example 5.

Vera Elm, an electrician, submitted a job estimate to a housing complex for electrical work at \$16 per hour for 400 hours. She is to receive \$1,280 every 2 weeks for the next 10 weeks. This is not considered payment by the hour. Even if she works more or less than 400 hours to complete the work, Vera Elm will receive \$6,400. She also performs additional electrical installations under contracts with other companies, that she obtained through advertisements. Vera is an independent contractor.

Trucking Industry**Example.**

Rose Trucking contracts to deliver material for Forest, Inc., at \$140 per ton. Rose Trucking is not paid for any articles that are not delivered. At times, Jan Rose, who operates as Rose Trucking, may also lease another truck and engage a driver to complete the contract. All operating expenses, including insurance coverage, are paid by Jan Rose. All equipment is owned or rented by Jan and she is responsible for all maintenance. None of the drivers are provided by Forest, Inc. Jan Rose, operating as Rose Trucking, is an independent contractor.

Computer Industry**Example.**

Steve Smith, a computer programmer, is laid off when Megabyte, Inc. downsizes. Megabyte agrees to pay Steve a flat amount to complete a one-time project to create a certain product. It is not clear how long that it will take to complete the project, and Steve is not guaranteed any minimum payment for the hours spent on the program. Megabyte provides Steve with no instructions beyond the specifications for the product itself. Steve and Megabyte have a written contract, which provides that Steve is considered to be an independent contractor, is required to pay federal and state taxes, and receives no benefits from Megabyte. Megabyte will file a Form 1099-MISC. Steve does the work on a new high-end computer that cost him \$7,000. Steve works at home and is not expected or allowed to attend meetings of the software development group. Steve is an independent contractor.

Automobile Industry**Example 1.**

Donna Lee is a salesperson employed on a full-time basis by Bob Blue, an auto dealer. She works six days a week and is on duty in Bob's showroom on certain assigned days and times. She appraises trade-ins, but her appraisals are subject to the sales manager's approval. Lists of prospective customers belong to the dealer. She is required to develop leads and report results to the sales manager. Because of

her experience, she requires only minimal assistance in closing and financing sales and in other phases of her work. She is paid a commission and is eligible for prizes and bonuses offered by Bob. Bob also pays the cost of health insurance and group-term life insurance for Donna. Donna is an employee of Bob Blue.

Example 2.

Sam Sparks performs auto repair services in the repair department of an auto sales company. He works regular hours and is paid on a percentage basis. He has no investment in the repair department. The sales company supplies all facilities, repair parts, and supplies; issues instructions on the amounts to be charged, parts to be used, and the time for completion of each job; and checks all estimates and repair orders. Sam is an employee of the sales company.

Example 3.

An auto sales agency furnishes space for Helen Bach to perform auto repair services. She provides her own tools, equipment, and supplies. She seeks out business from insurance adjusters and other individuals and does all of the body and paint work that comes to the agency. She hires and discharges her own helpers, determines her own and her helpers' working hours, quotes prices for repair work, makes all necessary adjustments, assumes all losses from uncollectible accounts, and receives, as compensation for her services, a large percentage of the gross collections from the auto repair shop. Helen is an independent contractor and the helpers are her employees.

Attorney

Example.

Donna Yuma is a sole practitioner who rents office space and pays for the following items: telephone, computer, on-line legal research linkup, fax machine, and photocopier. Donna buys office supplies and pays bar dues and membership dues for three other professional organizations. Donna has a part-time receptionist who also does the bookkeeping. She pays the receptionist, withholds and pays federal and state employment taxes, and files a Form W-2 each year. For the past 2 years, Donna has had only three clients, corporations with which there have been long-standing relationships. Donna charges the corporations an hourly rate for her services, sending monthly bills detailing the work performed for the prior month. The bills include charges for long distance calls, on-line research time, fax charges, photocopies, postage, and travel, costs for which the corporations have agreed to reimburse her. Donna is an independent contractor.

Taxicab Driver

Example.

Tom Spruce rents a cab from Taft Cab Co. for \$150 per day. He pays the costs of maintaining and operating the cab. Tom Spruce keeps all fares that he receives from customers. Although he receives the benefit of Taft's two-way radio communication equipment, dispatcher, and advertising, these items benefit both Taft and Tom Spruce. Tom Spruce is an independent contractor.

Salesperson

To determine whether salespersons are employees under the usual **common-law** rules, you must evaluate each individual case. If a salesperson who works for you does not meet the tests for a common-law employee, discussed earlier, you do not have to withhold federal income tax from his or her pay (see *Statutory Employees* in section 1). However, even if a salesperson is not an employee under the usual common-law rules, his or her pay may still be subject to social security, Medicare,

and FUTA taxes.

To determine whether a salesperson is an employee for social security, Medicare, and FUTA tax purposes, the salesperson must meet **all eight** elements of the statutory employee test. A salesperson is a statutory employee for social security, Medicare, and FUTA tax purposes if he or she:

1. Works full time for one person or company except, possibly, for sideline sales activities on behalf of some other person,
2. Sells on behalf of, and turns his or her orders over to, the person or company for which he or she works,
3. Sells to wholesalers, retailers, contractors, or operators of hotels, restaurants, or similar establishments,
4. Sells merchandise for resale, or supplies for use in the customer's business,
5. Agrees to do substantially all of this work personally,
6. Has no substantial investment in the facilities used to do the work, other than in facilities for transportation,
7. Maintains a continuing relationship with the person or company for which he or she works, and
8. Is **not** an employee under common-law rules.

3. Employees of Exempt Organizations

Many nonprofit organizations are exempt from income tax. Although they do not have to pay income tax themselves, they must still withhold income tax from the pay of their employees. However, there are special social security, Medicare, and federal unemployment (FUTA) tax rules that apply to the wages that they pay their employees.

Section 501(c)(3) organizations. Nonprofit organizations that are exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code include any community chest, fund, or foundation organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary or educational purposes, fostering national or international amateur sports competition, or for the prevention of cruelty to children or animals. These organizations are usually corporations and are exempt from federal income tax under section 501(a).

Social security and Medicare taxes. Wages paid to employees of section 501(c)(3) organizations are subject to social security and Medicare taxes unless one of the following situations applies.

- The organization pays an employee less than \$100 in a calendar year.
- The organization is a church or church-controlled organization opposed for religious reasons to the payment of social security and Medicare taxes and has filed Form 8274, Certification by Churches and Qualified Church-Controlled Organizations Electing Exemption From Employer Social Security and Medicare Taxes, to elect exemption from social security and Medicare taxes. The organization must have filed for exemption before the first date on which a quarterly employment tax return (Form 941) would otherwise be due.

An employee of a church or church-controlled organization that is exempt from

social security and Medicare taxes must pay self-employment tax if the employee is paid \$108.28 or more in a year. However, an employee who is a member of a qualified religious sect can apply for an exemption from the self-employment tax by filing Form 4029, Application for Exemption From Social Security and Medicare Taxes and Waiver of Benefits. See *Members of recognized religious sects opposed to insurance* in section 4.

Federal unemployment tax. An organization that is exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code is also exempt from the federal unemployment (FUTA) tax. This exemption cannot be waived.

Note.

An organization wholly owned by a state or its political subdivision should contact the appropriate state official for information about reporting and getting social security and Medicare coverage for its employees.

Other than section 501(c)(3) organizations. Nonprofit organizations that are not section 501(c)(3) organizations may also be exempt from federal income tax under section 501(a) or section 521. However, these organizations are not exempt from withholding federal income, social security, or Medicare tax from their employees' pay, or from paying FUTA tax. Two special rules for social security, Medicare, and FUTA taxes apply.

1. If an employee is paid less than \$100 during a calendar year, his or her wages are not subject to social security and Medicare taxes.
2. If an employee is paid less than \$50 in a calendar quarter, his or her wages are not subject to FUTA tax for the quarter.

The above rules do not apply to employees who work for pension plans and other similar organizations described in section 401(a).

4. Religious Exemptions

Special rules apply to the treatment of ministers for social security purposes. An exemption from social security is available for ministers and certain other religious workers and members of certain recognized religious sects. For more information on getting an exemption, see Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*.

Ministers. Ministers are individuals who are duly ordained, commissioned, or licensed by a religious body constituting a church or church denomination. They are given the authority to conduct religious worship, perform sacerdotal functions, and administer ordinances and sacraments according to the prescribed tenets and practices of that religious organization.

A minister who performs services for you subject to your will and control is your employee. The common-law rules discussed in sections 1 and 2 should be applied to determine whether a minister is your employee or is self-employed. The earnings of a minister are not subject to federal income, social security, and Medicare tax withholding. However, the earnings as reported on the minister's Form 1040 are subject to self-employment tax and federal income tax. You do not withhold these taxes from wages earned by a minister, but you may agree with the minister to voluntarily withhold tax to cover the minister's liability for self-employment tax and federal income tax.

Form W-2. If your employee is an ordained minister, report all taxable compensation as wages in box 1 on Form W-2. Include in this amount expense allowances or reimbursements paid under a nonaccountable plan, discussed in

section 5 of Publication 15 (Circular E). Do not include a parsonage allowance (excludable housing allowance) in this amount. You may report a parsonage or rental allowance (housing allowance), utilities allowance, and the rental value of housing provided in a separate statement or in box 14 on Form W-2. Do not show on Form W-2 or Form 941 any amount as social security or Medicare wages, or any withholding for social security or Medicare taxes. If you withheld tax from the minister under a voluntary agreement, this amount should be shown in box 2 on Form W-2 as federal income tax withheld. For more information on ministers, see Publication 517.

Exemptions for ministers and others. Certain ordained ministers, Christian Science practitioners, and members of religious orders who have not taken a vow of poverty, who are subject to self-employment tax, may apply to exempt their earnings from the tax on religious grounds. The application must be based on conscientious opposition to public insurance because of personal religious considerations. The exemption applies only to qualified services performed for the religious organization. See Rev. Proc. 91-20, 1991-1 C.B. 524, for guidelines to determine whether an organization is a religious order or whether an individual is a member of a religious order.

To apply for the exemption, the employee should file Form 4361, Application for Exemption From Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners. See Publication 517 for more information about claiming an exemption from self-employment tax using Form 4361.

Members of recognized religious sects opposed to insurance. If you belong to a recognized religious sect or to a division of such sect that is opposed to insurance, you may qualify for an exemption from the self-employment tax. To qualify, you must be conscientiously opposed to accepting the benefits of any public or private insurance that makes payments because of death, disability, old age, or retirement, or makes payments toward the cost of, or provides services for, medical care (including social security and Medicare benefits). If you buy a retirement annuity from an insurance company, you will not be eligible for this exemption. Religious opposition based on the teachings of the sect is the only legal basis for the exemption. In addition, your religious sect (or division) must have existed since December 31, 1950.

Self-employed. If you are self-employed and a member of a recognized religious sect opposed to insurance, you can apply for exemption by filing Form 4029, Application for Exemption From Social Security and Medicare Taxes and Waiver of Benefits, and waive all social security benefits.

Employees. The social security and Medicare tax exemption available to the self-employed who are members of a recognized religious sect opposed to insurance is also available to their employees who are members of such a sect. This applies to partnerships only if each partner is a member of the sect. This exemption for employees applies only if both the employee and the employer are members of such a sect, and the employer has an exemption. To get the exemption, the employee must file Form 4029.

An employee of a church or church-controlled organization that is exempt from social security and Medicare taxes can also apply for an exemption on Form 4029.

5. Wages and Other Compensation

Publication 15 (Circular E) , provides a general discussion of taxable wages. Publication 15-B discusses fringe benefits. The following topics supplement those discussions.

Relocating for Temporary Work Assignments

If an employee is given a temporary work assignment away from his or her regular

place of work, certain travel expenses reimbursed or paid directly by the employer in accordance with an accountable plan (see section 5 in Publication 15 (Circular E)) may be excludible from the employee's wages. Generally, a temporary work assignment in a single location is one that is realistically expected to last (and does in fact last) for one year or less. If the employee's new work assignment is indefinite, any living expenses reimbursed or paid by the employer (other than qualified moving expenses) must be included in the employee's wages as compensation. For the travel expenses to be excludable:

- The new work location must be outside of the city or general area of the employee's regular work place or post of duty,
- The travel expenses must otherwise qualify as deductible by the employee, and
- The expenses must be for the period during which the employee is at the temporary work location.

If you reimburse or pay any personal expenses of an employee during his or her temporary work assignment, such as expenses for home leave for family members or for vacations, these amounts must be included in the employee's wages. See chapter 1 of Publication 463, Travel, Entertainment, Gift, and Car Expenses, and section 5 of Publication 15 (Circular E), for more information. These rules generally apply to temporary work assignments both inside and outside the U.S.

Employee Achievement Awards

Do not withhold federal income, social security, or Medicare taxes on the fair market value of an employee achievement award if it is excludable from your employee's gross income. To be excludable from your employee's gross income, the award must be tangible personal property (not cash or securities) given to an employee for length of service or safety achievement, awarded as part of a meaningful presentation, and awarded under circumstances that do not indicate that the payment is disguised compensation. Excludable employee achievement awards also are not subject to FUTA tax.

Limits. The most that you can exclude for the cost of all employee achievement awards to the same employee for the year is \$400. A higher limit of \$1,600 applies to qualified plan awards. Qualified plan awards are employee achievement awards under a written plan that does not discriminate in favor of highly compensated employees. An award cannot be treated as a qualified plan award if the average cost per recipient of all awards under all of your qualified plans is more than \$400.

If during the year an employee receives awards not made under a qualified plan and also receives awards under a qualified plan, the exclusion for the total cost of all awards to that employee cannot be more than \$1,600. The \$400 and \$1,600 limits cannot be added together to exclude more than \$1,600 for the cost of awards to any one employee during the year.

Scholarship and Fellowship Payments

Only amounts that you pay as a qualified scholarship to a candidate for a degree may be excluded from the recipient's gross income. A qualified scholarship is any amount granted as a scholarship or fellowship that is used for:

- Tuition and fees required to enroll in, or to attend, an educational institution or
- Fees, books, supplies, and equipment that are required for courses at the educational institution.

Any amounts that you pay for room and board, and any amounts that you pay for teaching, research, or other services required as a condition of receiving the scholarship, are not excludable from the recipient's gross income. A qualified scholarship is not subject to social security, Medicare, and FUTA taxes, or federal income tax withholding. For more information, see Publication 970, Tax Benefits for Education.

Outplacement Services

If you provide outplacement services to your employees to help them find new employment (such as career counseling, resume assistance, or skills assessment), the value of these benefits may be income to them and subject to all withholding taxes. However, the value of these services will not be subject to any employment taxes if:

- You derive a substantial business benefit from providing the services (such as improved employee morale or business image) separate from the benefit that you would receive from the mere payment of additional compensation and
- The employee would be able to deduct the cost of the services as employee business expenses if he or she had paid for them.

However, if you receive no additional benefit from providing the services, or if the services are not provided on the basis of employee need, then the value of the services is treated as wages and is subject to federal income tax withholding and social security and Medicare taxes. Similarly, if an employee receives the outplacement services in exchange for reduced severance pay (or other taxable compensation), then the amount the severance pay is reduced is treated as wages for employment tax purposes.

Withholding for Idle Time

Payments made under a voluntary guarantee to employees for idle time (any time during which an employee performs no services) are wages for the purposes of social security, Medicare, FUTA taxes, and federal income tax withholding.

Back Pay

Treat back pay as wages in the year paid and withhold and pay employment taxes as required. If back pay was awarded by a court or government agency to enforce a federal or state statute protecting an employee's right to employment or wages, special rules apply for reporting those wages to the Social Security Administration. These rules also apply to litigation actions, and settlement agreements or agency directives that are resolved out of court and not under a court decree or order. Examples of pertinent statutes include, but are not limited to, the National Labor Relations Act, Fair Labor Standards Act, Equal Pay Act, and Age Discrimination in Employment Act. See Publication 957, Reporting Back Pay and Special Wage Payments to the Social Security Administration, and Form SSA-131, Employer Report of Special Wage Payments, for details.

Supplemental Unemployment Benefits

If you pay, under a plan, supplemental unemployment benefits to a former employee, all or part of the payments may be taxable and subject to federal income tax withholding, depending on how the plan is funded. Amounts that represent a return to the employee of amounts previously subject to tax are not taxable and are not subject to withholding. You should withhold federal income tax on the taxable part of the payments made, under a plan, to an employee who is involuntarily separated because of a reduction in force, discontinuance of a plant or operation, or other similar condition. It does not matter whether the separation is temporary or permanent.

There are special rules that apply in determining whether benefits qualify as supplemental unemployment benefits that are excluded from wages for social security, Medicare, and FUTA purposes. To qualify as supplemental unemployment benefits for these purposes, the benefits must meet the following requirements.

- Benefits are paid only to unemployed former employees who are laid off by the employer.
- Eligibility for benefits depends on meeting prescribed conditions after termination.
- The amount of weekly benefits payable is based upon state unemployment benefits, other compensation allowable under state law, and the amount of regular weekly pay.
- The duration of the benefits is affected by the fund level and employee seniority.
- The right to benefits does not accrue until a prescribed period after termination.
- Benefits are not attributable to the performance of particular services.
- No employee has any right to the benefits until qualified and eligible to receive benefits.
- Benefits may not be paid in a lump sum.

Withholding on taxable supplemental unemployment benefits must be based on the withholding certificate (Form W-4) that the employee gave to you.

Golden Parachute Payments

A golden parachute payment is a contract entered into by a corporation and key personnel under which the corporation agrees to pay certain amounts to its key personnel in the event of a change in ownership or control of the corporation. Payments to employees under golden parachute contracts are subject to social security, Medicare, FUTA taxes, and federal income tax withholding.

Beginning with payments under contracts entered into, significantly amended, or renewed after June 14, 1984, no deduction is allowed to the corporation for any excess parachute payment. A payment is generally considered to be an excess parachute payment if it equals or exceeds three times the average annual compensation of the recipient over the previous 5-year period. The amount over the average is the excess parachute payment. The recipient of an excess parachute payment is subject to a 20% nondeductible excise tax. If the recipient is an employee, the 20% excise tax is to be withheld by the corporation.

Example.

An officer of a corporation receives a golden parachute payment of \$400,000. This is more than three times greater than his or her average compensation of \$100,000 over the previous 5-year period. The excess parachute payment is \$300,000 (\$400,000 minus \$100,000). The corporation cannot deduct the \$300,000 and must withhold the excise tax of \$60,000 (20% of \$300,000).

Reporting golden parachute payments. Golden parachute payments to employees must be reported on Form W-2. See the *Instructions for Forms W-2 and W-3* for details. For nonemployee reporting of these payments, see Box 7 in the

Instructions for Form 1099-MISC.

Exempt payments. Most small business corporations are exempt from the golden parachute rules. See Regulations section 1.280G-1 for more information.

Interest-Free and Below-Market-Interest-Rate Loans

In general, if an employer lends an employee more than \$10,000 at an interest rate less than the current applicable federal rate (AFR), the difference between the interest paid and the interest that would be paid under the AFR is considered additional compensation to the employee. This rule applies to a loan of \$10,000 or less if one of its principal purposes is the avoidance of federal tax.

This additional compensation to the employee is subject to social security, Medicare, and FUTA taxes, but not to federal income tax withholding. Include it in compensation on Form W-2 (or Form 1099-MISC for an independent contractor). The AFR is established monthly and published by the IRS each month in the Internal Revenue Bulletin. You can get these rates by calling 1-800-829-4933 or by accessing the IRS website at www.irs.gov. For more information, see section 7872 and its related Regulations.

Workers' Compensation—Public Employees

State and local government employees, such as police officers and firefighters, sometimes receive payments due to injury in the line of duty under a statute that is not the general workers' compensation law of a state. If the statute limits benefits to work-related injuries or sickness and does not base payments on the employee's age, length of service, or prior contributions, the statute is "in the nature of" a workers' compensation law. Payments under the statute are not subject to FUTA tax or federal income tax withholding, but they are subject to social security and Medicare taxes to the same extent as the employee's regular wages. However, the payments are no longer subject to social security and Medicare taxes after the expiration of six months following the last calendar month in which the employee worked for the employer.

Leave Sharing Plans

If you establish a leave sharing plan for your employees that allows them to transfer leave to other employees for medical emergencies, the amounts paid to the recipients of the leave are considered wages. These amounts are includible in the gross income of the recipients and are subject to social security, Medicare, and FUTA taxes, and federal income tax withholding. Do not include these amounts in the income of the transferors. These rules apply only to leave sharing plans that permit employees to transfer leave to other employees for medical emergencies.

Nonqualified Deferred Compensation Plans

Income Tax and Reporting

Section 885 of the American Jobs Creation Act of 2004 added section 409A to the Internal Revenue Code. Section 409A provides that all amounts deferred under a nonqualified deferred compensation (NQDC) plan for all tax years are currently includible in gross income (to the extent not subject to a substantial risk of forfeiture and not previously included in gross income) and subject to additional taxes, unless certain requirements are met pertaining to, among other things, elections to defer compensation and distributions under a NQDC plan. Section 409A also includes rules that apply to certain trusts or similar arrangements associated with NQDC plans if the trusts or arrangements are located outside of the United States or are restricted to the provision of benefits in connection with a decline in the financial health of the plan sponsor. Employers must withhold federal income tax (but not the additional taxes) on any amount includible in gross income under section 409A. Other changes to the Internal Revenue Code provide that the deferrals under a NQDC plan must be

reported separately on Form W-2 or Form 1099-MISC, whichever applies. Specific rules for reporting are provided in the instructions to the forms. The new provisions do not affect the application or reporting of social security, Medicare, or FUTA taxes.

Section 409A applies to amounts deferred in tax years beginning after December 31, 2004, and may also apply to amounts deferred in tax years beginning before January 1, 2005, for example, if the plan under which the deferral is made is materially modified after October 3, 2004. The reporting requirements apply to amounts deferred after December 31, 2004. Public guidance on section 409A, including transition rules, was published on December 20, 2004, as Notice 2005-1. The new provisions do not prevent the inclusion of amounts in income or wages under other provisions of the Internal Revenue Code or common law tax principles, such as when amounts are actually or constructively received or irrevocably contributed to a separate fund.

Social security, Medicare, and FUTA taxes.

Employer contributions to nonqualified deferred compensation (NQDC) plans, as defined in the applicable regulations, are treated as social security, Medicare, and FUTA wages when the services are performed or the employee no longer has a substantial risk of forfeiting the right to the deferred compensation, whichever is later.

Amounts deferred are subject to social security, Medicare, and FUTA taxes at that time unless the amount that is deferred cannot be reasonably ascertained; for example, if benefits are based on final pay. If the value of the future benefit is based on any factors that are not yet reasonably ascertainable, you may choose to estimate the value of the future benefit and withhold and pay social security, Medicare, and FUTA taxes on that amount. You will have to determine later, when the amount is reasonably ascertainable, whether any additional taxes are required. If taxes are not paid before the amounts become reasonably ascertainable, when the amounts become reasonably ascertainable they are subject to social security, Medicare, and FUTA taxes on the amounts deferred plus the income attributable to those amounts deferred. For more information, see Regulations sections 31.3121(v)(2)-1 and 31.3306(r)(2)-1.

Tax-Sheltered Annuities

Employer payments made by an educational institution or a tax-exempt organization to purchase a tax-sheltered annuity for an employee (annual deferrals) are included in the employee's social security and Medicare wages if the payments are made because of a salary reduction agreement. However, they are not included in box 1 on Form W-2 in the year the deferrals are made and are not subject to federal income tax withholding. See Regulations section 31.3121(a)(5)-2T for the definition of a salary reduction agreement.

Contributions to a Simplified Employee Pension (SEP)

An employer's SEP contributions to an employee's individual retirement arrangement (IRA) are excluded from the employee's gross income. These excluded amounts are not subject to social security, Medicare, FUTA taxes, or federal income tax withholding. However, any SEP contributions paid under a salary reduction agreement (SARSEP) are included in wages for purposes of social security and Medicare taxes and for FUTA. See Publication 560, Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans), for more information about SEPs.

Salary reduction simplified employee pensions (SARSEP) repealed. You may not establish a SARSEP after 1996. However, SARSEPs established before January 1, 1997, may continue to receive contributions.

SIMPLE Retirement Plans

Employer and employee contributions to a savings incentive match plan for employees (SIMPLE) retirement account (subject to limitations) are excludable from the employee's income and are exempt from federal income tax withholding. An employer's nonelective (2%) or matching contributions are exempt from social security, Medicare, and FUTA taxes. However, an employee's salary reduction contributions to a SIMPLE are subject to social security, Medicare, and FUTA taxes. For more information about SIMPLE retirement plans, see Publication 560.

6. Sick Pay Reporting

Special rules apply to the reporting of sick pay payments to employees. How these payments are reported depends on whether the payments are made by the employer or a third party, such as an insurance company.

Sick pay is usually subject to social security, Medicare, and FUTA taxes. For exceptions, see *Social Security, Medicare, and FUTA Taxes on Sick Pay* later. Sick pay may also be subject to either mandatory or voluntary federal income tax withholding, depending on who pays it.

Sick Pay

Sick pay generally means any amount paid under a plan because of an employee's temporary absence from work due to injury, sickness, or disability. It may be paid by either the employer or a third party, such as an insurance company. Sick pay includes both short- and long-term benefits. It is often expressed as a percentage of the employee's regular wages.

Payments That Are Not Sick Pay

Sick pay does not include the following payments.

1. **Disability retirement payments.** Disability retirement payments are not sick pay and are not discussed in this section. Those payments are subject to the rules for federal income tax withholding from pensions and annuities. See section 8.
2. **Workers' compensation.** Payments because of a work-related injury or sickness that are made under a workers' compensation law are not sick pay and are not subject to employment taxes. But see *Workers' Compensation—Public Employees* in section 5.
3. **Medical expense payments.** Payments under a definite plan or system for medical and hospitalization expenses, or for insurance covering these expenses, are not sick pay and are not subject to employment taxes.
4. **Payments unrelated to absence from work.** Accident or health insurance payments unrelated to absence from work are not sick pay and are not subject to employment taxes. These include payments for:
 - a. Permanent loss of a member or function of the body,
 - b. Permanent loss of the use of a member or function of the body, or
 - c. Permanent disfigurement of the body.

Example. Donald was injured in a car accident and lost an eye. Under a policy paid for by Donald's employer, Delta Insurance Co. paid Donald \$5,000 as compensation for the loss of his eye. Because the payment was determined by the type of injury and was unrelated to Donald's absence from

work, it is not sick pay and is not subject to federal employment taxes.

Sick Pay Plan

A sick pay plan is a plan or system established by an employer under which sick pay is available to employees generally or to a class or classes of employees. This does not include a situation in which benefits are provided on a discretionary or occasional basis with merely an intention to aid particular employees in time of need.

You have a sick pay plan or system if the plan is in writing or is otherwise made known to employees, such as by a bulletin board notice or your long and established practice. Some indications that you have a sick pay plan or system include references to the plan or system in the contract of employment, employer contributions to a plan, or segregated accounts for the payment of benefits.

Definition of employer. The employer for whom the employee normally works, a term used in the following discussion, is either the employer for whom the employee was working at the time that the employee became sick or disabled or the last employer for whom the employee worked before becoming sick or disabled, if that employer made contributions to the sick pay plan on behalf of the sick or disabled employee.

Note.

Contributions to a sick pay plan through a cafeteria plan (by direct employer contributions or salary reduction) are employer contributions unless they are aftertax employee contributions (that is, included in taxable wages).

Third-Party Payers of Sick Pay

Employer's agent. An employer's agent is a third party that bears no insurance risk and is reimbursed on a cost-plus-fee basis for payment of sick pay and similar amounts. A third party may be your agent even if the third party is responsible for determining which employees are eligible to receive payments. For example, if a third party provides administrative services only, the third party is your agent. If the third party is paid an insurance premium and is not reimbursed on a cost-plus-fee basis, the third party is not your agent. Whether an insurance company or other third party is your agent depends on the terms of their agreement with you.

A third party that makes payments of sick pay as your agent is not considered the employer and generally has no responsibility for employment taxes. This responsibility remains with you. However, under an exception to this rule, the parties may enter into an agreement that makes the third-party agent responsible for employment taxes. In this situation, the third-party agent should use its own name and EIN (rather than your name and EIN) for the responsibilities that it has assumed.

Third party not employer's agent. A third party that makes payments of sick pay other than as an agent of the employer is liable for federal income tax withholding (if requested by the employee) and the employee part of the social security and Medicare taxes.

The third party is also liable for the employer part of the social security and Medicare taxes and the FUTA tax, unless the third party transfers this liability to the employer for whom the employee normally works. This liability is transferred if the third party takes the following steps:

1. Withholds the **employee** social security and Medicare taxes from the sick pay payments,
2. Makes timely deposits of the **employee** social security and Medicare taxes,

and

3. Notifies the employer for whom the employee normally works of the payments on which employee taxes were withheld and deposited. The third party must notify the employer within the time required for the third party's deposit of the employee part of the social security and Medicare taxes. For instance, if the third party is a monthly schedule depositor, it must notify the employer by the 15th day of the month following the month in which the sick pay payment is made because that is the day by which the deposit is required to be made. The third party should notify the employer as soon as information on payments is available so that an employer required to make electronic deposits can make them timely. For multi-employer plans, see the special rule discussed next.

Multi-employer plan timing rule. A special rule applies to sick pay payments made to employees by a third-party insurer under an insurance contract with a multi-employer plan established under a collectively bargained agreement. If the third-party insurer making the payments complies with steps 1 and 2 above and gives the plan (rather than the employer) the required timely notice described in step 3 above, then the plan (not the third-party insurer) must pay the employer part of the social security and Medicare taxes and the FUTA tax. Similarly, if within six business days of the plan's receipt of notification, the plan gives notice to the employer for whom the employee normally works, the employer (not the plan) must pay the employer part of the social security and Medicare taxes and the FUTA tax.

Reliance on information supplied by the employer. A third party that pays sick pay should request information from the employer to determine amounts that are not subject to employment taxes. Unless the third party has reason not to believe the information, it may rely on that information for the following items.

- The total wages paid to the employee during the calendar year.
- The last month in which the employee worked for the employer.
- The employee contributions to the sick pay plan made with aftertax dollars.

The third party should not rely on statements regarding these items made by the employee.

Social Security, Medicare, and FUTA Taxes on Sick Pay

Employer. If you pay sick pay to your employee, you must generally withhold employee social security and Medicare taxes from the sick pay. You must timely deposit employee and employer social security and Medicare taxes and FUTA tax. There are no special deposit rules for sick pay. See section 11 of Publication 15 (Circular E) for more information on the deposit rules.

Amounts not subject to social security, Medicare, or FUTA taxes. The following payments, whether made by the employer or a third party, are not subject to social security, Medicare, or FUTA taxes (different rules apply to federal income tax withholding).

- **Payments after an employee's death or disability retirement.** Social security, Medicare, and FUTA taxes do not apply to amounts paid under a definite plan or system, as defined under *Sick Pay Plan* earlier, on or after the termination of the employment relationship because of death or disability retirement. However, even if there is a definite plan or system, amounts paid to a former employee are subject to social security, Medicare, and FUTA taxes if they would have been paid even if the employment relationship had not terminated because of death or disability retirement. For example, a payment to a disabled former employee for unused vacation time would have

been made whether or not the employee retired on disability. Therefore, the payment is wages and is subject to social security, Medicare, and FUTA taxes.

- **Payments after calendar year of employee's death.** Sick pay paid to the employee's estate or survivor after the calendar year of the employee's death is **not** subject to social security, Medicare, or FUTA taxes. (Also, see *Amounts not subject to income tax withholding* under *Income Tax Withholding on Sick Pay* later.)

Example. Sandra became entitled to sick pay on November 26, 2004, and died on December 31, 2004. On January 13, 2005, Sandra's sick pay for the period from December 24 through December 31, 2004, was paid to her survivor. The payment is not subject to social security, Medicare, or FUTA taxes.

- **Payments to an employee entitled to disability insurance benefits.** Payments to an employee when the employee is entitled to disability insurance benefits under section 223(a) of the Social Security Act are not subject to social security and Medicare taxes. This rule applies only if the employee became entitled to the Social Security Act benefits before the calendar year in which the payments are made, and the employee performs no services for the employer during the period for which the payments are made. However, these payments **are** subject to FUTA tax.
- **Payments that exceed the applicable wage base.** Social security and FUTA taxes do not apply to payments of sick pay that, when combined with the regular wages and sick pay previously paid to the employee during the year, exceed the applicable wage base. Because there is no Medicare tax wage base, this exception does not apply to Medicare tax. The social security tax wage base for 2005 is \$90,000. The FUTA tax wage base is \$7,000.

Example. If an employee receives \$80,000 in wages from an employer in 2005 and then receives \$15,000 of sick pay, only the first \$10,000 of the sick pay is subject to social security tax. All of the sick pay is subject to Medicare tax. None of the sick pay is subject to FUTA tax. See *Example of Figuring and Reporting Sick Pay* later.

- **Payments after six months absence from work.** Social security, Medicare, and FUTA taxes do not apply to sick pay paid more than six calendar months after the last calendar month in which the employee worked.

Example 1. Ralph's last day of work before he became entitled to receive sick pay was December 13, 2004. He was paid sick pay for nine months before his return to work on September 12, 2005. Sick pay paid to Ralph after June 30, 2005, is not subject to social security, Medicare, or FUTA taxes.

Example 2. The facts are the same as in Example 1, except that Ralph worked 1 day during the 9-month period, on February 11, 2005. Because the 6-month period begins again in March, only the sick pay paid to Ralph after August 31, 2005, is exempt from social security, Medicare, and FUTA taxes.

- **Payments attributable to employee contributions.** Social security, Medicare, and FUTA taxes do not apply to payments, or parts of payments, attributable to employee contributions to a sick pay plan made with aftertax dollars. (Contributions to a sick pay plan made on behalf of employees with employees' pretax dollars under a cafeteria plan are **employer** contributions.)

Group policy. If both the employer and the employee contributed to the sick pay plan under a group insurance policy, figure the taxable sick pay by multiplying it by the percentage of the policy's cost that was contributed by the

employer for the three policy years before the calendar year in which the sick pay is paid. If the policy has been in effect fewer than three years, use the cost for the policy years in effect or, if in effect less than one year, a reasonable estimate of the cost for the first policy year.

Example. Alan is employed by Edgewood Corporation. Because of an illness, he was absent from work for three months during 2005. Key Insurance Company paid Alan \$2,000 sick pay for each month of his absence under a policy paid for by contributions from both Edgewood and its employees. All of the employees' contributions were paid with aftertax dollars. For the three policy years before 2005, Edgewood paid 70% of the policy's cost and its employees paid 30%. Because 70% of the sick pay paid under the policy is due to Edgewood's contributions, \$1,400 ($\$2,000 \times 70\%$) of each payment made to Alan is taxable sick pay. The remaining \$600 of each payment that is due to employee contributions is not taxable sick pay and is not subject to employment taxes. Also, see *Example of Figuring and Reporting Sick Pay* later.

Income Tax Withholding on Sick Pay

The requirements for federal income tax withholding on sick pay and the methods for figuring it differ depending on whether the sick pay is paid by:

- The employer,
- An agent of the employer (defined earlier), or
- A third party that is not the employer's agent.

Employer or employer's agent. Sick pay paid by you or your agent is subject to **mandatory** federal income tax withholding. An employer or agent paying sick pay generally determines the federal income tax to be withheld based on the employee's Form W-4. The employee cannot choose how much will be withheld by giving you or your agent a Form W-4S, Request for Federal Tax Withholding From Sick Pay. Sick pay paid by an agent is treated as supplemental wages. If the agent does not pay regular wages to the employee, the agent may choose to withhold federal income tax at a flat 25% rate, rather than at the wage withholding rate. See section 7 in Publication 15 (Circular E) for the flat rate (35%) when supplemental wage payments to an individual exceed \$1,000,000 during the year.

Third party not an agent. Sick pay paid by a third party that is not your agent is **not** subject to mandatory federal income tax withholding. However, an employee may elect to have federal income tax withheld by submitting Form W-4S to the third party.

If Form W-4S has been submitted, the third party should withhold federal income tax on all payments of sick pay made eight or more days after receiving the form. The third party may, at its option, withhold federal income tax before eight days have passed.

The employee may request on Form W-4S to have a specific whole dollar amount withheld. However, if the requested withholding would reduce any net payment below \$10, the third party should not withhold any federal income tax from that payment. The minimum amount of withholding that the employee can specify is \$20 a week.

Withhold from all payments at the same rate. For example, if \$25 is withheld from a regular full payment of \$100, then \$20 (25%) should be withheld from a partial payment of \$80.

Amounts not subject to income tax withholding. The following amounts, whether paid by you or a third party, are not wages subject to federal income tax withholding.

- **Payments after the employee's death.** Sick pay paid to the employee's estate or survivor at any time after the employee's death is not subject to federal income tax withholding, regardless of who pays it.
- **Payments attributable to employee contributions.** Payments, or parts of payments, attributable to employee contributions made to a sick pay plan with aftertax dollars are not subject to federal income tax withholding. For more information, see the corresponding discussion in *Amounts not subject to social security, Medicare, or FUTA taxes* earlier.

Depositing and Reporting

This section discusses who is liable for depositing social security, Medicare, FUTA, and withheld federal income taxes on sick pay. These taxes must be deposited under the same rules that apply to deposits of taxes on regular wage payments. See Publication 15 (Circular E) for information on the deposit rules.

This section also explains how sick pay should be reported on Forms W-2, W-3, 940 (or Form 940-EZ), and 941.

Sick Pay Paid by Employer or Agent

If you or your agent (defined earlier) make sick pay payments, you deposit taxes and file Forms W-2, W-3, 940 (or Form 940-EZ), and 941 under the same rules that apply to regular wage payments.

However, the agreement between the parties may require your agent to carry out responsibilities that would otherwise have been borne by you. In this situation, your agent should use its own name and EIN (rather than yours) for the responsibilities that it has assumed.

Reporting sick pay on Form W-2. You may either combine the sick pay with other wages and prepare a single Form W-2 for each employee, or you may prepare separate Forms W-2 for each employee, one reporting sick pay and the other reporting regular wages. A Form W-2 must be prepared even if all of the sick pay is nontaxable (see Box 12 below in the list of information that must be included on Form W-2). All Forms W-2 must be given to the employees by January 31.

The Form W-2 filed for the sick pay must include the employer's name, address, and EIN; the employee's name, address, and SSN; and the following information.

Box 1 – Sick pay the employee must include in income.

Box 2 – Any federal income tax withheld from the sick pay.

Box 3 – Sick pay subject to employee social security tax.

Box 4 – Employee social security tax withheld from the sick pay.

Box 5 – Sick pay subject to employee Medicare tax.

Box 6 – Employee Medicare tax withheld from the sick pay.

Box 12 – Any sick pay that was paid by a third party and was **not** subject to federal income tax because the employee contributed to the sick pay plan (enter code J).

Box 13– Check the "Third-party sick pay" box **only** if the amounts were paid by a third party.

Sick Pay Paid by Third Party

The rules for a third party that is not your agent depend on whether liability has been transferred as discussed under *Third-Party Payers of Sick Pay* earlier.

To figure the due dates and amounts of its deposits of employment taxes, a third party should combine:

- The liability for the wages paid to its own employees and
- The liability for payments it made to all employees of all its clients. This does not include liability transferred to the employer.

Liability not transferred to the employer. If the third party does not satisfy the requirements for transferring liability for FUTA tax and the **employer's part** of the social security and Medicare taxes, the third party reports the sick pay on its own Form 940 (or Form 940-EZ) and 941. In this situation, the employer has no tax responsibilities for sick pay.

The third party must deposit social security, Medicare, FUTA, and withheld federal income taxes using its own name and EIN. The third party must give each employee to whom it paid sick pay a Form W-2 by January 31 of the following year. The Form W-2 must include the third party's name, address, and EIN instead of the employer information. Otherwise, the third party must complete Form W-2 as shown in *Reporting sick pay on Form W-2* earlier.

Liability transferred to the employer. Generally, if a third party satisfies the requirements for transferring liability for the **employer part** of the social security and Medicare taxes and for the FUTA tax, the following rules apply.

Deposits. The third party must make deposits of withheld employee social security and Medicare taxes and withheld federal income tax using its own name and EIN. You must make deposits of the **employer part** of the social security and Medicare taxes and the FUTA tax using your name and EIN. In applying the deposit rules, your liability for these taxes begins when you receive the third party's notice of sick pay payments.

Form 941. The third party and you must each file Form 941. Line 7b of each Form 941 must contain a special adjusting entry for social security and Medicare taxes. These entries are required because the total tax liability for social security and Medicare taxes (employee and employer parts) is split between you and the third party.

- Employer. You must include third-party sick pay on lines 2, 5a, and 5c of Form 941. (There should be no entry on line 3 because the third party withheld federal income tax, if any.) After completing line 6, subtract on line 7b the employee social security and Medicare taxes withheld and deposited by the third party.
- Third party. The third party must include on Form 941 the employee part of the social security and Medicare taxes (and federal income tax, if any) it withheld. The third party does not include on line 2 any sick pay paid as a third party but does include on line 3 any federal income tax withheld. On line 5a, column 1, the third party enters the total amount it paid subject to social security taxes. This amount includes both wages paid to its own employees and sick pay paid as a third party. The third party completes line 5c, column 1, in a similar manner. On line 7b, the third party subtracts the employer part of the social security and Medicare taxes that you must pay.

Form 940 (or Form 940-EZ). You, not the third party, must prepare Form 940 (or Form 940-EZ) for sick pay.

Third-party sick pay recap Forms W-2 and W-3. The third party must prepare a "Third-Party Sick Pay Recap" Form W-2 and a "Third-Party Sick Pay Recap" Form W-3. These forms, previously called "Dummy" forms, do not reflect sick pay paid to individual employees, but instead show the combined amount of sick pay paid to all employees of all clients of the third party. The recap forms provide a means of reconciling the wages shown on the third party's Form 941. However, see *Optional rule for Form W-2* later. Do not file the recap Form W-2 and W-3 electronically or on

magnetic media.

The third party fills out the third-party sick pay recap Form W-2 as follows.

Box b – Third party's EIN.

Box c – Third party's name and address.

Box e – "Third-Party Sick Pay Recap" in place of the employee's name.

Box 1 – Total sick pay paid to all employees.

Box 2 – Any federal income tax withheld from the sick pay.

Box 3 – Sick pay subject to employee social security tax.

Box 4 – Employee social security tax withheld from sick pay.

Box 5 – Sick pay subject to employee Medicare tax.

Box 6 – Employee Medicare tax withheld from the sick pay.

The third party attaches the third-party sick pay recap Form W-2 to a separate recap Form W-3, on which only boxes b, e, f, g, 1, 2, 3, 4, 5, 6, and 13 are completed. Enter "Third-Party Sick Pay Recap" in box 13. (Only the employer makes an entry in box 14 of Form W-3.)

Optional rule for Form W-2. You and the third party may choose to enter into a legally binding agreement designating the third party to be your agent for purposes of preparing Forms W-2 reporting sick pay. The agreement must specify what part, if any, of the payments under the sick pay plan is excludable from the employees' gross incomes because it is attributable to their contributions to the plan. If you enter into an agreement, the third party prepares the actual Forms W-2, not the "Third-Party Sick Pay Recap" Form W-2 as discussed earlier, for each employee who receives sick pay from the third party. If the optional rule is used:

- The third party does not provide you with the sick pay statement described below and
- You (not the third party) prepare "Third-Party Sick Pay Recap" Forms W-2 and W-3. These recap forms are needed to reconcile the sick pay shown on your Form 941.

Sick pay statement. The third party must furnish you with a sick pay statement by January 15 of the year following the year in which the sick pay was paid. The statement must show the following information about each employee who was paid sick pay.

- The employee's name.
- The employee's SSN (if social security, Medicare, or income tax was withheld).
- The sick pay paid to the employee.
- Any federal income tax withheld.
- Any employee social security tax withheld.
- Any employee Medicare tax withheld.

Example of Figuring and Reporting Sick Pay

Dave, an employee of Edgewood Corporation, was seriously injured in a car accident on January 1, 2004. Dave's last day of work was December 31, 2003. The accident was not job related.

Key, an insurance company that was not an agent of the employer, paid Dave \$2,000 each month for 10 months, beginning in January 2004. Dave submitted a Form W-4S to Key, requesting \$210 be withheld from each payment for federal income tax. Dave received no payments from Edgewood, his employer, from January 2004 through October 2004. Dave returned to work in November 2004.

For the policy year in which the car accident occurred, Dave paid a part of the premiums for his coverage, and Edgewood paid the remaining part. The plan was, therefore, a "contributory plan." During the 3 policy years before the calendar year of the accident, Edgewood paid 70% of the total of the net premiums for its employees' insurance coverage, and its employees paid 30%.

Social security and Medicare taxes. For social security and Medicare tax purposes, taxable sick pay was \$8,400 ($\$2,000 \text{ per month} \times 70\% = \$1,400 \text{ taxable portion per payment}$; $\$1,400 \times 6 \text{ months} = \$8,400 \text{ total taxable sick pay}$). Only the six \$2,000 checks received by Dave from January through June are included in the calculation. The check received by Dave in July (the seventh check) was received more than 6 months after the month in which Dave last worked.

Of each \$2,000 payment Dave received, 30% (\$600) is not subject to social security and Medicare taxes because the plan is contributory and Dave's aftertax contribution is considered to be 30% of the premiums during the 3 policy years before the calendar year of the accident.

FUTA tax. Of the \$8,400 taxable sick pay (figured the same as for social security and Medicare taxes), only \$7,000 is subject to the FUTA tax because the FUTA contribution base is \$7,000.

Federal income tax withholding. Of each \$2,000 payment, \$1,400 ($\$2,000 \times 70\%$) is subject to voluntary federal income tax withholding. In accordance with Dave's Form W-4S, \$210 was withheld from each payment (\$2,100 for the 10 payments made during 2004).

Liability transferred. For the first 6 months following the last month in which Dave worked, Key was liable for social security, Medicare, and FUTA taxes on any payments that constituted taxable wages. However, Key could have shifted the liability for the employer part of the social security and Medicare taxes (and for the FUTA tax) during the first six months by withholding Dave's part of the social security and Medicare taxes, timely depositing the taxes, and notifying Edgewood of the payments.

If Key shifted liability for the employer part of the social security and Medicare taxes to Edgewood and provided Edgewood with a sick pay statement, Key would not prepare a Form W-2 for Dave. However, Key would prepare "Third-Party Sick Pay Recap" Forms W-2 and W-3. Key and Edgewood must each prepare Form 941. Edgewood must also report the sick pay and withholding for Dave on Forms W-2, W-3, and 940.

As an alternative, the parties could have followed the optional rule described under *Optional rule for Form W-2* earlier. Under this rule, Key would prepare Form W-2 even though liability for the employer part of the social security and Medicare taxes had been shifted to Edgewood. Also, Key would not prepare a sick pay statement, and Edgewood, not Key, would prepare the recap Forms W-2 and W-3 reflecting the sick pay shown on Edgewood's Form 941.

Liability not transferred. If Key did not shift liability for the employer part of the social security and Medicare taxes to Edgewood, Key would prepare Forms W-2 and W-3 as well as Forms 941 and 940. In this situation, Edgewood would not report the sick pay.

Payments received after 6 months. The payments received by Dave in July

through October are not subject to social security, Medicare, or FUTA taxes, because they were received more than 6 months after the last month in which Dave worked (December 2003). However, Key must continue to withhold federal income tax from each payment because Dave furnished Key with a Form W-4S. Also, Key must prepare Forms W-2 and W-3, unless it has furnished Edgewood with a sick pay statement. If the sick pay statement was furnished, then Edgewood must prepare Forms W-2 and W-3.

7. Special Rules for Paying Taxes

Common Paymaster

If two or more related corporations employ the same individual at the same time and pay this individual through a common paymaster, which is one of the corporations, the corporations are considered to be a single employer. They have to pay, in total, no more in social security and Medicare taxes than a single employer would.

Each corporation must pay its own part of the employment taxes and may deduct only its own part of the wages. The deductions will not be allowed unless the corporation reimburses the common paymaster for the wage and tax payments. See Regulations section 31.3121(s)-1 for more information.

Agents

You must submit an application for authorization to act as an agent to the IRS Service Center where you will be filing returns. A Form 2678, Employer Appointment of Agent, properly completed by each employer, must be submitted with this application. See Rev. Proc. 70-6, 1970-1 C.B. 420, Rev. Proc. 84-33, 1984-1 C.B. 502, and the separate Instructions for Forms W-2 and W-3 for procedures and reporting requirements. Form 2678 does not apply to FUTA taxes reportable on Form 940.

Reporting Agents

Magnetic tape filing of Forms 940 and 941. Reporting agents may not use magnetic tape for filing Forms 940 and 941 after February 2004. Instead, see *Electronic filing of Forms 940 and 941* below.

Electronic filing of Forms 940 and 941. Reporting agents may file Forms 940 and 941 electronically. Get Publication 3112, IRS e-file Application and Participation, for details. File Form 8633, Application to Participate in the IRS e-file Program, and Form 8655, Reporting Agent Authorization for Magnetic Tape/Electronic Filers. See Rev. Procs. 99-39 and 2001-9 for authorization information. You can find Rev. Proc. 99-39 on page 532 of Internal Revenue Bulletin 1999-43 at www.irs.gov/pub/irs-irbs/irb99-43.pdf and Rev. Proc. 2001-9 on page 328 of Internal Revenue Bulletin 2001-3 at www.irs.gov/pub/irs-irbs/irb01-03.pdf. See Rev. Proc. 2003-69 for the requirements on completing and submitting Form 8655. You can find Rev. Proc. 2003-69 on page 403 of Internal Revenue Bulletin 2003-34 at www.irs.gov/pub/irs-irbs/irb03-34.pdf. Visit the IRS website at www.irs.gov/efile or call 1-866-255-0654 for more information.

Payment of Employment Taxes by Disregarded Entities

Employment taxes for employees of a qualified subchapter S subsidiary or other entity disregarded as an entity separate from its owner may be reported and paid under one of the following methods:

- By its owner (as if the employees of the disregarded entity are employed directly by the owner) using the owner's name and taxpayer identification number or

- By each entity recognized as a separate entity under state law using the entity's own name and taxpayer identification number.

If the second method is chosen, the owner retains responsibility for the federal employment tax obligations of the disregarded entity. For more information, see Notice 99-6, 1999-3 C.B. 321. You can find Notice 99-6 on page 12 of Internal Revenue Bulletin 1999-3 at www.irs.gov/pub/irs-irbs/irb99-03.pdf.

Employee's Portion of Taxes Paid by Employer

If you pay your employee's social security and Medicare taxes without deducting them from the employee's pay, you must include the amount of the payments in the employee's wages for federal income tax withholding and social security, Medicare, and FUTA taxes. This increase in the employee's wage payment for your payment of the employee's social security and Medicare taxes is also subject to employee social security and Medicare taxes. This again increases the amount of the additional taxes you must pay.

Note.

This discussion (see both above and below) does not apply to household and agricultural employers. If you pay a household or agricultural employee's social security and Medicare taxes, these payments must be included in the employee's wages. However, this wage increase due to the tax payments made for the employee is not subject to social security or Medicare taxes as discussed in this section.

To figure the employee's increased wages in this situation, divide the stated pay (the amount that you pay without taking into account your payment of employee social security and Medicare taxes) by a factor for that year. This factor is determined by subtracting from 1 the combined employee social security and Medicare tax rate for the year that the wages are paid. For 2005, the factor is .9235 (1 - .0765). If the stated pay is more than \$83,115 (2005 wage base \$90,000 × .9235), follow the procedure described under **Stated pay of more than \$83,115 in 2005** below.

Stated pay of \$83,115 or less in 2005. For an employee with stated pay of \$83,115 or less in 2005, figure the correct wages (wages plus employer-paid employee taxes) and withholding to report by dividing the stated pay by .9235. This will give you the wages to report in box 1 and the social security and Medicare wages to report in boxes 3 and 5 of Form W-2.

To figure the correct social security tax to enter in box 4 and Medicare tax to enter in box 6, multiply the amounts in boxes 3 and 5 by the withholding rates (6.2% and 1.45%) for those taxes, and enter the results in boxes 4 and 6.

Example.

Donald Devon hires Lydia Lone for only one week during 2005. He pays her \$300 for that week. Donald agrees to pay Lydia's part of the social security and Medicare taxes. To figure her reportable wages, he divides \$300 by .9235. The result, \$324.85, is the amount that he reports as wages in boxes 1, 3, and 5 of Form W-2. To figure the amount to report as social security tax, Donald multiplies \$324.85 by the social security tax rate of 6.2% (.062). The result, \$20.14, is entered in box 4 of Form W-2. To figure the amount to report as Medicare tax, Donald multiplies \$324.85 by the Medicare tax rate of 1.45% (.0145). The result, \$4.71, is entered in box 6 of Form W-2. Although he did not actually withhold the amounts from Lydia, he will report these amounts as taxes withheld on Form 941 and is responsible for matching the amounts with the employer share of these taxes.

For FUTA tax and federal income tax withholding, Lydia's weekly wages are \$324.85.

Stated pay of more than \$83,115 in 2005. For an employee with stated pay of more than \$83,115 in 2005, the correct social security wage amount is \$83,115 (the first \$90,000 of wages + .9235). The stated pay in excess of \$83,115 is not subject to social security tax because the tax only applies to the first \$90,000 of wages (stated pay plus employer-paid employee taxes). Enter \$90,000 in box 3 of Form W-2. The social security tax to enter in box 4 is \$5,580 ($90,000 \times .062$).

To figure the correct Medicare wages to enter in box 5 of Form W-2, subtract \$83,115 from the stated pay. Divide this amount by .9855 ($1 - .0145$) and add \$90,000. For example, if stated pay is \$100,000, the correct Medicare wages are figured as follows.

$$\$100,000 - \$83,115 = \$16,885$$

$$\$16,885 \div .9855 = \$17,133.43$$

$$\$17,133.43 + \$90,000 = \$107,133.43$$

The Medicare wages are \$107,133.43. Enter this amount in box 5 of Form W-2. The Medicare tax to enter in box 6 is \$1,553.43 ($\$107,133.43 \times .0145$).

Although these employment tax amounts are not actually withheld from the employee's pay, report them as withheld on Form 941, and pay this amount as the employer's share of the social security and Medicare taxes. If the wages for federal income tax purposes in the preceding example are the same as for social security and Medicare purposes, the correct wage amount for income tax withholding is \$107,133.43 ($\$100,000 + \$5,580 + \$1,553.43$), which is included in box 1 of Form W-2.

Tax deposits and Form 941. If you pay your employee's portion of his or her social security and Medicare taxes rather than deducting them from his or her pay, you are liable for timely depositing the increased taxes associated with the wage increase. Also, report the increased wages on the appropriate lines of Form 941 for the quarter during which the wages were paid.

International Social Security Agreements

The United States has social security agreements with many countries to eliminate dual taxation and coverage under two social security systems. Under these agreements, sometimes known as totalization agreements, employees generally must pay social security taxes only to the country where they work. Employees and employers who are subject only to foreign social security taxes under these agreements are exempt from U.S. social security taxes, including the Medicare portion.

The United States has social security agreements with the following countries: Australia, Austria, Belgium, Canada, Chile, Finland, France, Germany, Greece, Ireland, Italy, South Korea, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom. Additional agreements are expected in the future. For more information, see Publication 519, U.S. Tax Guide for Aliens, or contact:

Social Security Administration
Office of International Programs
P.O. Box 17741
Baltimore, MD 21235-7741

You can get more information from the SSA at www.socialsecurity.gov/international.

8. Pensions and Annuities

Generally, federal income tax withholding applies to the taxable part of payments

made from pension, profit-sharing, stock bonus, annuity, and certain deferred compensation plans; from individual retirement arrangements (IRAs); and from commercial annuities. The method and rate of withholding depends on (a) the kind of payment, (b) whether the payments are delivered outside the United States or its possessions, and (c) whether the payee is a nonresident alien individual, a nonresident alien beneficiary, or a foreign estate. Qualified distributions from Roth IRAs are nontaxable and, therefore, not subject to withholding. See *Payments to Foreign Persons and Payments Outside the United States* later for special withholding rules that apply to payments outside the United States and payments to foreign persons.

The recipient of pension or annuity payments can choose not to have income tax withheld from the payments by using line 1 of Form W-4P. For an estate, the election to have no income tax withheld can be made by the executor or personal representative of the decedent. The estate's EIN should be entered in the area reserved for "Your social security number" on Form W-4P.

A recipient cannot make this choice for eligible rollover distributions. See *Eligible Rollover Distribution—20% Withholding* later.

Federal Income Tax Withholding

Periodic Payments

Withholding from periodic payments of a pension or annuity is figured in the same manner as withholding from wages. Periodic payments are made in installments at regular intervals over a period of more than 1 year. They may be paid annually, quarterly, monthly, etc.

If the recipient wants income tax withheld, he or she must designate the number of withholding allowances on line 2 of Form W-4P and can designate an additional amount to be withheld on line 3. If the recipient does not want any income tax withheld from his or her periodic payments, he or she can check the box on line 1 of Form W-4P and submit the form to you. If the recipient does not submit Form W-4P, you must withhold on periodic payments as if the recipient were married claiming three withholding allowances. Generally, this means that tax will be withheld if the pension or annuity is at least \$1,480 a month.

If you receive a Form W-4P that does not contain the recipient's correct taxpayer identification number (TIN), you must withhold as if the recipient were single claiming zero withholding allowances even if the recipient choose not to have income tax withheld.

There are some kinds of periodic payments for which the recipient cannot use Form W-4P because they are already defined as wages subject to income tax withholding. These include retirement pay for service in the U.S. Armed Forces and payments from certain nonqualified deferred compensation plans and compensation plans of exempt organizations described in section 457.

The recipient's Form W-4P stays in effect until he or she changes or revokes it. You must notify recipients each year of their right to choose not to have federal income tax withheld or to change their previous choice.

Nonperiodic Payments—10% Withholding

You must withhold at a flat 10% rate from nonperiodic payments (but see *Eligible Rollover Distribution—20% Withholding* later) unless the recipient chooses not to have income tax withheld. Distributions from an IRA that are payable on demand are treated as nonperiodic payments. A recipient can choose not to have income tax withheld from a nonperiodic payment by submitting Form W-4P (containing their correct TIN) and checking the box on line 1. Generally, this choice not to have

income tax withheld will apply to any later payment from the same plan. A recipient cannot use line 2 for nonperiodic payments. But they may use line 3 to specify an additional amount that they want withheld.

If a recipient submits a Form W-4P that does not contain their correct TIN, you cannot honor their request not to have income tax withheld and you must withhold 10% of the payment for federal income tax.

Eligible Rollover Distribution—20% Withholding

Distributions from qualified pension or annuity plans (for example, 401(k) pension plans, IRAs, and section 457(b) plans maintained by a governmental employer) or tax-sheltered annuities that are eligible to be rolled over tax free to an IRA or qualified plan are subject to a flat 20% withholding rate. The 20% withholding rate is required and a recipient cannot choose not to have income tax withheld from eligible rollover distributions. However, you should not withhold income tax if the entire distribution is transferred by the plan administrator in a direct rollover to a traditional IRA, qualified pension plan, governmental section 457(b) plan (if allowed by the plan), or tax-sheltered annuity.

Payments to Foreign Persons and Payments Outside the United States

Unless the recipient is a nonresident alien, withholding (in the manner described above) is required on any periodic or nonperiodic payments that are delivered outside the United States or its possessions. A recipient cannot choose not to have income tax withheld.

In the absence of a treaty exemption, nonresident aliens, nonresident alien beneficiaries, and foreign estates generally are subject to a 30% withholding tax under section 1441 on the taxable portion of a periodic or nonperiodic pension or annuity payment that is from U.S. sources. However, most tax treaties provide that private pensions and annuities are exempt from withholding and tax. Also, payments from certain pension plans are exempt from withholding even if no tax treaty applies. See Publication 515, Withholding of Tax on Nonresident Aliens and Foreign Entities, and Publication 519, U.S. Tax Guide for Aliens, for details. A foreign person should submit Form W-8BEN, Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding, to you before receiving any payments. The Form W-8BEN must contain the foreign person's TIN.

Statement of Income Tax Withheld

By January 31 of the next year, you must furnish a statement on Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., showing the total amount of the recipient's pension or annuity payments and the total income tax you withheld during the prior year. Report income tax withheld on Form 945, Annual Return of Withheld Federal Income Tax, not on Form 941.

If the recipient is a foreign person who has provided you with Form W-8BEN, you instead must furnish a statement to the recipient on Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding, by March 15 for the prior year. Report income tax withheld on Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons.

9. Alternative Methods for Figuring Withholding

You may use various methods of figuring federal income tax withholding. The methods described below may be used instead of the common payroll methods provided in Publication 15 (Circular E). Use the method that best suits your payroll system and employees.

Annualized wages. Using your employee's annual wages, figure the withholding using the Percentage Method, Table 7—Annual Payroll Period, in Publication 15 (Circular E). Divide the amount from the table by the number of payroll periods, and the result will be the amount of withholding for each payroll period.

Average estimated wages. You may withhold the tax for a payroll period based on estimated average wages, with necessary adjustments, for any quarter. For details, see Regulations section 31.3402(h)(1)-1.

Cumulative wages. An employee may ask you, in writing, to withhold tax on cumulative wages. If you agree to do so, and you have paid the employee for the same kind of payroll period (weekly, biweekly, etc.) since the beginning of the year, you may figure the tax as follows.

Add the wages you have paid the employee for the current calendar year to the current payroll period amount. Divide this amount by the number of payroll periods so far this year including the current period. Figure the withholding on this amount, and multiply the withholding by the number of payroll periods used above. Use the percentage method shown in Publication 15 (Circular E). Subtract the total withholding calculated from the total tax withheld during the calendar year. The excess is the amount to withhold for the current payroll period. (See Rev. Proc. 78-8, 1978-1 C.B. 562, for an example of the cumulative method.)

Part-year employment. A part-year employee who figures income tax on a calendar-year basis may ask you to withhold tax by the part-year employment method. The request must be in writing and must contain the following information:

- The last day of any employment during the calendar year with any prior employer.
- A statement that the employee uses the calendar year accounting period.
- A statement that the employee reasonably anticipates that he or she will be employed by all employers for a total of no more than 245 days in all terms of continuous employment (defined below) during the current calendar year.

Complete the following steps to figure withholding tax by the part-year method.

1. Add the wages to be paid to the employee for the current payroll period to any wages that you have already paid to the employee in the current term of continuous employment.
2. Add the number of payroll periods used in step 1 to the number of payroll periods between the employee's last employment and current employment. To find the number of periods between the last employment and current employment: divide the number of calendar days between the employee's last day of earlier employment (or the previous December 31, if later) and the first day of current employment by the number of calendar days in the current payroll period.
3. Divide the step 1 amount by the total number of payroll periods from step 2.
4. Find the tax in the withholding tax tables on the step 3 amount. Be sure to use the correct payroll period table and to take into account the employee's withholding allowances.
5. Multiply the total number of payroll periods from step 2 by the step 4 amount.
6. Subtract from the step 5 amount the total tax already withheld during the current term of continuous employment. Any excess is the amount to withhold

for the current payroll period.

(See Regulations section 31.3402(h)(4)-1(c)(4) for examples of the part-year method.)

Term of continuous employment. A term of continuous employment may be a single term or two or more following terms of employment with the same employer. A continuous term includes holidays, regular days off, and days off for illness or vacation. A continuous term begins on the first day that an employee works for you and earns pay. It ends on the earlier of the employee's last day of work for you or, if the employee performs no services for you for more than 30 calendar days, the last workday before the 30-day period. If an employment relationship is ended, the term of continuous employment is ended even if a new employment relationship is established with the same employer within 30 days.

Other methods. You may use other methods and tables for withholding taxes, as long as the amount of tax withheld is consistently about the same as it would be under the percentage method shown in Publication 15 (Circular E). If you develop an alternative method or table, you should test the full range of wage and allowance situations to be sure that they meet the tolerances contained in Regulations section 31.3402(h)(4)-1 as shown in the chart below.

If the tax required to be withheld under the annual percentage rate is—	The annual tax withheld under your method may not differ by more than—
Less than \$10	\$0.99
\$10 or more but under \$100	\$10 plus 10% of the excess over \$10
\$100 or more but under \$1,000	\$19 plus 3% of the excess over \$100
\$1,000 or more	\$46 plus 1% of the excess over \$1,000

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Formula Tables for Percentage Method Withholding (for Automated Payroll Systems)

Two formula tables for percentage method withholding are on pages 24 and 25. The differences in the Alternative Percentage Method formulas and the steps for figuring withheld tax for different payroll systems are shown in this example.

MARRIED PERSON (Weekly Payroll Period)

If wages exceeding the allowance amount are over \$154 but not over \$435:

Method:	Income Tax Withheld:
Percentage (Pub. 15)	10% of excess over \$154
Alternative 1 (Page 24)	10% of such wages minus \$15.40
Alternative 2 (Page 25)	Such wages minus \$154, times 10% of remainder

When employers use the percentage method in Publication 15 (Circular E) or the

formula tables for percentage method withholding in this publication, the tax for the pay period may be rounded to the nearest dollar. If rounding is used, it must be used consistently. Withheld tax amounts should be rounded to the nearest whole dollar by (a) dropping amounts under 50 cents and (b) increasing amounts from 50 to 99 cents to the next higher dollar. This rounding will be considered to meet the tolerances under section 3402(h)(4).

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Formula Tables 1

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Formula Tables 2

Wage Bracket Percentage Method Tables (for Automated Payroll Systems)

The *Wage Bracket Percentage Method Tables* show the gross wage brackets that apply to each withholding percentage rate for employees with up to nine withholding allowances. These tables also show the computation factors for each number of withholding allowances and the applicable wage bracket. The computation factors are used to figure the amount of withholding tax by a percentage method.

Two kinds of *Wage Bracket Percentage Method Tables* are shown. Each has tables for married and single persons for weekly, biweekly, semimonthly, and monthly payroll periods.

The difference between the two kinds of tables is the reduction factor to be subtracted from wages before multiplying by the applicable percentage withholding rate. In the tables for *Computing Income Tax Withholding From Gross Wages* on pages 27–30, the reduction factor includes both the amount for withholding allowances claimed and a rate adjustment factor as shown in the *Alternative 2—Tables for Percentage Method Withholding Computations* on page 25. In the tables for *Computing Income Tax Withholding From Wages Exceeding Allowance Amount* on pages 31–34, the reduction factor does not include an amount for the number of allowances claimed.

Use the kind of wage bracket table that best suits your payroll system. For example, some payroll systems automatically subtract from wages the allowance amount for each employee before finding the amount of tax to withhold. The tables for *Computing Income Tax Withholding From Wages Exceeding Allowance Amount* can be used in these systems. The reduction factors in these tables do not include the allowance amount that was automatically subtracted before applying the table factors in the calculation. For other systems that do not separately subtract the allowance amount, use the tables for *Computing Income Tax Withholding From Gross Wages*.

When employers use the *Wage Bracket Percentage Method Tables*, the tax for the period may be rounded to the nearest dollar. If rounding is used, it must be used consistently. Withheld tax amounts should be rounded to the nearest whole dollar by (a) dropping amounts under 50 cents and (b) increasing amounts from 50 to 99 cents to the next higher dollar. Such rounding will be deemed to meet the tolerances under section 3402(h)(4).

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Wage Bracket 1

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Wage Bracket 2

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Wage Bracket 3

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Wage Bracket 4

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Wage Bracket 5

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Wage Bracket 6

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Wage Bracket 7

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Wage Bracket 8

Combined Income Tax, Employee Social Security Tax, and Employee Medicare Tax Withholding Tables

If you want to combine amounts to be withheld as income tax, employee social security tax, and employee Medicare tax, you may use the combined tables on pages 36–55.

Combined withholding tables for single and married taxpayers are shown for weekly, biweekly, semimonthly, monthly, and daily or miscellaneous payroll periods. The payroll period and marital status of the employee determine the table to be used.

If the wages are greater than the highest wage bracket in the applicable table, you will have to use one of the other methods for figuring income tax withholding described in this publication or in Publication 15 (Circular E). For wages that do not exceed \$90,000 the combined social security tax rate and Medicare tax rate is 7.65% each for both the employee and the employer for wages paid in 2005. You can figure the employee social security tax by multiplying the wages by 6.2%, and you can figure the employee Medicare tax by multiplying the wages by 1.45%.

The combined tables give the correct total withholding only if wages for social security and Medicare taxes and income tax withholding are the same. When you have paid more than the maximum amount of wages subject to social security tax (\$90,000 in 2005) in a calendar year, you may no longer use the combined tables.

If you use the combined withholding tables, use the following steps to find the amounts to report on your Form 941, Employer's Quarterly Federal Tax Return.

1. Employee social security tax withheld. Multiply the wages by 6.2%.
2. Employee Medicare tax withheld. Multiply the wages by 1.45%.
3. Income tax withheld. Subtract the amounts from steps 1 and 2 from the total tax withheld.

You can figure the amounts to be shown on Form W-2, Wage and Tax Statement, in the same way.

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Combined Withholding 1

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Combined Withholding 2

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Combined Withholding 4

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Combined Withholding 9

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Combined Withholding 10

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Combined Withholding 11

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Combined Withholding 16

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Combined Withholding 17

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Combined Withholding 19

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Combined Withholding 20

10. Tables for Withholding on Distributions of Indian Gaming Profits to Tribal Members

If you make certain payments to members of Indian tribes from gaming profits, you must withhold federal income tax. You must withhold if (a) the total payment to a member for the year is over \$8,200 and (b) the payment is from the net revenues of class II or class III gaming activities (classified by the Indian Gaming Regulatory Act) conducted or licensed by the tribes.

A class I gaming activity is not subject to this withholding requirement. Class I activities are social games solely for prizes of minimal value or traditional forms of Indian gaming engaged in as part of tribal ceremonies or celebrations.

Class II. Class II includes (a) bingo and similar games, such as pull tabs, punch boards, tip jars, lotto, and instant bingo, and (b) card games that are authorized by the state or that are not explicitly prohibited by the state and played at a location within the state.

Class III. A class III gaming activity is any gaming that is not class I or class II. Class III includes horse racing, dog racing, jai alai, casino gaming, and slot machines.

Withholding Tables

To figure the amount of tax to withhold each time you make a payment, use the table on page 57 for the period for which you make payments. For example, if you make payments weekly, use Table 1; if you make payments monthly, use Table 4. If the total payments to an individual for the year are \$8,200 or less, no withholding is required.

Example:

A tribal member is paid monthly. The monthly payment is \$5,000. Using Table 4, Monthly Distribution Period, figure the withholding as follows:

Subtract \$3,158 from the \$5,000 payment for a remainder of \$1,842. Multiply this amount by 25%, for a total of \$460.50. Add \$340.80, for total withholding of \$801.30.

Depositing and reporting withholding. Combine the Indian gaming withholding with all other nonpayroll withholding (for example, backup withholding and withholding on gambling winnings). Generally, you must deposit the amounts withheld by EFTPS (see *Electronic filing and payment* on page 2) or at an authorized financial institution using Form 8109, Federal Tax Deposit Coupon. See Publication 15 (Circular E), Employer's Tax Guide, for a detailed discussion of the deposit requirements.

Report Indian gaming withholding on Form 945, Annual Return of Withheld Federal Income Tax. For more information, see Form 945 and the Instructions for Form 945. Also, report the payments and withholding to tribal members and to the IRS on Form 1099-MISC, Miscellaneous Income (see the Instructions for Forms 1099-MISC).

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6. Continuing Relationship

- A continuing relationship between the worker and the hiring firm indicates an employer-employee relationship exists
- Contractors usually work for the hiring firm at irregular intervals, on call whenever work is available

7. Set Hours of Work

- The establishment of set hours of work by the hiring firm is a factor indicating control over the worker
- Contractors set their own hours of work

8. Full Time Required

- If the worker must devote substantially full time to the business of the hiring firm, then the hiring firm controls the worker, and restricts the worker from doing other gainful work
- Contractors should not be restricted from seeking and performing other work

9. Doing Work on Employer's Premises

- If the work is performed on the premises of the hiring firm, that factor shows control over the worker, especially if the work could be done elsewhere
- Contractors control where they work. If contractors perform work on the premises of the hiring firm, the firm should not direct or supervise their activities

10. Order or Sequence Set

- If the hiring firm sets, or reserves the right to set, the order or sequence in which work is to be performed, that factor shows control over the worker
- Contractors determine the order and sequence of their work

11. Oral or Written Reports

- A requirement that the worker submit regular or written reports to the hiring firm indicates a degree of control
- Contractors are hired to produce a final result, and therefore should not be required to submit interim reports

12. Payment by Hour, Week or Month

- Payment by the hour, week or month generally points to an employer-employee relationship
- Payment made by the job or on a straight commission generally indicates the worker is an independent contractor. Contractors may accept periodic payments based on a percentage of work completed, or some other fixed schedule determined before the job begins

13. Payment of Business and/or Traveling Expenses

- If the hiring firm ordinarily pays the worker's business and/or traveling expenses, the worker is ordinarily an employee. An employer, to be able to control expenses, generally retains the right to regulate and direct the worker's business activities
- Contractors pay their own incidental expenses

14. Furnishing of Tools and Materials

- The fact that the hiring firm furnishes significant tools, materials, and other equipment tends to show the existence of an employer-employee relationship
- Usually contractors furnish their own tools, materials, and other equipment. If the hiring firm provides such items, they should be leased to the contractor at a fair market rate

15. Significant Investment

- Lack of investment in separate facilities, such as maintenance or rental of an office, indicates dependence on the hiring firm, and accordingly, the existence of an employer-employee relationship
- Contractors should be able to do their work without using the hiring firm's facilities. The contractor's investment in their trade must be real, essential, and adequate

16. Realization of Profit or Loss

- Employees do not realize entrepreneurial profit, and are not at risk of loss as a result of their work
- Contractors should be able to make a profit or suffer a loss as a result of their work

17. Working for More Than One Firm at a Time

- The hiring firm may restrict its employees from working for another firm as a competitor, as a condition of employment
- Contractors are not restricted from working for more than one firm at a time

18. Making Service Available to General Public

- Employees work primarily for the hiring firm
- Contractors make their services available to the general public on a regular and consistent basis

19. Right to Discharge

- An employer exercises control through the threat of dismissal, which causes the worker to obey the employer's instructions
- An independent contractor, on the other hand, cannot be fired so long as the independent contractor produces a result that meets the contract specifications

20. Right to Terminate

- Employees have the right to terminate their relationship at any time without liability

- Contractors are responsible for the satisfactory completion of their contract obligation, and may be subject to a penalty/legal action if they fail to complete the agreed upon work

The above list is adapted from IRS Revenue Ruling 87-41 Listing the 20 Common Law Factors -- Complete Text (1987-1 CB 296).

- A summary of legal issues related to the hiring of independent contractors: *Independent Contractors: A Manager's Guide and Audit Reference*, published by the California Chamber of Commerce, P.O. Box 1736, Sacramento, CA 95812-1736, (916) 444-6670.
- Another resource when considering hiring independent contractors: *The Employer's Legal Guide (1997)* by Stephen Fishman, published by Nolo. An in-depth and comprehensive discussion of employee vs. independent contractor legal issues is available on-line at Fenwick & West: Publications

Contract Employment Agencies (such as Bay Area Recruiters, Inc.) can a Insurance

Independent contractors are NOT necessarily contract employees. But the hiring of independent contractors directly impact the work environment of contract employees. Indeed, the issues related to the hiring of independent contractors are largely responsible for creating the entire independent contractor employment agencies. Hiring firms are at risk from the IRS and contract employment agencies whenever they employ independent contractors.

- One mistake by the hiring firm or its employees, and an independent contractor can be converted into an employee.
- The IRS now investigates the status of independent contractors in all business audits they conduct. The burden of proof is always on the hiring firm to demonstrate unequivocally that an independent contractor is NOT their employee
- If the matter goes to court, and the hiring firm wins, the legal cost of successfully defending itself can be huge. If the hiring firm loses, the cost is even greater still
- Contract employment agencies offer the protection that businesses need to avoid problems with the IRS

It is not surprising that hiring firms seek to protect themselves from legal liability by scrupulously heeding the twenty common law factors and by contacting **Bay Area Recruiters, Inc.** for recruitment services to meet their temporary recruitment needs. There is little question the recruiters BAR supplies are employees of Bay Area Recruiters, Inc. and not your independent contractor.

As you can see from the foregoing discussion, a contract employment agency (such as Bay Area Recruiters, Inc.) provide insurance against the risk of the IRS and other government agencies will reclassify independent contractors as employees.

Please see the section on "The 20 Common Law Guidelines" from the IRS. You can visit this website at: <http://www.edd.ca.gov/taxrep/de38.pdf>.

This information is not meant as legal advice...please consult a legal or tax advisor for advice concerning specific questions and situations.

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