**Chapter Nine**

**Withholding, Estimated Payments and Payroll Taxes**

**Learning Objective 9.1 Withholding Methods**

Employers are required to withhold taxes from the amounts paid to employees as wages. Each employee should complete a Form W-4 to establish their filing status and number of withholding allowances. Employees may have additional amounts withheld from their wages, which can be authorized on a Form W-4. Single employees with only one job may claim one special withholding allowance. Married employees may also claim the special withholding allowance if the employee has only one job and the spouse does not work or wages earned from a second job, or the spouse’s job, are $1,500 or less. Federal withholding is computed based on gross wages before Social Security taxes, pension payments, union dues, insurance and other deductions. Most accounting software has the withholding tables in the payroll programs. The withholding tables are included in IRS Publication 15. Withholding taxes are required on pension and other deferred income payments. For periodic payments, rates are based on the taxpayer’s withholding certificate as if the payments were additional wages. For nonperiodic payments, the withholding is a flat 10 percent, except for certain distributions that have a required 20 percent withholding. Tips are also subject to taxation. Employers are not required to withhold income, Social Security, or Medicare taxes on allocated tips, but are required to collect those taxes on tips reported by employees. Individuals may be subject to backup withholding on payments such as interest and dividends. The payor must withhold 28 percent for payments made to the taxpayers.

**Learning Objective 9.2 Estimated Payments**

Self-employed taxpayers must make quarterly estimated tax payments since they are not subject to withholding. Payments are made on April 15, June 15, and September 15 of the tax year and January 15 of the following tax year based on the estimated tax liability for the tax year. Any taxpayer who has estimated tax liability of $1,000 or more (less withholdings) must make quarterly estimated payments. The requirements for the minimum annual payment are as follows:

1. Ninety percent of the tax shown on the current year’s return, or
2. One hundred percent of the tax shown on the preceding year’s return, or
3. Ninety percent of the tax determined by placing taxable income, alternative minimum taxable income, and adjusted self-employment income on an annualized basis.

Individuals with adjusted gross income in excess of $150,000 for the previous year must pay 110 percent instead of 100 percent to qualify for the safe harbor. The IRS assesses penalties on the underpayment of estimated tax.

**Learning Objective 9.3 The FICA Tax**

The Federal Insurance Contributions Act (FICA) imposed Social Security taxes. FICA taxes have two parts, Social Security (old age, survivors, and disability insurance) and Medicare (hospital insurance). Both employees and employers pay the same FICA tax rates. The Social Security (OASDI) tax rate is 6.2 percent on the first $117,000 of wages and a Medicare tax rate is 1.45 percent on all wages. In addition, the Affordable Care Act imposes an additional Medicare surtax of 0.9 percent applies to high-income taxpayers. (See LO 9.9) The original FICA tax in 1935 was 1 percent on the first $3,000 in earnings. Taxpayers who work for more than one employer could pay more than the maximum amount of FICA taxes. If an overpayment exists, the taxpayer receives a credit on their personal tax return.

**Learning Objective 9.4 Federal Tax Deposit System**

Employers must make deposits for the withholding taxes. The frequency of deposits, typically monthly or semiweekly, is based on the amounts withheld. The deposit status is determined by using a lookback period, consisting of the four quarters beginning July 1 of the second preceding year and ending June 30 of the prior year. If the attributable FICA and withholdings are $50,000 or less, employers are considered monthly depositors. If the attributable FICA and withholdings are greater than $50,000, employers are semiweekly depositors. Tax payments must be remitted through the EFTPS (Electronic Federal Tax Payment System). Each quarter, employers must file a Form 941 to report federal income taxes and total taxes for the quarter.

**Learning Objective 9.5 Employer Reporting Requirements**

Form W-2 is used to report wages, tips and other compensation paid to employees. These forms must be furnished to employees by January 31 of the following calendar year. Form W-3 must be filed with the Social Security Administration by February 28 of the year following the calendar year of payment. Also, gambling winnings are reported on a Form W-2G. Form W-3G is sent to the IRS by February 28 of the year following payment. Form 1099 is used to report the earnings of nonemployees. A Form 1096 must be transmitted to the appropriate IRS Service Center by February 28 of the year following the calendar year of payment.

**Learning Objective 9.6 Self-Employment Tax**

Self-employed taxpayers pay self-employment tax instead of FICA taxes. The individual pays the entire tax. Like the FICA taxes, self-employment taxes consist of a Social Security (OASDI) and a Medicare part. The rate of 12.4 percent on net earnings up to $117,000 for Social Security taxes and 2.9 percent on all net earnings for Medicare is used for self-employed taxpayers. In addition, the Medicare surtax of 0.9 percent applies to high-income taxpayers. (See LO 9.9) Individuals with net earnings from self-employment of $400 or more are subject to self-employment tax.

**Learning Objective 9.7 The FUTA Tax**

Employers are required to pay unemployment tax equal to 6.0 percent of an employee’s wages up to $7,000, but a credit is allowed for state unemployment taxes up to 5.4 percent. Therefore, the effective federal tax rate is only .6 percent if the maximum amount of state tax is paid. Employers in states that have not repaid money borrowed from the federal government for unemployment benefits will have a higher FUTA tax. Employers file a Form 940 once a year and remit payment when the FUTA tax for the quarter plus any amount not yet deposited for prior quarter(s) exceed $500.

**Learning Objective 9.8 The Nanny Tax**

Household employers are not required to pay FICA taxes on cash payments of less than $1,900 paid to any household employee in a calendar year. If the payments exceed $1,900, then the wages are subject to FICA and Medicare taxes. The employer must also pay FUTA tax if more than $1,000 in cash wages is paid to household employees during any calendar quarter. Examples of household employees are babysitters, caretakers, cooks, drivers, gardeners, housekeepers and maids. Under the nanny tax provisions, household employers only have to report FICA and Medicare, federal income tax withholding and FUTA tax once a year. The taxpayer remits the withholdings with their Form 1040. See IRS Publication 926 for more details on the nanny tax.

**LO 9.9 Computing the 0.9 Percent Medicare Surtax for High-Income Taxpayers**

The Affordable Care Act (ACA) imposes a 0.9 percent Medicare surtax on earned income such as salaries, wages and self-employment. This new surtax applies when earned income exceeds $200,000 for taxpayers filing single, head of household and qualifying widow(er), $250,000 for taxpayers filing married filing joint and $125,000 for taxpayers filing married filing separately.

**Employees**

Employers are require to withhold the 0.9 percent surtax when a taxpayer’s salary reaches $200,000 whether single or married. Married couples must combine their earned income and compare the total with the $250,000 threshold to determine if they owe the 0.9 Medicare surtax. When computing the surtax on Form 1040 return they could actually owe additional amounts not withheld or get a refund. Employers report all Medicare taxes withheld on the employee’s W-2. Unlike the ordinary Medicare Tax, employers are not required to share in paying the surtax.

**Self-employed taxpayers**

Self-employed taxpayers generally report earnings on Schedules C, F and E and partnership income is passed through on Schedule K-1. The new Medicare surtax is reported on Form 1040. Several additional rules apply to high-income self-employed taxpayers:

* 0.9 percent surtax is not included in the calculation of deductible self-employment tax to arrive at AGI
* A loss incurred by one spouse can offset earned income by the other self-employed spouse for the calculation of the 0.9 percent surtax. This is not the case with the regular Medicare tax of 2.9 percent calculation since it is calculated separately.
* Losses from self-employment are not allowed to offset salary or wages earned by a high-income taxpayer.