# **ACCT 1130**

# **CHAPTER 4 – INCOME TAX WITHHOLDING**

Before federal income taxes are computed, we must first determine if the following three conditions exist:

1. an employee/employer relationship
2. the payments must be defined as wages by law
3. the employment must not be exempted by the law

Remember, independent contractors such as accountants, doctors, lawyers, architects are not considered employees--thus no federal income taxes are withheld from amounts paid to such individuals. Superintendents, managers and other administrative and executive personnel are considered employees. Partners are not considered employees. An employer is any person or organization for whom an individual performs any service as an employee. This includes: sole proprietors, partnerships, corporations, non-for-profit corporations, federal and state governments.

The term wages includes the total compensation paid to employees for services.

Employers withhold federal income taxes on the gross amount of wages before any payroll deductions are made.

Examples of employee compensation subject to federal income tax withholding include: wages and salaries, vacation allowances, supplemental payments, bonuses and commissions, fringe benefits, tips (more than $20 a month), and cash awards. Payments to employees in a medium other than cash are also taxed. Payments in the form of goods, lodging, food, clothing, or services are taxed at their fair market value at the time that they are given.

Refer to Figure 4.2 for examples of payments exempt from federal income tax withholding. Note that there are no federal income taxes withheld from a deceased person’s wages paid to a beneficiary or an estate. Remember this for the computerized payroll project.

Also note that payments made under worker’s compensation law or contract of insurance are also exempt from federal income tax.

## Pretax salary reductions

Employees can authorize an employer to deduct certain withholdings from his or her pay on a pretax basis. These withholdings are taken from the gross pay and THEN the federal income tax is figured—so the amount of pay subject to federal income taxes is reduced.

Salary reductions under a cafeteria plan are also pretax (exempt from federal income tax, FICA, FUTA, and most states’ income taxes). However certain benefits cannot be included in a cafeteria plan, such as educational assistance.

## Tax Deferred Retirement Accounts

These types of accounts allow employees to contribute amounts from their wages into retirement accounts. These contributions reduce the amount of employees’ wages that are subject to federal income tax.

IRA (Individual Retirement Account) Under certain conditions, employees can put aside each year the lesser of $6,000 or 100% ($7,000 if over age 50) of their compensation without paying federal income taxes on their contributions. The amounts are taxable upon withdrawal at retirement.

In order to make a fully tax deductible IRA contribution, either of these two conditions must be met:

1. individual must not belong to a company-funded retirement account
2. individual has modified adjusted gross income less than $65,000 single) or $104,000 (married).

If the employee belongs to another qualified plan, the amount a single individual can contribute to an IRA tax-free is reduced when their modified adjusted gross income reaches $65,000 and completely phases out at $75,000. If the individual is married, the amount they can contribute to an IRA tax-free is reduced when their modified adjusted gross income reaches $104,000 and completely phases out at $124,000. If the individual is married filing separately, the amount they can contribute to an IRA tax-free is completely phased out at $10,000.

If an employee’s SPOUSE belongs to a company-funded retirement plan, the employee is not considered an active participant in the plan. However, the nonactive spouse’s tax-free IRA deduction ($6,000) will begin to phase out between $196,000 and $206,000. It is completely phased out at $206,000 of their adjusted gross income.

## Roth IRA

Another type of IRA that allows taxpayers and their spouses to make annual nondeductible contributions up to $6,000 ($7,000 if over age 50) is the Roth IRA. The amount that may be contributed is reduced by the amount contributed into other IRAS. Allowable contributions are phased out for employees have an adjusted gross income of between $124,000 and $139,000 for single taxpayers, $196,000 and $206,000 for joint taxpayers, and $0 and $10,000 for married taxpayers filing separately.

The advantage of a ROTH IRA is that distributions made out of the fund at retirement are tax-free if all requirements are met.

401K Employees can contribute up to $19,500 or 100% of their pay, whichever is less, an extra $6,500 if age 50 or over. Employer can contribute up to 100% of employee’s pay. Maximum combined contribution is $57,000 ($63,500 if age 50 or over)

## Simple Retirement Accounts

Simple Retirement Accounts are for employers with up to 100 employees. Employer cannot have an employer-sponsored retirement plan. Employees can contribute a maximum of $13,500 per year, and extra $3,000 if over age 50. Employers must match employee’s contribution up to 3% of their gross pay.

## Withholding Allowances

The law entitles employees to exempt a portion of their earnings from withholding by claiming a personal allowance and allowances for their dependents if they furnish their employers with a claim for the allowances. (Form W-4) The allowance amount was $4,200 for 2019. Employees cannot claim the same withholding allowances with more than one employer at the same time. If the employee has a second job or if the spouse also works, the personal allowances that the employee is entitled to should not also be claimed on the other job.

All employees should complete a W-4 when he or she begins work for an employer. The certificate remains in effect until an amended certificate takes effect. Withholding certificates should be retained as long as they are in effect and for 4 years thereafter. If the employee does not complete the W-4, the employer withholds taxes as if the employee is single, with no withholding allowances.

Employees may amend W-4 certificates, if necessary. The employer makes the certificate effective no later than the start of the first payroll period ending on or after the 30th day from the date the replacement Form W-4 is received.

Employees claiming to be exempt from federal income taxes still will have Social Security withheld. In order to be exempt, the taxpayer must have had no income tax liability last year and not expect tax liability this year.

Employers are not required to verify the authenticity of the information on employees’ W-4’s. However, if the form is altered in any way or if the employee acknowledges that the information is false, the employer cannot accept the invalid W-4. The employer can ask for a new W-4. If the employee refuses to submit a new one, the employer can use the employee’s most recent W-4 on file or, if a new hire, withholding as I the employee were single with no allowances. Regulations require employees to only submit copies of employees’ Forms W-4 that are requested in a written notice from the IRS.

Penalties are steep for employees who willfully file false W-4's. Fines are up to $1,000 or imprisonment for up to one year, or both.

## Computing Federal Income Tax Withholding

2 methods for computing federal income tax withheld:

Percentage method - using the tax rate schedules—Refer to Tax Table A at T-1 thru T-4

Wage Bracket method - using the tax tables—Refer to Tax Table B at T-5 thru T-14

Both of these methods distinguish between married and unmarried persons, and both methods provide the full benefit of the allowances claimed by the employee on his/her W-4. Both methods take into account a standard deduction, an amount of money used to reduce an individual’s adjusted gross income in arriving at the taxable income.

Supplemental wages include such items as vacation pay, bonuses, commissions, and dismissal pay.

Vacation pay is subject to withholding as though it were a regular payment made for the payroll period or periods occurring during the vacation.

If supplemental wages are paid in with regular wages, the employer has 2 options:

1. If supplemental wage amount is not specified, then compute withholdings as if the total were a single payment for a regular payroll period.
2. if the employer specifically indicates the amount of each payment, the employer may withhold at a *flat 25%* on the supplemental wages, if the tax is withheld on the employee’s regular wages at the appropriate rate.

**Gross Up**

In order to give an employee the intended amount of a supplemental payment, the employer will need to gross up the payment so that after the appropriate payroll taxes are withheld, the net amount left is equal to the original intended payment.

## Wage and Tax Statements

Forms W-2 Wage and Tax Statement (see Figure 4.8) must be furnished to employees by January 31 following the close of the calendar year. Such info is included as wages, tips, social security withheld, federal income taxes withheld, advance earned income credits received, etc.

If 250 or more W-2’s are being filed, reporting must be done electronically.

The IRS allows employers to put W-2’s on a secure Web site and provide employees with passwords to access their individual W-2’s. As long as an employee has affirmatively consented, his or her W-2 can be send electronically. The consent by the employee must also be made electronically in a manner that indicates that the employee will be able to access the W-2. The W-2 must be posted on or before January 31 (kept until October 15) and the employee must be notified of its availability and must be given instructions on how to access and print the W-2.

Form W-2c in Figure 4.10 is the Statement of Corrected Income and Tax Amounts. Form W-3 (see Figure 4.11) is the Transmittal of Wage and Tax Statements -- Must be filed with the Social Security Administration by employers and other payers as a transmittal (summary) for Forms W-2. Note the penalties imposed for late or incorrect filing of W-2’s referred to at 4-7d.

Employers must complete certain tax returns and reports during the year--we have already studied Form 941, for example. The IRS requires employers to file information returns to report compensation paid to certain individuals who are not employees. Refer to Figure 4.12.

Students will not be responsible for preparing 941's or W-2's on the test.

Payments made to independent contractors of at least $600 must be reported on Form 1090-Miscellaneous Income.

Independent contractors must provide taxpayer identification numbers to their employers (orally, in writing, or on Form W-9). If this is not done and the company anticipates paying the contractor $600 or more, the company must withhold federal income taxes of 28 percent of the payments made.

If employers file 250 or more W-2's or information returns, they must use electronic filing instead of paper forms.

State and local withholding and reporting varies according to state, therefore, employers should become familiar with the tax regulations of the state in which their business is located and of the state or states in which their employees reside.