EMPLOYMENT TAXES

UNDERSTANDING AND PAYING PAYROLL TAXES

Wolters Kluwer

Understanding and Paying Payroll Taxes

As an employer, one of your automatically-assigned responsibilities is to withhold and pay federal and state payroll taxes. The IRS takes your obligation very seriously. The payroll tax system is a voluntary one in the sense that you must take the initiative to comply. To ensure compliance, however, the IRS cracks down hard on violators.

This booklet will help you to understand the basic concepts of payroll tax withholding. You'll learn what federal taxes must be withheld from an employee's pay, how those taxes are deposited with the government, and how to report withholding to the IRS. This booklet is designed for the small to medium size employer, with special highlights for very small employers.

WHAT ARE PAYROLL TAXES?

When people talk about "payroll taxes" they mean the bundle of taxes that are withheld from most workers' paychecks every week, bi-weekly or monthly. Payroll taxes include Social Security, Medicare, unemployment insurance, and state and federal income taxes. As we all know, payroll taxes add up very quickly.

Employers have a huge responsibility to pay federal payroll taxes on behalf of their employees. Employers act as the government's collection agents much the same way as retailers act as collection agents for sales taxes. The federal government keeps careful track of payroll. Employers that do not deposit their employment taxes timely, fall behind in their payments or get into other trouble are severely sanctioned.

Employers must:

- Withhold payroll taxes from their employees' paychecks;
- Deposit the withheld taxes;
- Report their withholding activities to the federal government either monthly, quarterly or annually; and
- Keep records of their withholding and deposits.

SOCIAL SECURITY AND MEDICARE

FICA stands for the *Federal Insurance Contributions Act*. This law imposes two taxes on employers and employees. One tax pays for the federal old-age, survivor and disability insurance (OASDI) program, which we know more commonly

as Social Security. The other tax pays for the hospital and hospital service insurance (HI) program for individuals age 65 and older. HI is more commonly known as Medicare.

FICA requires employers to withhold the employee's portion of these taxes from each payment of wages, which are computed at a fixed rate of the employee's gross taxable wages. The fixed Social Security rate is different than the fixed Medicare rate.

Your withholding duty is triggered whenever wages are paid, regardless of how often they are paid. If wages are paid weekly, withholding must be weekly. If wages are paid monthly, withholding must be monthly.

Reminder. You must withhold payroll taxes even if you are providing noncash compensation. In that case, you have to calculate the cash equivalent that would have been withheld and pay it over to the government.

The second FICA requirement is that you pay your own portion of the tax. Because the employer's portion of the tax is usually identical to that withheld from the employee's wages, you are effectively paying double the amount withheld for employees.

TAXABLE WAGE BASE

An employee's "taxable wage base" is an annual limit for Social Security taxes. Once that limit is reached, you do not have to withhold any more Social Security tax for that employee.

For 2014, the maximum amount of earnings subject to Social Security tax is $117,000. This amount is adjusted each year for inflation.

UNEMPLOYMENT INSURANCE

FUTA, the *Federal Unemployment Tax Act*, pays for a joint federal/state program to provide unemployment benefits. Only employers (or self-employed persons) pay FUTA tax. Employees do not.

FUTA tax is not withheld from employees' paychecks. Employers must deposit and pay over FUTA taxes.

FUTA, like FICA, is subject to a taxable wage base. Employers no longer owe the tax once the wage base is met.

The FUTA taxable wage base is $7,000, and does not change from year to year, unlike FICA's Social Security wage base.

> ***Caution.*** The $7,000 FUTA taxable wage base is the federal wage base. Your state wage base may differ. The IRS allows you to take a credit against your FUTA tax for amounts that you paid into state unemployment funds. The maximum credit is 5.4% of taxable wages.

FEDERAL INCOME TAX

Income tax withholding is different from FICA and FUTA withholding. FICA and FUTA are both a tax and a system for collecting the tax.

You must withhold a specified amount or percentage from each paycheck that is intended to approximate the employee's income tax liability. The computation is based on information the employee provides to you, such as his or her filing status, the number of dependents and the number of exemptions. Employers send withheld income taxes to the federal government on the employee's behalf.

WHO MUST WITHHOLD

Income tax and FICA. The tax law requires "employers" to withhold income tax and FICA. The definition of employer for income tax and FICA withholding is very broad and inclusive. An employer is a person for whom an individual performs services as an employee.

PAYROLL TAX	EMPLOYEE PAYS?	EMPLOYER PAYS?	WAGE BASE APPLICABLE?
Social Security (FICA)	Yes	Yes	Yes
Medicare (FICA)	Yes	Yes	No
FUTA	No	Yes	Yes
Income	Employer estimates for employee and withholds	N/A	No

The "person" referred to in the definition can be an individual, an organization or a government. It can be a corporation, a partnership, or a trust…pretty much anything.

There is one important distinction between "employer" for income tax withholding and FICA withholding. This involves the situation where one entity hires the employee but another controls payment of the wages. Income tax withholding looks to who controls the payment of wages. FICA withholding looks to who controls the employees.

FUTA. The definition of employer for FUTA is based on numerical guides. You are an employer for FUTA purposes if you:

- Paid wages of $1,500 or more during any calendar quarter; or
- Had at least one individual as an employee for some part of the day in each of 20 different calendar weeks.

The second part of the test is called the "1-in-20" test.

> ***Caution.*** The FUTA definition of "employer" is different for agricultural employers and employers of domestic help.

TYPES OF EMPLOYMENT SUBJECT TO PAYROLL TAXES

Most people see payroll taxes deducted from their paychecks. However, a large

number of people are fully or partially exempt. Special rules and exemptions from withholding apply to:

- Agricultural laborers;
- Casual laborers;
- Child care and other domestic workers;
- Family employment;
- Fishing and related activities;
- Service as a federal employee;
- Service as a state or municipal employee;
- Service outside the U.S.;
- Service as a newspaper distributor;
- Service performed for a religious, charitable or other non-profit organization;
- Service as a student nurse;
- Services by an alien or other nonresident; and
- Service as an employee representative.

COMPUTING INCOME TAX WITHHOLDING

The income tax withholding computation begins with Form W-4, Employee's Withholding Allowance Certificate. Your employees must file this form with you. Form W-4 tells you how many allowances and exemptions the employee is claiming.

> ***Comment.*** Once an employee gives you a Form W-4, it remains in effect until he or she gives you a new one. If an employee changes his or her Form W-4, you must begin withholding from the start of the first payroll period ending on or after the 30th day from the date when you received the new W-4.

> ***Comment.*** Form W-4 is also available in Spanish. The Spanish-version is Form W-4(SP), Certificado de Exencion de la Retencion del(la) Empleado(a). The instructions are also available in Spanish.

Exemptions. Some employees may claim an exemption from federal income tax withholding. Nonetheless, the employee's wages are still subject to Social Security and Medicare taxes.

If an employee claims an exemption from federal income tax withholding, the exemption is valid for only one year. If the employee wishes to continue having no income tax withheld, he or she must give you a new Form W-4 by February 15. Otherwise, you must withhold tax as if the employee is single with zero withholding allowances or withhold based on the last Form W-4 that you have for the employee.

You should not send completed Forms W-4 to the IRS unless the IRS requests that you do so. If the IRS discovers a problem, you may receive what is known as a "lock-in" letter. The IRS will tell you the maximum number of allowances permitted for the employee.

Withholding method. The next step is to select a withholding method. The general rule is that taxes to be withheld can be computed in any of the following ways:

- The percentage method;
- The wage bracket method;
- A method using alternative formula tables; or
- Any other method that produces an amount withheld that is substantially the same as that calculated under the wage bracket method.

These methods are based on tables that can be found in Circular E, Employer's Tax Guide, published by the IRS.

COMPUTING FICA AND FUTA

Computing FICA is a little more complicated than computing FUTA. FICA consists of two taxes: Social Security (the old-age, survivors and disability insurance (OASDI)) and Medicare (hospital insurance (HI)), which differ some in their treatments.

The Social Security portion of FICA is imposed on both employer and employee. For 2014, Social Security tax is imposed on both the employer and employee at 6.2 percent each, up to the taxable wage base of $117,000 (discussed in further detail below).

The Medicare tax is imposed on both employer and employee at 1.45 percent each. However, an employee with wages in excess of $200,000 ($250,000 if married filing jointly, $125,000 if married filing separately) is subject to an additional Medicare tax on those wages at a rate of 0.9 percent. There is no employer share for this tax. As an employer, you are required only to withhold as to wages that you pay to your employee in excess of $200,000. In other words, when withholding, you disregard the employee's marital status and the spouse's income.

> ***Comment.*** An employee who, after factoring in his or her spouse's wages, earns more than the threshold amount is responsible for paying the additional Medicare tax without employer-required withholding. If, on the other hand, too much is withheld, the employee may be able to claim a credit on his or her return.

When computing FICA tax liability, you have to remember the wage bases. Wages above the wage base are exempt from the Social Security portion of FICA. They are not exempt from Medicare tax, but a separate threshold applies for purposes of the additional Medicare tax, above which the tax is imposed.

Accordingly, the amount that employers and employees pay in FICA tax depends on the amount of wages paid to the employee. In general, however, employers and employees normally each pay FICA tax at rate of 7.65 percent. As a comparison, self-employed individuals pay twice that, 15.3 percent, on self-employment income.

Second job. If your employee also works elsewhere, you cannot subtract his or her salary elsewhere from the annual maximum wage base. You must continue to pay your full share of FICA taxes as if you are the only employer. Your employee, however, is allowed to get a refund of his or her share of excess payments when filing their tax return for the year. For 2014, the FUTA tax rate is 6.0 percent of wages.

FUTA is also subject to a wage base but it is much lower than the Social Security wage base. It is only $7,000. You pay FUTA tax only on an employee's first $7,000 of wages.

DEPOSITING PAYROLL TAXES

Depositing payroll taxes correctly, fully and on time is very important. If you miss any of these steps, the IRS will penalize you, and the penalties can be harsh.

> ***Comment.*** An employer who fails to make a timely deposit generally must pay a 10-percent failure-to-deposit penalty.

In general, employers must deposit federal income taxes withheld and both the employer and employee Social Security and Medicare taxes. Employers must use electronic fund transfers to make all federal tax deposits.

Generally, electronic fund transfers are made through the Electronic Federal Tax Payment System (EFTPS), a free service provided by the Treasury Department. Employers who do not want to use EFTPS can have a tax professional, financial institution, payroll service or other third party make deposits on the employer's behalf. New employers will be automatically enrolled in EFTPS.

HOW OFTEN MUST PAYROLL TAXES BE PAID?

Most small employers deposit payroll taxes quarterly. Large employers reporting total payroll taxes of more than $50,000 make semi-weekly deposits; medium employers reporting total payroll taxes of $50,000 or less make monthly deposits. Under the Form

944 Program, discussed in further detail later, very small employers are able to pay their payroll taxes annually instead of quarterly.

"Look-back" period. The frequency and amount of deposits depend on your deposit history. The IRS uses a "look-back" period, which is the four calendar quarters ending June 30 of the preceding year. The look-back period for calendar year 2014 is the period from July 1, 2012, through June 30, 2013.

> ***Example.*** For calendar year 2014, ABC Co. determines its depositor status using the look-back period July 1, 2012, through June 30, 2013. For the four calendar quarters within this period, ABC Co. reported aggregate employment tax liabilities of $42,000 on its quarterly Form 941, Employer's Quarterly Federal Tax Return. Because the aggregate amount did not exceed $50,000, ABC Co. is a monthly depositor for the entire calendar year 2014 (unless the special "one day" rule, see below, comes into play).

Small employers for purposes of qualifying for the annual payment schedule generally accumulate less than $2,500 during the current or preceding quarter, adding together FICA taxes (including the employer and employee portions) and income tax withholding.

Medium employers generally accumulate $50,000 or less during the look-back period. Large employers accumulate more than $50,000 during the look-back period.

> ***Example.*** XYZ Co. reported $88,000 in aggregate employment tax liabilities on Form 941, Employer's Quarterly Federal Tax Return for the four quarters spanning July 1, 2012, through June 30, 2013. Because XYZ Co.'s aggregate amount exceeds $50,000, it is a semi-weekly depositor for the entire calendar year 2014.

Monthly depositors must deposit payroll taxes on or before the 15th day of the following month. Semi-weekly depositors must make deposits with respect to payments made on Wednesday, Thursday, and/or Friday on or before the following Wednesday. Deposits made with respect to payments made Saturday, Sunday, Monday, and/or Tuesday must be made on or before the following Friday.

Exception. There is one exception. If you accumulate $100,000 or more of payroll taxes on any day, you are subject to a special one-day rule. You must deposit the accumulated taxes by the close of the following day. If you had been a monthly depositor, you become a semi-weekly depositor for the remainder of the calendar year and for the following year.

Timely deposits. Deposits are only due on business days (any day other than a Saturday, Sunday, or legal holiday). If a deposit is required on a non-business

day, it is considered timely if it is made by the close of the next business day. Semiweekly depositors have at least three business days to make a deposit. If any of the three weekdays is a legal holiday, the deposit period is extended an additional day for each holiday.

For deposits made by EFTPS to be on time, the employer must initiate the deposit by 8 P.M. Eastern time the day before the deposit is due. A third party used by an employer to make a deposit may have a different cutoff time.

Employers who do not initiate an EFTPS payment by 8 P.M. Eastern time can make a deposit on time (same-day payment option) using the Federal Tax Application. Employers must make arrangements with a financial institution ahead of time to use this method. Information on this method is available on the Same-Day Payment Worksheet, available on the Internet through *www.eftps.gov.*

FUTA taxes. Up to now we've discussed only FICA and income tax withholding. You are required to compute your FUTA liability quarterly. If at the end of any calendar quarter, your undeposited FUTA tax liability is more than $500, you must make a FUTA deposit by the last day of the following month. You make your FUTA deposit in the same manner as FICA and income taxes. If your unpaid balance at the end of the year is more than $500, you must make a deposit by January 31. Otherwise, you can send the payment to the IRS with Form 940, which is the annual FUTA tax return.

Form 944 Program. The IRS's Form 944 Program allows eligible small employers to file an annual return on new Form 944, Employer's Annual Federal Tax Return, rather than a quarterly return on Form 941, Employer's Quarterly Tax Return.

Most participating employers can also pay their employment taxes annually with their Form 944, rather than making monthly or semi-weekly deposits. Generally, Form 944 is due January 31 of the year following the year for which the return is filed.

The Form 944 Program is generally limited to employers whose annual estimated employment tax liability is $1,000 or less. The program modifies the "look-back" period discussed above. For most employers, the look-back period is the 12-month period ending on the preceding June 30. For employers in the Form 944 Program, the look-back period is the second calendar year preceding the current calendar year.

> ***Example.*** ABC Co. is a very small employer with an annual estimated employment tax liability of $1,000 or less. ABC Co.'s look-back period for 2014 is the calendar year 2012.

An employer may not realize that its annual employment tax liability exceeds $1,000 until it files its Form 944 on January 31 of the following year. The employer can avoid the penalty for failing to make a timely deposit of its January taxes as long as it pays its January employment taxes by March 15.

If the IRS notifies an employer to file Form 944, that employer is required to file Form 944 unless the employer opts out. An employer that does not receive a notice but would like to file Form 944 may contact the IRS to request to file Form 944.

TIP WITHHOLDING

If any of your employees earn $20 or more in tips in one month, he or she must report them to you. The tips reported are subject to income tax withholding.

You have two options if income tax was withheld from regular wages. You can withhold on the tips at a flat rate of 25 percent or you can add the tips to the regular wages and withhold as if the total was a single wage payment.

You need to estimate how much tip income your employees will receive in a quarter and then withhold for those tips from the regular wages. The IRS requires that you allocate the withholding in a special order.

Comment. Large food and beverage establishments must report allocated tips in some circumstances. If you have more than 10 employees on a typical business day, you may be a large food and beverage establishment. There are also additional criteria.

Comment. The IRS has several voluntary tip compliance programs in which employers can participate.

REPORTING PAYROLL TAXES

Quarterly tax returns. Quarterly tax returns are made on Form 941, Employer's Quarterly Federal Tax Return. This form records the amount of federal income and FICA taxes withheld for that quarter. Form 941 is due at the end of the month following the end of the quarter.

Comment. There are special forms for some employers. Agricultural employers use Form 943, Employer's Annual Tax Return for Agricultural Employees. Employers that pay wages for domestic services in their private homes use Schedule H, Household Employment

Taxes, which they attach to Form 1040, U.S. Individual Income Tax Return.

Form 944 Program for small employers. Very small employers that qualify for the Form 944 Program will file annual returns on Form 944, Employer's Annual Federal Tax Return (see above).

Annual FUTA returns. The general rule is that every employer who is subject to FUTA tax during a calendar year must file an annual return with the IRS on Form 940, Employer's Annual Federal Unemployment Tax Return. Form 940 is due by January 31.

Small employers may be eligible to use Form 940-EZ.

FORM W-2

The withholding tax information statement, which is sent annually to the Social Security Administration (SSA), is Form W-2, Wage and Tax Statement. Form W-3, Transmittal of Wage and Tax Statements, must accompany all Forms W-2.

You must file Forms W-2 and W-3 by the last day of February. The IRS will give you an extension of up to 30-days for good cause.

Employers complete one Form W-2 for each employee. The information includes all wages, tips and other compensation, and withheld income and Social Security taxes. Form W-3 contains the totals of all W-2s. You file one Form W-3 with the W-2s.

> ***Comment.*** If you file at least 250 W-2s you have until March 31 to file with the IRS. However, they then must be filed electronically.

Copies to employees. You must give each employee copies of Form W-2 by January 31 for wages paid the previous year.

> ***Caution.*** If an employee terminates employment and requests, in writing, a Form W-2, you must supply one within 30 days.

Independent contractors. Payments of more than $600 made to independent contractors are not reported on Form W-2. Instead, you must use Form 1099-MISC, Miscellaneous Income.

RECORDKEEPING

You must keep accurate records of payroll taxes and give them to the IRS if the IRS asks to see them. The IRS doesn't require that you keep these records in any particular manner but the method must be good enough for the IRS to determine if you've satisfied all of your withholding obligations.

At a minimum, your records should:

- Identify the employee;
- Record the total amount and date of each wage payment;

- List the period of services covered by the wage payment;
- Provide the amount of each wage payment that is wages subject to withholding; and
- Record the amount of tax collected with respect to each wage payment.

It's also a good idea to keep copies of Forms W-2 given to each employee. If your employees receive tips, you need to keep copies of the statements of tip income employees provide to you.

FAILING TO PAY PAYROLL TAXES

Employers that do not deduct and pay payroll taxes are liable for civil and criminal penalties as well as interest. The punishment differs depending on whether the failure to pay was intentional or inadvertent and, in some cases, how long the failure lasted. The penalties for intentional mistakes are much harsher than for inadvertent mistakes.

Comment. What is an "inadvertent" mistake? This includes everything from wrongly but honestly treating an employee as an independent contractor to mathematical errors.

Caution. The fact that your business may be in financial trouble is never an excuse for "borrowing" withheld amounts and then being unable to pay over those amounts to the government when due. Even going into formal bankruptcy doesn't change this rule. The IRS also has made no exception because of the current economic downturn.

Overwithholding and underwithholding. An employer that underpaid should:

- File its return showing the proper amount of withholding; and
- Pay that amount by the due date of the return.

If these conditions are met, the employer generally will not owe interest on the underwithholding. If underwithholding is habitual or otherwise intentional, however, penalties may apply.

An employer that overpaid should:

- Repay the amount overwithheld to the employee before the return is filed; and
- Get a receipt from the employee showing the amount of overpayment.

If these conditions are met, the employer generally will not need to report or pay any overwithholding to the IRS.

Errors on returns. The situation is more complicated if you discover an error on your return. If the return has already been filed, you must amend it. You'll also have to pay interest on any underpayment.

Criminal penalties. In egregious cases, failure to report and pay federal payroll taxes can be a felony. Violators risk five years in prison and a fine of up to $10,000. Failing to collect and pay after notice from the IRS is a misdemeanor and is punishable by imprisonment for up to one year and a fine of up to $5,000. Both failing to furnish or furnishing false returns and supplying false withholding information are misdemeanors.

The statute of limitations for these offenses is generally three years. This means that the government cannot prosecute violators more than three years after the date the crime was allegedly committed.

Civil penalties. The most important civil penalty is the "trust fund recovery penalty." The penalty is equal to the amount of tax evaded, or not collected, or not accounted for and paid over to the government. Violators pay not only the amount due but also the same amount as a penalty.

> ***Caution.*** The trust fund recovery penalty applies to the individual who is responsible for collecting and paying federal payroll taxes and not the employer. The employer's liability is separate. The IRS can impose a separate penalty of up to 15 percent of the underpayment on the employer. When payroll taxes aren't paid, some business owner/managers blame the bookkeeper. That finger-pointing usually does no good since any and all "responsible persons" are liable for the payments. A responsible person is someone within the company in a position of authority who knew *or should have known* about the mishandling of the payments. The IRS can single out one among several "responsible persons" and force that person to pay all taxes, penalties and interest. It would then be up to that responsible person to sue the others in civil court.

Other penalties. The IRS can also impose monetary penalties for failing to file a timely tax return, payment by bad check, underpayment of tax caused by negligence, failing to pay the employer portion of FICA, and aiding and abetting the understatement of tax.

Interest. The IRS also charges interest on assessed payroll taxes that are not timely deducted or paid. The interest rate for noncorporate underpayments is the federal short-term rate plus three percent. For large corporate underpayments, the rate increases to five percent on top of the federal short-term rate. If interest is excessive, the IRS can abate it but this is solely within the discretion of the IRS.

Comment. The federal short-term rate is adjusted quarterly.

Caution. Many employers outsource their payroll to a third party. The liability of the third party depends on its relationship to the employer. The IRS looks to whether the third party acts as an actual payer of the taxes or merely as a conduit for the employer's payment of the taxes. In the first case, the third party generally will be liable just like the employer for failing to withhold and pay over federal payroll taxes. In the second case, the third party's liability arises if the IRS has given it authority to act as a payer.