After reading this chapter, we finally understand all those boxes and how they were calculated on the W-2 form that we received at year’s end. What are taxable fringe benefits? How do we withhold on tips? What are pre-tax deductions? How do you fill out a W-4 form?

After studying forms W-2, W-2c, W-3, W-4, W-5, 941, 1099-MISC, etc., we realize why the Internal Revenue Service needs over 100,000 employees.
AFTER STUDYING THIS CHAPTER, YOU SHOULD BE ABLE TO:

1. Explain coverage under the federal income tax withholding law by determining: (a) the employer-employee relationship, (b) the kinds of payments defined as wages, and (c) the kinds of employment excluded under the law.

2. Explain the types of withholding allowances that may be claimed by employees for income tax withholding purposes.

3. Explain the purpose of Form W-4 and list the proper procedures for using the information contained on the form.

4. Compute the amount of federal income tax to be withheld using: (a) the percentage method and (b) the wage-bracket method.

5. Compute the amount of federal income tax to be withheld using alternative methods such as quarterly averaging and annualizing of wages.

6. Compute the withholding of federal income taxes on supplementary wage payments.

7. Explain how employees may receive advance earned income credit and how the employer computes the amount of the advance.

8. Complete Form W-2 and become familiar with other wage and tax statements.


10. Describe the major types of information returns.

11. Explain the impact of state and local income taxes on the payroll accounting process.
Due to printing schedules, the tax tables at the end of the book are the tables that were in effect until December 31, 2004.

At the beginning of World War II, the income tax became the principal source of revenue to finance government operations. The Rumr plan put the collection of this tax on a pay-as-you-go basis. This chapter describes the employer’s responsibility for withholding income taxes from employees’ wages and paying these taxes to the federal government. In addition, many employers must also comply with state, city, and county income tax withholding laws. Employers must be aware of these laws to avoid possible penalties.

**COVERAGE UNDER FEDERAL INCOME TAX WITHHOLDING LAWS**

Before an individual withholds any tax under the tax law, the following conditions must exist:

1. There must be, or have been, an employer-employee relationship.
2. The payments received by the employee must be defined as wages under the law.
3. The employment must not be exempted by the law.

**Employer-Employee Relationship**

As discussed in Chapter 3, establishing the correct relationship between the employer and employee is a very important factor in complying with the Social Security Tax Law. This also applies to the Federal Income Tax Withholding Law.

If a business has the right to control and direct the worker, it meets the definition of an employer under the common-law criteria.

Employers can be sole proprietorships, partners, corporations, not-for-profit corporations, and federal and state governments. No distinctions are made between classes or grades of employees—from executives to entry-level personnel. Directors of a corporation are not considered employees unless they perform services other than participation in board meetings. Partners are also eliminated from the definition of an employee.

If the employer-employee relationship exists, the pay is subject to federal income tax withholding.

**Statutory Employees/Nonemployees**

If a worker does not qualify as an employee under the Common Law Test, federal income taxes are not withheld. However, by statute, he or she may be considered an employee for FICA and FUTA taxes under certain conditions. As discussed in Chapter 3, this applies to agent drivers, full-time life insurance salespersons, homeworkers, and traveling or city salespersons.

Direct sellers and qualified real estate agents are considered nonemployees by statute. They are treated as self-employed for all federal tax purposes.

**Taxable Wages**

For withholding purposes, the term wages includes the total compensation paid to employees for services. Employers withhold federal income taxes on the gross amount of wages before deductions such as state and local taxes, insurance premiums, savings bonds, profit-sharing contributions, and union dues. Examples of employee compensation subject to withholding include:

- Wages and salaries
- Vacation allowances
- Supplemental payments
- Bonuses and commissions
- Taxable fringe benefits
- Tips
- Cash awards
Employees may receive compensation in ways other than their regular wage payments. Figure 4–1 shows some special types of payments that are also subject to federal income tax withholding.

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.

**Fringe Benefits**

Unless the law says otherwise, fringe benefits are subject to federal income tax withholding. In general, the taxable portion is the amount by which the fair market value of the benefits exceed what the employee paid, plus any amount the law excludes. Fringe benefits include employer-provided items such as those listed at the top of page 4-6.

<table>
<thead>
<tr>
<th>Taxable Payments to Employees</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Disabled Worker's Wages</strong></td>
</tr>
<tr>
<td><strong>Drawing Account Advances</strong></td>
</tr>
<tr>
<td><strong>Meals and Lodging</strong></td>
</tr>
<tr>
<td><strong>Moving Expenses</strong></td>
</tr>
<tr>
<td><strong>Partially Exempt Employment</strong></td>
</tr>
<tr>
<td><strong>Payments to Nonresident Aliens</strong></td>
</tr>
<tr>
<td><strong>Sick Pay</strong></td>
</tr>
<tr>
<td><strong>Supplemental Unemployment Compensation</strong></td>
</tr>
<tr>
<td><strong>Travel and Business Expenses (non-accountable plans)</strong></td>
</tr>
</tbody>
</table>
• Cars
• Free or discounted flights
• Discounts on property or services
• Vacations
• Memberships in social or country clubs
• Tickets for entertainment and sporting events

Withholding on Fringe Benefits. Determination of the value of the fringe benefit must be made by January 31 of the following year. For withholding and depositing purposes, reasonable estimates may be used before that date. The employer may add the value of fringe benefits to regular wages for a payroll period and figure withholding taxes on the total or may withhold the tax on the value of the benefits at the flat 25 percent supplemental wage rate.

The employer may choose not to withhold income tax on the value of an employee's personal use of a vehicle. The employer must, however, withhold social security, Medicare, or railroad retirement taxes on the use of the vehicle.

Flexible Reporting. With noncash fringe benefits, the employer has the option of treating the benefits as being paid on any basis (paying monthly, at year-end, etc.). As long as the benefits are treated as paid by December 31, the employer can choose any option.

Due to a special period rule, employers can even use October 31 as the cutoff date for valuing the noncash fringe benefit. This rule allows employers to treat noncash fringe benefits of November and December as being provided in the following year and therefore taxed in the next year.

If this special rule is applied to a particular benefit, it must apply to all employees who receive this benefit. Also, if applied, the employer must notify the employees of this special rule treatment prior to giving them their W-2 forms.

Employers may treat the value of a single fringe benefit as paid on one or more dates in the same calendar year even if the employee receives the entire benefit at one time.

A one-time receipt of a $1,000 fringe benefit in 2005 can be treated as four payments of $250, each in a different pay period of 2005.

Nontaxable Fringe Benefits

Fringe benefits that are nontaxable include:

• Services provided at no additional cost
• Qualified employee discounts
• Working condition fringes
• Minimal value fringes
• Qualified transportation fringes
• Use of on-premises athletic facilities
• Reduced tuition for education
• Job-placement assistance

Services the employer provides at no additional cost, qualified employee discounts, meals at employer-run eating establishments, and reduced tuition are excluded from their income only if the benefits are given to employees on a nondiscriminatory basis.

Taxable Tips

As reported in Chapter 3, employees must report cash tips to the employer by the 10th of the month following the month they receive the tips. This report includes tips paid by the employer for charge customers and tips the employee receives directly from the customers. Tips of less than $20 in a month and noncash tips need not be reported.
**Withholding from Tips.** The employer collects income tax, as well as social security taxes, on reported tips. The following procedures apply to withholding income tax on reported tips:

1. The employer collects the tax from the employee’s wages or from other funds the employee makes available.
2. When tips are reported in connection with employment where the employee also receives a regular wage, compute the withholding tax on the aggregate—treat tips as a supplemental wage payment.
3. If the withholding tax exceeds the amount of wages paid to the employee, the employee must pay the uncollected portion of the taxes directly to the IRS when filing the annual income tax return (Form 1040).
4. The employer is not required to audit or verify the accuracy of the tip income reported.

**Allocated Tips.** Large food and beverage establishments that have customary tipping and normally had more than 10 employees on a typical business day in the preceding year may be required to allocate tips among employees if:

- The total tips reported by the employees during any payroll period are less than 8 percent of the establishment’s gross receipts for that period.

The amount of allocated tips to employees equals:

- The difference between tips reported and 8 percent of gross receipts, other than carry-out sales and sales with at least a 10 percent service charge added.

The tip allocation may be made using one of three methods: hours worked, gross receipts, good faith agreement. Federal income taxes are to be withheld only on the tips reported to the employer; no taxes are withheld on the tips that are merely allocated.

**Traveling Expenses**

**Accountable Plan.** Employee expense reimbursement amounts paid under an accountable plan are not subject to income tax withholding. An accountable plan requires the employer’s reimbursement or allowance arrangement to meet all three of the following rules:

1. Business connected.
2. Adequate accounting within a reasonable time period.
3. Employee return of excess of substantiated amounts.

**Nonaccountable Plan.** A nonaccountable plan is an arrangement that does not meet all of the previous requirements. All amounts paid under this plan are considered wages and are subject to income tax withholding.

**Payments Exempt from Withholding**

The law excludes certain payments and payments to certain individuals from federal income tax withholding, as shown in Figure 4–2.

**SELF-STUDY QUIZ 4–1.** Check any item of employee compensation not subject to withholding:

- a. Company-provided lunches at the plant to reduce tardiness by keeping employees on the premises.
- b. Year-end bonuses to managers and supervisors.
- c. Work-out room for employee use during lunch hours.
- d. Travel advances to salespersons for overnight sales calls out of town.
- e. Employer-paid sick pay.
- f. Memberships in the local country club for department managers.
- g. Meals provided by a local restaurant for its employees.
### FIGURE 4–2

**Exempt Payments**

<table>
<thead>
<tr>
<th>Type of Payment or Individual</th>
<th>Conditions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advances</td>
<td>For travel and other business expenses reasonably expected to be incurred.</td>
</tr>
<tr>
<td>Accident and Health Insurance Payments</td>
<td>Exempt except 2% shareholder-employees of S corporations.</td>
</tr>
<tr>
<td>De Minimus Fringe Benefits</td>
<td>Benefits of so little value as to make accounting for the benefit unreasonable and administratively impractical.</td>
</tr>
<tr>
<td>Deceased Person’s Wages</td>
<td>Paid to the person’s beneficiary or estate.</td>
</tr>
<tr>
<td>Dependent Care Assistance</td>
<td>To the extent it is reasonable to believe the amounts will be excludable from gross income. Up to $5,000 can be excluded from an employee’s gross income without being subject to social security, medicare, or income tax withholding.</td>
</tr>
<tr>
<td>Domestic Service</td>
<td>Private home, local college club, or local chapter of college fraternity or sorority.</td>
</tr>
<tr>
<td>Educational Assistance</td>
<td>If education maintains or improves employee’s skills required by the job. For the nonjob-related educational assistance, up to $5,250 per year of employer-provided assistance for undergraduate and graduate education is tax-free.</td>
</tr>
<tr>
<td>Employee Business Expense Reimbursements</td>
<td>Accountable plans for amounts not exceeding specified government rates for mileage, lodging, meals, and incidental expenses.</td>
</tr>
<tr>
<td>Employee-Safety and Length-of-Service Awards</td>
<td>If merchandise costs $400 or less. Rises to $1,600 for a written nondiscriminatory plan.</td>
</tr>
<tr>
<td>Employer-Provided Parking</td>
<td>Up to $180 per month.</td>
</tr>
<tr>
<td>Foreign Service by U.S. Citizens</td>
<td>As employees for affiliates of American employers if entitled to exclusion under section 911 or required by law of foreign country to withhold income tax on such payment.</td>
</tr>
<tr>
<td>Group-Term Life Insurance Costs</td>
<td>The employer’s cost of group-term life insurance less than $50,000.</td>
</tr>
<tr>
<td>Health Reimbursement Arrangements (HRA)</td>
<td>As long as no person has the right to receive cash or any other taxable or nontaxable benefit other than medical care reimbursement.</td>
</tr>
<tr>
<td>Individuals Under 18</td>
<td>For delivery or distribution of newspapers, shopping news, and vendors of newspapers and magazines where payment is the difference between the purchase and sales price.</td>
</tr>
<tr>
<td>Long-Term Care Insurance Premiums</td>
<td>Employer-paid premiums for long-term care insurance up to a limit. For example, for an employee age 40 or under, the first $260 of premiums are nontaxable.</td>
</tr>
<tr>
<td>Ministers of Churches, Members of Religious Orders</td>
<td>Performing services for the order agency of the supervising church or associated institution.</td>
</tr>
<tr>
<td>Moving Expense Reimbursements</td>
<td>For qualified expenses, if the employee is entitled to a deduction for these expenses on the individual’s federal income tax return.</td>
</tr>
<tr>
<td>Public Officials</td>
<td>For fees only, not salaries.</td>
</tr>
</tbody>
</table>
| Retirement and Pension Plans | • Employer contributions to a qualified plan.  
• Employer contributions to IRA accounts under an SEP [see section 402(g) for salary reduction limitation].  
• Employer contributions to section 403(b) annuity contract [see section 402(g) for limitation].  
• Elective contributions and deferrals to plans containing a qualified cash or deferred compensation arrangement, such as 401(k). |
| Sickness or Injury Payments  | Payments made under worker’s compensation law or contract of insurance. |
Pretax Salary Reductions

An employee 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 therefore reduce the amount of pay that is subject to federal income tax.

Cafeteria Plans. Some employers offer their employees a choice between cash (pay) or qualified (nontaxable) benefits. Employees can select various levels of health, accident, and life insurance coverage or choose to contribute to cash or deferred plans. The salary reductions are used to pay for the desired benefit, and these pretax contributions are not included in taxable wages for FIT. These salary reductions, which are allowed under a cafeteria plan, are also exempt from FICA and FUTA taxes and from most states’ taxes.

The following benefits may be included in the plan:

- Accident and health insurance
- Self-insured medical reimbursement plan
- Group-term life insurance (first $50,000 of coverage)
- Dependent care assistance (first $5,000)
- Health savings accounts

These benefits cannot be included in a cafeteria plan:

- Transportation fringe benefits
- Educational assistance
- Scholarships and fellowships grants
- Meals and lodging for the convenience of employer
- Dependent group-term life insurance
- Deferred compensation except for 401(k) contributions

Deferred Arrangements. Many deferred arrangements are usually set up as retirement plans. The most common of these is the defined contribution plan that provides future benefits based solely on the amount paid by each employee and employer into the account, plus investment gains. These plans are tax-deferred savings or stock accounts held in trust for employees. The most popular types of retirement accounts are the 401(k) and IRAs (see pages 4-22-24).

Daniel Rowland, an employee for the Harden School, belongs to a tax-deferred retirement plan to which he contributes 3 percent of his pay which is matched by the school. His biweekly pay is $2,500. Because of the deferral \( \frac{3\% \times \$2,500}{\$75} \), $2,425 is subject to federal income tax withholding.

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. Employees may also claim special allowances and allowances for itemized deductions and tax credits. However, employees cannot claim the same withholding allowances with more than one employer at the same time.

Personal Allowances

Employees can claim a personal allowance for themselves and each qualified dependent, provided they are not claimed on another person’s tax return. In 2004, the amount of the personal allowance was $3,100, and this was treated as a deduction in computing taxable income. A married employee may also claim one personal allowance for his or her spouse if the spouse is not claimed as a dependent on another person’s tax return.

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.
Allowances for Dependents

Employees may claim one allowance for each dependent (other than a spouse) who will be claimed on their federal income tax returns. To qualify as a dependent, the person must meet specific requirements that are listed in the instructions accompanying the individual’s federal income tax return.

Additional Withholding Allowance

Employees can also reduce the amount of withholding by claiming a special withholding allowance, whether or not they plan to itemize deductions on their tax returns. An additional withholding allowance can be claimed by a person under any one of the following situations:

1. Single person who has only one job.
2. Married person who has only one job with nonworking spouse.
3. Person’s wages from a second job or the spouse’s wages (or both) equal $1,000 or less.

This allowance is only used to compute the employee’s income tax withholding. The employee cannot claim this allowance on his or her income tax return.

Other Withholding Allowances

Withholding allowances reduce the overwithholding of income taxes on employees’ wages. In addition to the allowances already discussed, employees may be entitled to withholding allowances based on estimated tax credits, such as child care, and itemized deductions for medical expenses, mortgage interest, and charitable contributions. Employees take these credits when filing their federal income tax returns. The number of withholding allowances is determined on the worksheet that accompanies Form W-4, Employee’s Withholding Allowance Certificate, and is then reported on that form.

Form W-4 (Employee’s Withholding Allowance Certificate)

The employer uses the information from Form W-4, Employee’s Withholding Allowance Certificate, to compute the amount of income tax to withhold from employees’ wages. The employer must have Form W-4 on file for each employee. This form contains the withholding allowance certificate (shown in Figure 4–3), detailed instructions, and worksheets for employees to use in completing the certificate.

Completing Form W-4. The employee completes Form W-4 when he or she begins work for an employer. Employers must retain the withholding certificate as a supporting record of the withholding allowances used in deducting income taxes from the employees’ salaries and wages. Once filed, 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 four 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.

Since the employers are required to get each employee’s social security number on Form W-4, they can request to see the employee’s social security card, and they can photocopy the card for their files.

Withholding Allowances. The number of withholding allowances claimed on Form W-4 may differ from the number of exemptions claimed on the employee’s tax return. The process of determining the correct number of withholding allowances begins with the number of personal exemptions the employee expects to claim on his or her tax return. The employee then increases or decreases this number based on the employee’s eligibility and desire for a higher paycheck or a higher tax refund. The worksheets provided with Form W-4 enable the employee to determine the exact number of allowances to enter on the certificate.

Changing Form W-4. If the status of an employee changes with respect to the number of withholding allowances or marital status, the employee files an amended W-4. If there is a decrease in the number of allowances, the employee must furnish the employer with a
If there is an increase in the number of allowances, the employee can either file a new certificate or allow the current certificate to remain in effect. 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. The employer may not repay or reimburse the employee for income taxes overwithheld before the effective date of the new certificate but may reimburse the employee after that date if the employer failed to implement the new certificate.

### Exemption from Income Tax Withholding

Employees may claim exemption from income tax withholding if they had no income tax liability last year and expect none in the current year. The exemption is valid for one year and must be claimed on a new Form W-4 filed by February 15 of each succeeding year. If a new certificate is not filed, taxes are withheld at the single rate with zero withholding allowances.

**Single persons who made less than $7,950 in 2004 owed no federal income tax. Married couples filing jointly with combined wages up to $15,900 incurred no tax liability.**

Employees may not claim exemption from withholding if (1) another person claims the employee as a dependent on his or her tax return and (2) income exceeds $800 annually and includes more than $250 of unearned income (interest or dividends).

### Additional and Voluntary Withholding Agreements

In some instances, employees want additional federal income taxes withheld from their wages, such as a person with two or more jobs, or a married couple where both work. The simplest way to increase the amount of tax withheld is to reduce the number of withholding allowances claimed. Another method is to request that the employer withhold an additional amount from the employee's pay. These requests must be done on Forms W-4 by filling in the additional amounts to be withheld on line 6.

If an employee receives payments not classified as wages, or an employer-employee relationship does not exist, individuals can voluntarily request that the employer or the one...
making the payments withhold federal income taxes from their payments. These individuals need only furnish a Form W-4. Requests for additional and voluntary withholding become effective when the employer accepts them and begins to withhold tax. The agreements remain in effect until the specified termination date or until the termination is mutually agreed upon. Either party may terminate an agreement prior to a specified date or mutual agreement by furnishing the other party with a signed, written notice of termination.

**Individuals who may wish to request additional withholding or a voluntary agreement to withhold include:**
- Clergy
- Two wage-earner married couples
- Domestic workers in a private home
- Individuals receiving significant amounts of interest or dividends
- Individuals receiving self-employment income

**Invalid W-4s.** Employers are not required to verify the authenticity of the information on employees’ W-4s. 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 correct W-4 on file or, if a new hire, withhold as if the employee were single with no allowances.

**Sending Forms W-4 to the IRS.** To curb the practice of filing false Forms W-4 by claiming unreasonable numbers of allowances or total exemption from withholding, the IRS requires employers to submit a copy of each form on which:
1. An employee claims 11 or more withholding allowances, or
2. An employee, usually earning more than $200 a week at the time the certificate was filed, claims to be exempt from withholding.

Figure 4-4 outlines the procedures to follow in submitting Forms W-4 to the IRS.

**FIGURE 4–4**

**Procedures for Submitting Forms W-4**

- Send Forms W-4 that meet the prescribed conditions each quarter with Form 941. In such cases, complete boxes 8 and 10 on any Forms W-4 you send.
- Send copies of any written statements from employees in support of the claims made on the form, even if the Forms W-4 are not in effect at the end of the quarter.
- In certain cases, the IRS may notify you in writing that you must submit specified forms more frequently to your district director separate from Form 941.
- Unless notified, base withholding on the Forms W-4 that you send to the IRS.
- If notified by the IRS (“lock-in letters”), base withholding on the number of allowances shown in the IRS notice. The employee will also receive a similar notice.
- If the employee later files a new Form W-4, follow it only if exempt status is not claimed or the number of withholding allowances does not exceed the IRS notice.
- If the employee later files a new Form W-4 that does not follow the IRS notice, disregard it and continue to withhold based on the IRS notice.
- If the employee prepares a new Form W-4, explaining any difference with the IRS notice, and submits it to you, send the Form W-4 and explanation to the IRS office shown in the notice. Continue to withhold according to the IRS notice until notified.
Employee Penalties. Employees who willfully file false information statements (Form W-4) are, in addition to any other penalty, subject to fines of up to $1,000 or imprisonment for up to one year or both.

Employees claiming excess deductions are subject to a $500 civil penalty for each offense.

Withholding on Nonresident Aliens. Resident aliens (those with green cards) are lawful citizens and are taxed similar to U.S. citizens. To avoid underwithholding, nonresident aliens (who cannot claim the standard exemption and are limited to one allowance when filing their personal U.S. income tax returns) should (1) not claim exemption from income tax withholding; (2) request withholding as single, regardless of actual status; and (3) claim only one allowance. Residents of Canada, Mexico, Japan, or Korea may claim more than one allowance.

Other Withholdings

Federal income taxes are also withheld from other kinds of payments made to current and former employees, as described below.

Withholding for Pension or Annuity Payments. Generally, the withholding of federal income taxes applies to payments made from pension, profit-sharing, stock bonus, annuity, and certain deferred compensation plans and individual retirement arrangements. You treat the payments from any of these sources as wages for the purpose of withholding. Unless the recipients of pension or annuity payments elect not to have federal income taxes withheld from such payments, the taxes will be withheld. Payers must withhold on monthly pension and annuity payments exceeding $1,225 ($14,700 a year), unless the payees elect otherwise. If the recipients do not instruct the payers to the contrary, the payers are required to withhold income taxes as if the recipients were married and claiming three withholding allowances.

By completing Form W-4P or a substitute form furnished by the payer, an employee can elect to have no income tax withheld from the payments received. The form may also be used to change the amount of tax that would ordinarily be withheld by the payers. Once completed, Form W-4P remains in effect until the recipient changes or revokes the certificate. The payer must notify the recipients each year of their right to elect to have no taxes withheld or to revoke their election.

Withholding from Sick Pay. Form W-4S, Request for Federal Income Tax Withholding from Sick Pay, must be filed with the payer of sick pay if the employee wants federal income taxes to be withheld from the payments. Form W-4S is filed only if the payer is a third party, such as an insurance company. The form should not be filed with the worker’s employer, who makes such payments, since employers already must withhold income taxes from sick pay.

Withholding on Government Payments. Form W-4V can be used to request federal income tax withholding on government payments (such as social security benefits or unemployment compensation). This request is voluntary. The individual can choose to have 7%, 10%, 15%, or 27% withheld from each payment.

SELF-STUDY QUIZ 4–2

1. Grace Kyle submitted a new Form W-4 claiming one additional withholding allowance. Kyle also requested to be reimbursed for the overwithholding prior to the change. How should the payroll manager respond to Kyle?

2. Bob Bradley is upset because his paycheck on February 27, 2005, has federal income tax withheld, even though he filed a W-4 in 2004 claiming exemption from withholding. What should the payroll manager say to Bradley?

3. Greg Volmer, married with a nonemployed spouse, has three dependent children. How many allowances can Volmer claim on his W-4?
**FEDERAL INCOME TAX WITHHOLDING**

After the employer learns from Form W-4 the number of withholding allowances for an employee, the employer selects a withholding method. Employers usually choose either the *percentage method* or the *wage-bracket method*. Both distinguish between married and unmarried persons, and both methods provide the full benefit of the allowances claimed by the employee on Form W-4.

The choice of methods is usually based on the number of employees and the payroll accounting system used. The employer can change from one method to another at any time, and different methods may be used for different groups of employees.

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. For 2004, the following standard deductions apply:

- Joint return filers and surviving spouses: $9,700
- Married persons filing separately: $4,850
- Head of household filers: $7,150
- Single filers: $4,850

These amounts are increased for single and married individuals or surviving spouses age 65 or older or blind. Each year, the standard deductions are adjusted for inflation. The adjustment also applies to the additional standard deductions available to elderly or blind persons.

**Percentage Method**

To compute the tax using the percentage method, follow these steps:

1. **Step 1**
   - Determine the amount of gross wages earned. If the wage ends in a fractional dollar amount, you may round the gross pay to the nearest dollar.

   Nick Volente, single, claims two allowances and earns $802.63 semimonthly. Round Gross Wages to $803.00

2. **Step 2**
   - Multiply the number of allowances claimed by the amount of one allowance for the appropriate payroll period, as shown in the Table of Allowance Values in Figure 4–5.

   Table of Allowance Values for semimonthly payroll period shows $129.17. Multiply $129.17 × 2 = $258.34

3. **Step 3**
   - Subtract the amount for the number of allowances claimed from the employee’s gross pay to find the excess of wages over allowances claimed.

   Gross pay $803.00
   Less: Allowances $258.34
   Excess wages $544.66

4. **Step 4**
   - Determine the withholding tax on the excess of wages over allowances claimed by referring to the appropriate Percentage Method Withholding Table (rates in effect for January 1, 2004).

   Compute tax from Tax Table 3(a), page T–3.

   15% of ($544.66 − $404.00) + $29.40 = $50.50
Step 1
Select the withholding table that applies to the employee's marital status and pay period.

Step 2
Locate the wage bracket (the first two columns of the table) in which the employee's gross wages fall.

Step 3
Follow the line for the wage bracket across to the right to the column showing the appropriate number of allowances. Withhold this amount of tax.

Step 4
Move across the line to the column showing 3 allowances.

If the employee's wages are higher than the last amount listed on the appropriate wage-bracket table, the percentage method must be used for that employee.
SELF-STUDY QUIZ 4–4. Quirk Motors uses the wage-bracket method to withhold from the semimonthly earnings of its employees. For each employee, compute the amount to be withheld from their earnings for the payroll period ending March 15.

<table>
<thead>
<tr>
<th>Employee</th>
<th>Marital Status</th>
<th>No. of Allowances</th>
<th>Salary</th>
<th>Federal Income Tax Withheld</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kyle Lamb</td>
<td>S</td>
<td>1</td>
<td>$1,100</td>
<td></td>
</tr>
<tr>
<td>Zed Nurin</td>
<td>S</td>
<td>0</td>
<td>$850</td>
<td></td>
</tr>
<tr>
<td>Carol Hogan</td>
<td>M</td>
<td>4</td>
<td>$3,000</td>
<td></td>
</tr>
<tr>
<td>Marla Vick</td>
<td>M</td>
<td>2</td>
<td>$1,200</td>
<td></td>
</tr>
<tr>
<td>Al Marks</td>
<td>S</td>
<td>3</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

OTHER METHODS OF WITHHOLDING

In addition to the two principal methods of withholding previously described, employers may use other methods such as quarterly averaging and annualizing wages.

EXAMPLE

QUARTERLY AVERAGING. Turner, Inc., estimates that Carl Moyer will be paid $6,000 during the second quarter of the year. Moyer is married, claims five withholding allowances, and is paid semimonthly.

Step 1—Divide the estimated quarterly wages by 6 (the number of semimonthly pay periods in the quarter).

\[ \frac{6,000}{6} = 1,000 \]

Step 2—Find the amount of federal income tax to withhold from each semimonthly payment.

MARRIED Persons—SEMIMONTHLY Payroll Period

Wages at least $1,000 but not more than $1,020 for 5 allowances = $3

The withholding is based on the average payment instead of the actual payment.
ANNUALIZING WAGES. Marc Field, married with 3 allowances, receives $1,050 semimonthly. Under the annualizing method, do the following:

**Step 1**—Multiply the semimonthly wage by 24 pay periods to compute his annual wage.

\[
\$1,050 \times 24 = \$25,200
\]

**Step 2**—Subtract withholding allowances of $9,300 (3 \times \$3,100).

\[
\$25,200 - 9,300 = \$15,900
\]

**Step 3**—Use Tax Table 7(b) and apply the percentage method to the taxable wages.

\[
10\% \text{ of the excess over } \$8,000 (\$15,900 - \$8,000) \times 0.10 = \$790.00.
\]

\[
\$790.00 \div 24 \text{ semimonthly payrolls} = \$32.92 \text{ per paycheck}
\]

SUPPLEMENTAL WAGE PAYMENTS

*Supplemental wage payments* include items such as vacation pay, bonuses, commissions, and dismissal pay. Since these types of payments may be paid at a different time from the regular payroll and not related to a particular payroll, the employer must decide whether to lump the regular wages and supplemental wages together or withhold from the supplemental wages separately. The first distinction is the treatment of vacation pays versus other types of supplemental pays.

**Vacation 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 the vacation pay is for a time longer than your usual payroll period, spread it over the pay period(s) for which you pay it. If an employee is paid weekly and is paid for two weeks of vacation, treat each vacation week separately and calculate the tax on each vacation week using the weekly tax tables or wage brackets.

However, if vacation pay is in lieu of taking vacation time, treat it as a regular supplemental wage payment and calculate the tax on the total as a single payment. A lump-sum vacation payment on termination of employment is also treated as a supplemental wage payment.

**Supplemental Wages Paid with Regular Wages**

If the employer pays supplemental wages with regular wages but does not specify the amount of each type of wage, the employer withholds as if the total were a single payment for a regular payroll period.

Ashley Watson, married with 3 allowances, earns a monthly salary of $1,800. She also receives a bonus on sales that exceed her quota for the year. For this year, her bonus amounts to $4,600. Watson’s employer pays her the regular salary and the bonus together on her December paycheck. The withholding for the December pay is computed on the total amount of $6,400 ($1,800 + $4,600). After deducting the allowances, using the percentage Tax Table 4(b), the amount to withhold is $707.05.

However, if the employer indicates specifically the amount of each payment, the employer may withhold at a flat 25 percent rate on the supplemental wages if the tax is withheld on the employee’s regular wages at the appropriate rate.
If you indicate separately on Watson's paycheck stub the amount of each payment, the amount of federal income tax to be withheld is computed as follows:

<table>
<thead>
<tr>
<th>Taxes Withheld</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Regular monthly earnings</td>
<td>$1,800</td>
</tr>
<tr>
<td>Annual bonus</td>
<td>4,600</td>
</tr>
<tr>
<td>Totals</td>
<td>$6,400</td>
</tr>
<tr>
<td></td>
<td>$1,188.00</td>
</tr>
</tbody>
</table>

*The percentage table could also be used.

Supplemental Wages Paid Separately from Regular Wages

If the supplemental wages are paid separately, the income tax withholding method depends on whether or not you withheld income tax from the employee's regular wage payment. If you withheld income tax from the employee's regular wages, you can use either of the following methods for supplemental wages.

**Method A.** Add the supplemental wages and regular wages for the most recent payroll period. Then, figure the income tax as if the total were a single payment. Subtract the tax already withheld from the regular wage. Withhold the remaining tax from the supplemental wage.

Brian Early, married with 2 allowances, is paid $985 semimonthly. The tax to be withheld under the wage-bracket method on each semimonthly pay is $40. Early is paid his regular wage on June 15. On June 18, he receives a bonus of $500. The tax on the bonus is computed as follows:

<table>
<thead>
<tr>
<th>Tax on total from the wage-bracket table in Tax Table B</th>
<th>$105</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: Tax already withheld on $985</td>
<td>40</td>
</tr>
<tr>
<td>Tax to be withheld from $500 bonus</td>
<td>$65</td>
</tr>
</tbody>
</table>

If you did not withhold income tax from the employee's regular wage payment, use Method A.

**Method B.** Withhold a flat 25 percent on the supplemental pay.

The tax withheld on Brian Early's June 18 bonus of $500 is computed as follows:

| Tax withheld on bonus                               | $125 |

If a supplemental payment is paid in a year where no regular wages are paid, the payment is treated as a regular wage payment, and withholding is determined by the rules that apply to a miscellaneous payroll period.
**SELF-STUDY QUIZ 4–5.** Milton Stewart, married with 2 allowances, received his regular semimonthly wage of $1,450 on June 15. On June 20, he received a semiannual bonus of $500. Compute the amount of federal income tax to be withheld on the bonus using each method for computing supplemental wage payments. The employer uses the wage-bracket tables.

Method A __________________
Method B __________________

**Gross-Up Supplementals**

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.

A special “gross-up” formula can be applied in this situation:

\[
\text{Grossed-Up Amount} = \frac{\text{Intended payment}}{1 - \text{applicable tax rates (FICA, 25% Federal Income Tax rate, and state tax rate)}}
\]

**Example**

Grossing-up. Cotter Company wants to award a $4,000 bonus to Donna D’Amico. In addition, they want the net bonus payment to equal $4,000. Assuming D’Amico is still under the OASDI/FICA limit, the calculation would be:

A. \[\frac{4,000}{1 - 0.25 \text{ (supplemental W/H rate)} - 0.062 \text{ (OASDI)} - 0.0145 \text{ (HI)}}\]

B. \[\frac{4,000}{0.6735} = \$5,939.12 \text{ grossed-up bonus}\]

If state or local taxes apply, they must also be included in the formula.

**ADVANCE EARNED INCOME CREDIT**

The earned income credit (EIC) reduces federal income taxes and is intended to offset living expenses for an eligible employee (see Figure 4–7) who has a qualifying child and for the low-income taxpayers who have no qualifying children. The credit can be claimed at the time of filing their individual income tax returns, and they receive a lump-sum tax refund. For 2004, the refund, as calculated at the time of filing Form 1040, could be as much as $2,604 if the employee had one qualifying child; with two or more qualifying children, $4,300. However, to get these payments in advance with his or her paycheck, the employee must give the employer a properly completed Form W-5, Earned Income Credit.

**Figure 4–7**

*Employees Eligible for Advance EIC*

Only eligible employees can receive advance EIC payments. The eligibility requirements are summarized below.

1. Employee must have a qualifying child, as defined on Form W-5;
2. Employee’s expected 2004 earned income and adjusted gross income must each be less than $30,338 ($31,338 if filing jointly); and
3. Expect to be able to claim the EIC for 2004.
**Advance Payment Certificate.** The employer must make advance EIC payments to employees who complete and sign Form W-5. For 2004, the maximum advance payment (up to 60% of the credit available) was $1,563. Employees will receive the balance of the credit when they file their federal income tax returns.

**Form W-5**

Eligible employees who want to receive advance EIC payments must file Form W-5 with their employer. On this form, the employee shows the following:

- Expected eligibility for the credit in 2004.
- If they have a qualifying child.
- If they are married.
- If married, whether their spouse has a certificate in effect with any other employer.
- If another W-5 is on file with another current employer.

An employee can have only one certificate in effect with a current employer. If the employee is married and the employee’s spouse works, each spouse files a separate Form W-5. This form remains in effect until the end of the calendar year or until the employee revokes the certificate or files another one. A new certificate must be filed by December 31 in order to continue receiving payment in the new year. Figure 4–8 shows an example of a filled-in Form W-5.

**Employee’s Change of Status**

If circumstances change after an employee has submitted a signed Form W-5 that make the employee ineligible for the credit, he or she must revoke the certificate within 10 days after learning of the change. The employee then gives the employer a new Form W-5, stating that he or she is no longer eligible for advance EIC payments. If the employee’s situation changes because his or her spouse files a Form W-5, the employee must file a new certificate showing that his or her spouse has a certificate in effect with an employer.

**Employer Responsibilities**

Employers must notify employees who have no income tax withheld that they may be eligible for EIC payments. The employer may use any of the following methods to notify employees.

---

**Figure 4–8**

**Earned Income Credit Advance Payment Certificate**

**Form W-5**

**Earned Income Credit Advance Payment Certificate**

- Use the current year’s certificate only.
- Give this certificate to your employer.
- This certificate expires on December 31, 20--.

Print or type your full name
Mary Sue Graser

Your social security number
269: 11: 0001

**Note:** If you get advance payments of the earned income credit for 20--, you must file a 20-- Federal income tax return. To get advance payments, you must have a qualifying child and your filing status must be any status except married filing a separate return.

1 I expect to have a qualifying child and be able to claim the earned income credit for 20--, I do not have another Form W-5 in effect with any other current employer, and I choose to get advance EIC payments . ☐ Yes ☐ No

2 Check the box that shows your expected filing status for 20--:
☑ Single, head of household, or qualifying widow(er) ☐ Married filing jointly

3 If you are married, does your spouse have a Form W-5 in effect for 20-- with any other employer? . . . . . . ☐ Yes ☐ No

Under penalties of perjury, I declare that the information I have furnished above is, to the best of my knowledge, true, correct, and complete.

Signature ☑ Mary Sue Graser

Date ☑ 1/24/--
1. The IRS Form W-2, which has the required statement about the EIC on the back of Copy C.
2. A substitute Form W-2 with the same EIC statement on the back of the employee’s copy.
3. Notice 797, Possible Federal Refund Due to the Earned Income Credit (EIC).
4. Your written statement with the same wording as Notice 797.

**Computing the Advance EIC**

Employers must include the advance EIC payment with wages paid to their eligible employees who have filed Form W-5. In determining the advance payment, the employer considers the following factors:

1. Wages and reported tips for the pay period.
2. Whether the employee is married or single.
3. Whether a married employee’s spouse has a Form W-5 in effect with an employer.

To figure the amount of the advance payment, the employer uses either the *Tables for Percentage Method of Advance EIC Payments* or *Tables for Wage-Bracket Method of Advance EIC Payments*. There are separate tables for employees whose spouses have a certificate in effect, without spouses filing certificate, or single/head of household.

Renee Riley is paid $150 per week. She has filed Form W-5 showing that she is married and that her husband has given his employer Form W-5. Using the “Married With Both Spouses Filing Certificate” in Figure 4–9, the advance EIC payment is $14.

**Paying the Advance EIC**

The advance EIC payments do not affect the amount of income taxes or FICA taxes withheld from employees’ wages. Since the EIC payments are not compensation for services rendered, they are not subject to payroll taxes. Generally, the employer pays the amount of the advance EIC payment from withheld income taxes and FICA taxes. It is possible that for a payroll period the advance EIC payments may be more than the withheld income taxes and the FICA taxes. In such cases, the employer can:

1. Reduce each advance EIC payment proportionately, or
2. Elect to make full payment of the advance EIC amount and treat such full amounts as an advance payment of the company’s employment payroll taxes.

The amount of the advance EIC payments does not change the amount that employers must withhold from their employees’ wages for income taxes and FICA. Advance EIC payments made by the employer are treated as having been made from amounts withheld as income tax, employee FICA taxes, and from the employer’s FICA taxes. The amount of advance EIC payments is considered to have been paid over to the IRS on the day the wages are paid to employees.

**Figure 4–9**

*MARRIED With Both Spouses Filing Certificate—Weekly Payroll Period*

<table>
<thead>
<tr>
<th>Wages— At least But less than</th>
<th>Payment to be made</th>
<th>Wages— At least But less than</th>
<th>Payment to be made</th>
<th>Wages— At least But less than</th>
<th>Payment to be made</th>
<th>Wages— At least But less than</th>
<th>Payment to be made</th>
<th>Wages— At least But less than</th>
<th>Payment to be made</th>
<th>Wages— At least But less than</th>
<th>Payment to be made</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0</td>
<td>$5</td>
<td>$0</td>
<td>$35</td>
<td>$40</td>
<td>$7</td>
<td>$70</td>
<td>$140</td>
<td>$14</td>
<td>$200</td>
<td>$210</td>
<td>$270</td>
</tr>
<tr>
<td>5</td>
<td>10</td>
<td>1</td>
<td>40</td>
<td>45</td>
<td>8</td>
<td>140</td>
<td>150</td>
<td>15</td>
<td>210</td>
<td>220</td>
<td>280</td>
</tr>
<tr>
<td>10</td>
<td>15</td>
<td>2</td>
<td>45</td>
<td>50</td>
<td>9</td>
<td>160</td>
<td>170</td>
<td>13</td>
<td>230</td>
<td>240</td>
<td>290</td>
</tr>
<tr>
<td>15</td>
<td>20</td>
<td>3</td>
<td>50</td>
<td>55</td>
<td>10</td>
<td>180</td>
<td>190</td>
<td>11</td>
<td>250</td>
<td>260</td>
<td>290</td>
</tr>
<tr>
<td>20</td>
<td>25</td>
<td>4</td>
<td>55</td>
<td>60</td>
<td>11</td>
<td>170</td>
<td>180</td>
<td>12</td>
<td>240</td>
<td>250</td>
<td>290</td>
</tr>
<tr>
<td>25</td>
<td>30</td>
<td>5</td>
<td>60</td>
<td>65</td>
<td>12</td>
<td>180</td>
<td>190</td>
<td>11</td>
<td>250</td>
<td>260</td>
<td>290</td>
</tr>
<tr>
<td>30</td>
<td>35</td>
<td>6</td>
<td>65</td>
<td>70</td>
<td>13</td>
<td>190</td>
<td>200</td>
<td>10</td>
<td>260</td>
<td>270</td>
<td>290</td>
</tr>
</tbody>
</table>

*EXAMPLE* Studies done by the General Accounting Office have revealed massive losses to the federal government in the EIC program due to fraud and errors. Losses have been estimated to range from 20% to 30% of all EIC benefits.
Nolan Inc. has 10 employees who are each entitled to advance EIC payments of $12. The total advance payments made by Nolan for the payroll period amount to $120. The total income tax withheld for the payroll period is $110. The total FICA taxes for employees and employer are $128. Nolan is considered to have made a deposit of $120 from the advance EIC payments on the day the wages are paid. The $120 is treated as if the company has paid the total $110 in income tax withholding and $10 of the employee FICA taxes to the IRS. The company must deposit only $118 of the remaining FICA taxes.

Employer’s Returns and Records

The employer takes into account the amount of the advance EIC payments when completing Form 941. The amount of the advance EIC payments is subtracted from the total amount of income taxes and FICA taxes in order to determine the net taxes due for the quarter. All records of advance EIC payments should be retained four years and be available for review by the IRS. These records include:

1. Copies of employees’ Forms W-5.
2. Amounts and dates of all wage payments and advance EIC payments.
3. Dates of each employee’s employment.
4. Dates and amounts of tax deposits made.
5. Copies of returns filed.

SELF-STUDY QUIZ 4–6.

1. During one week, Georgia Brewer earned $175. She and her spouse have both filed Form W-5. Using the information presented in Figure 4–9, compute the amount of advance EIC payment Brewer is entitled to receive. $

2. On a certain payday, the Gregory Company made advance EIC payments to its employees that amounted to more than the federal income taxes withheld. Does the company have to make a tax deposit for this payday? Explain.

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 the employees’ wages that are subject to federal income tax. These tax-deferred plans set limits on the amounts that employees can contribute tax free and also provide for additional contributions to be made into the accounts by the employers. Upon retirement, the employees will receive their contributions back in the form of regular payments from their retirement plans. These payments are then subject to federal income tax.

- **401(k) Plan.** A standard tax-deferred retirement plan. A set percentage of an employee’s wages is contributed on a pretax basis. Employers can limit the percentage of an employee’s pay that can be contributed. This limit can be lower than the maximum set by law. Employees can add after-tax contributions to this total, and the employer can contribute to the employees’ plan.
- **Simple Plans.** A small company plan for a company with up to 100 employees. The employer can offer a SIMPLE plan as part of a 401(k) plan. This plan allows employees to contribute a percentage of their pay toward retirement.
- **Section 403(b) Plan.** A plan for employees of tax-exempt organizations.
- **Section 457 Plan.** A plan for employees of state and local governments and of tax-exempt organizations other than churches.
The following information applies to 2005:

- **401(k)**: $14,000/100% of pay lesser is maximum employee-deferred contribution
- **403(b)**: $4,000 extra deferred if age 50 or over
- **403(b)**: 100% of pay/$41,000 maximum contribution of employer
- **457**: $41,000 maximum total combined contribution

**SIMPLE**
- **$10,000**: maximum employee-deferred contribution
- **$2,000**: extra deferred if age 50 or over
- **3% of pay**: employer must match employee’s contribution up to this maximum

### Individual Retirement Accounts

Beyond the various payroll-related tax deferred accounts, individuals can set up their own retirement accounts. Under certain conditions, an employee may put aside each year the lesser of $4,000 or 100% of their compensation without paying federal income taxes on their contributions. Eligible employees may make an additional $4,000 contribution on behalf of a nonworking or low-earning spouse provided the combined compensation is at least equal to the total combined IRA contribution. For individuals age 50 or older, the limit is increased by $500 in 2005. To be eligible for such deductible (tax-free) contributions, either of the following two conditions must be met:

1. The individual does not belong to a company-funded retirement plan.
2. The individual has modified adjusted gross income less than $50,000. (In the case of a married employee, the combined modified adjusted gross income must be less than $70,000.)

If the employee belongs to another qualified plan, full and partial tax-free deductions are allowed if:

1. The employee is single or head of household and has modified adjusted gross income less than $50,000 with phase-out at $60,000.
2. The employee is married, filing a joint return, and has modified adjusted gross income less than $70,000 with phase-out at $80,000.
3. The employee is married, filing separately, and has zero adjusted gross income with phase-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 ($4,000) will begin to phase out between $150,000 to $160,000 of their total adjusted gross income.

Even though these contributions can be made through payroll deductions, the employer is not considered a pension plan sponsor and is not subject to ERISA as long as the following guidelines are met:

1. The employer makes no matching contributions.
2. Participation is not mandatory.
3. The employer does not endorse any IRA sponsors.

### Roth IRA

Another type of IRA that allows taxpayers and their spouses to make annual nondeductible contributions of up to $4,000 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 those with adjusted gross income of between $95,000 to $110,000 for single taxpayers, $150,000 to $160,000 for joint taxpayers, and $0 to $10,000 for married taxpayers filing separately.
The advantage of this type of IRA is that distributions made out of the fund at retirement are tax-free.

WAGE AND TAX STATEMENTS

Employers must furnish wage and tax statements to employees informing them of the wages paid during the calendar year and the amount of taxes withheld from those wages. The employer sends copies of these statements to the federal government and, in many cases, to state, city, and local governments.

Form W-2

Form W-2, Wage and Tax Statement, shown in Figure 4–10, is prepared if any of the following items apply to an employee during the calendar year:

1. Income tax or social security taxes were withheld.
2. Income tax would have been withheld if the employee had not claimed more than one withholding allowance or had not claimed exemption from withholding on Form W-4.
3. Any amount was paid for services if the employer is in a trade or business. The cash value of any noncash payments made should be included.
4. Any advance EIC payments were made.

Figure 4–11 summarizes the instructions for completing each of the boxes on Form W-2. If an entry does not apply to the firm or employee, leave the box blank. Employers must give employees Form W-2 on or before January 31 following the close of the calendar year. When employees leave the service of the employer, you may give them Form W-2.

LEARNING OBJECTIVE 8

On Form W-2, enter name exactly as shown on employee’s social security card. Do not include titles (Mr., Mrs., Dr., etc.), suffixes (RN, MD, CPA, etc.), or Jr. or Sr.

on the Net

For access to all federal tax forms, see the IRS Digital Daily forms download page: http://www.irs.gov/formspubs/
How to Complete Form W-2

Box A—Control number: For the employer to identify the individual Forms W-2. Up to 7 digits may be used to assign the number, which the employer uses when writing the Social Security Administration about the form. The employer does not have to use this box.

Void: Put an X in this box when an error has been made. Amounts shown on void forms should not be included in your subtotal Form W-2.

Box B—Employer’s identification number (EIN): Enter the number assigned to you by the IRS. Do not use a prior owner’s EIN. If you do not have an EIN when filing Forms W-2, enter “Applied For.” You can get an EIN by filing Form SS-4.

Box C—Employer’s name, address, and ZIP code: This entry should be the same as shown on your Form 941 or 943.

Box D—Employee’s social security number: An employee who does not have an SSN should apply for one by completing Form SS-5.

Box E—Employee’s name: The name should be entered exactly as shown on the employee’s social security card.

Box F—Employee’s address and ZIP code: This box is combined with Box E on all copies except Copy A, to allow you to mail employee’s copies in a window envelope or as a self-mailer.

Box 1—Wages, tips, other compensation: Record, before any payroll deductions, the total of (1) wages, prizes, and awards paid; (2) noncash payments (including certain fringe benefits); (3) tips reported by employee to employer (not allocated tips); (4) certain employee business expense reimbursements; (5) cost of accident and health insurance premiums paid on behalf of 2% or more shareholder employees by an S corporation; (6) taxable benefits made from a Section 125 (cafeteria plan); and (7) all other compensation including certain scholarships and fellowship grants and payments for moving expenses. Other compensation is an amount you pay your employee from which federal income tax is not withheld. You may show other compensation on a separate Form W-2.

Box 2—Federal income tax withheld: Record the amount of federal income tax withheld from the employee’s wages for the year.

Box 3—Social security wages: Enter the total wages paid (before payroll deductions) subject to employee social security (OASDI) tax. Do not include social security tips and allocated tips. Generally, noncash payments are considered wages. Include employee business expenses reported in Box 1. Include employer contributions to qualified cash or deferred compensation plans and to retirement arrangements described in Box 12 (Codes D, E, F, and G), even though the deferrals are not includible in Box 1 as wages, tips, and other compensation. Include any employee OASDI and HI taxes and employee state unemployment compensation taxes you paid for your employee rather than deducting it from wages. Report in this box the cost of group-term life insurance coverage over $50,000 that is taxable to former employees. Report the cost of accident and health insurance premiums paid on behalf of 2% or more shareholder-employees by an S corporation only if the exclusion under Section 312(a)(2)(B) is not satisfied. Do not enter more than the maximum OASDI taxable wage base for the year.

Box 4—Social security tax withheld: Record the total social security (OASDI) tax (not your share) withheld or paid by you for the employee. Include only taxes withheld for the year’s wages.

Box 5—Medicare wages and tips: Enter the medicare (HI) wages and tips. Be sure to enter tips the employee reported even if you did not have enough employee funds to collect the HI tax for those tips. Report in this box the cost of group-term life insurance coverage over $50,000 that is taxable to former employees.

Box 6—Medicare tax withheld: Enter the total employee medicare (HI) tax (not your share) withheld or paid by you for your employee. Include only taxes withheld for the year’s wages.

Box 7—Social security tips: Record the amount the employee reported even if you did not have enough employee funds to collect the social security (OASDI) tax for the tips. The total of Boxes 3 and 7 should not be more than the maximum OASDI wage base for the year. But report all tips in Box 1 along with wages and other compensation.

Box 8—Allocated tips: If you are a large food or beverage establishment, record the amount of tips allocated to the employee. Do not include this amount in Boxes 1, 3, 5, or 7.

Box 9—Advance EIC payment: Record the total amount paid to the employee as advance earned income credit payments.

Box 10—Dependent care benefits: Record the total amount of dependent care benefits paid or incurred by you for your employee. This total should include any amount in excess of the exclusion ($5,000).

Box 11—Nonqualified plans: Enter the amount from a nonqualified deferred compensation plan or Section 457 plan that was distributed or became taxable because the substantial risk of forfeiture lapsed. Include this amount in Box 11 only if it is also includible in Boxes 1, 3, and 5. Report distributions to beneficiaries of deceased employees on Form 1099-R.
Box 12—Complete and code this box for all applicable items listed below in the Reference Guide. Additional information about any coded item may be found in the IRS's Instructions for Form W-2. Do not enter more than four codes in this box. If you are reporting more than four items, use a separate Form W-2 or a substitute Form W-2 to report the additional items. Use a capital letter when entering each code and enter the dollar amount on the same line. Use decimal points.

Box 13: Mark the boxes that apply.
- **Statutory employee:** Mark this box for statutory employees whose earnings are subject to social security (OASDI) and medicare (HI) taxes but not subject to federal income tax withholding.
- **Retirement plan:** Mark this box if the employee was an active participant (for any part of the year) in a retirement plan such as 401(k) and SEP.
- **Third-party sick plan:** Mark this box only if you are a third-party, sick-pay payer filing a Form W-2 for an insured's employee.

Box 14—Other: Use this box for any other information you want to give your employee. Label each item. Examples are union dues, health insurance premiums deducted, moving expenses paid, nontaxable income, or educational assistance payments.

Boxes 15 through 20—State or local income tax information: You do not have to complete these boxes, but you may want to if you use copies of this form for your state and local returns. The ID number is assigned by each individual state. The state and local information boxes can be used to report wages and taxes on two states and two localities. Keep each state's and locality's information separated by the dotted line.

Reference Guide for Box 12 Codes

- **A**—Uncollected social security (OASDI) tax on tips
- **B**—Uncollected medicare (HI) tax on tips
- **C**—Group-term life insurance over $50,000
- **D**—Elective deferrals to a Section 401(k) cash or deferred arrangement
- **E**—Elective deferrals to a Section 403(b) salary reduction agreement
- **F**—Elective deferrals to a Section 408(k)(6) salary reduction SEP
- **G**—Elective and nonelective deferrals to a Section 457(b) deferred compensation plan (state and local government and tax-exempt employers)
- **H**—Elective deferrals to a Section 501(c)(18)(D) tax-exempt organization plan
- **J**—Nontaxable sick pay
- **K**—20% excise tax on excess golden parachute payments
- **L**—Substantiated employee business expense (federal rate)
- **M**—Uncollected social security (OASDI) tax on group-term life insurance coverage
- **N**—Uncollected medicare (HI) tax on group-term life insurance coverage
- **P**—Excludable reimbursed moving expenses
- **Q**—Military employee basic housing, subsistence and combat zone pay
- **R**—Employer contributions to medical savings account
- **S**—Employee salary reduction contributions to a 408(p) SIMPLE retirement plan
- **T**—Employer-provided qualified adoption benefits
- **V**—Exercise of nonstatutory stock options
- **W**—Employer contributions to an employee’s health savings account (HSA).

W-2 any time after employment ends. If employees ask for Form W-2, the employer should give it to them within 30 days of their request or the final wage payment, whichever is later. In instances where terminated workers may be rehired at some time before the year ends, the employer may delay furnishing the form until January 31 following the close of the calendar year. Employers distribute Form W-2 copies as follows:

- **Copy A**—To the Social Security Administration by the end of February following the year for which Form W-2 is applicable. If filed electronically, March 31 is the due date.
- **Copy 1**—To the state, city, or local tax department.
- **Copy B**—To employees for filing with their federal income tax return.
- **Copy C**—To employees for their personal records.
- **Copy 2**—To employees for filing with their state, city, or local income tax returns.
- **Copy D**—Retained by the employer.
If 250 or more Forms W-2 are being filed, reporting must be done electronically with the IRS with an extended deadline of March 31.

Employers that are going out of business must send W-2 forms to the employees by the date the final Form 941 is due. One month later, the W-2 forms are due at the Social Security Administration.

If Form W-2 has been lost or destroyed, employers are authorized to furnish substitute copies to the employee. The substitute form should be clearly marked REISSUED STATEMENT. Do not send Copy A of the substitute statement to the Social Security Administration. If, after a reasonable effort, the employer cannot deliver a Form W-2, the employer retains the employee's copies of the form for a four-year period. A “reasonable effort” means the forms were mailed to the last known address of the employee.

The IRS allows employers to put W-2s on a secure Web site and provide employees with passwords to access their individual W-2s. As long as an employee has affirmatively consented, his or her W-2 can be sent 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**

To correct errors in previously filed Forms W-2, employers file Form W-2c, Statement of Corrected Income and Tax Amounts, shown in Figure 4–12. File Copy A with the Social Security Administration and the remaining copies as noted on the bottom of each form. Form W-3c should accompany all corrected wage and tax statements unless the correction is for only one employee or to correct employees' names, addresses, or social security numbers. In the case of an incorrect address, the employer can mail the “incorrect” W-2 in an envelope bearing the corrected address.

**Form W-3**

Form W-3, Transmittal of Wage and Tax Statements, must be filed with the Social Security Administration by employers and other payers as a transmittal for Forms W-2. On Form W-3, the employer indicates the number of documents being transmitted. Form W-3 and the accompanying documents enable the Social Security Administration and the IRS to compare the totals to the amounts for the income tax withholdings, social security wages, social security tips, medicare wages and tips, and the advanced earned income credits, as reported on the employer’s 941s for the year. The IRS will require explanations of any differences and corrections to any errors. Figure 4–13, on page 4-29, shows a completed Form W-3. The employer files all Forms W-2 with one W-3. Forms W-3 and the related documents are filed with the Social Security Administration by the end of February each year. Form W-3 is mailed to employers during the fourth quarter.

The information shown on Form W-3 is matched against the employer’s Forms 941 for the year. If the totals do not match, the IRS notifies the employer of the discrepancy, and the employer is required to provide additional information.

**Penalties**

The following penalties are imposed for late or incorrect filing of W-2s:

1. If filed correctly within 30 days after the due date, $15 per return ($75,000 maximum penalty/$25,000 for small businesses).
2. If filed between 30 days after the due date and August 1, $30 per return ($150,000 maximum penalty/$50,000 for small businesses).
3. After August 1, $50 per return ($250,000 maximum penalty/$100,000 for small businesses).
4. Penalties of $100 per return, or if greater, 10 percent of the amount to be reported correctly for intentional disregard of the requirements for filing, providing payee statements, and reporting incorrect information (no maximum penalty).
5. Filing W-2s with mismatched names and social security numbers, $50 per form.
**FIGURE 4-12**

*Form W-2c, Statement of Corrected Income and Tax Amounts*

<table>
<thead>
<tr>
<th>Item</th>
<th>Previous reported</th>
<th>Correct information</th>
<th>Previously reported</th>
<th>Correct information</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Wages, tips, other compensation</td>
<td>1 Wages, tips, other compensation</td>
<td>2 Federal income tax withheld</td>
<td>2 Federal income tax withheld</td>
</tr>
<tr>
<td>2</td>
<td>Social security wages</td>
<td>3 Social security wages</td>
<td>4 Social security tax withheld</td>
<td>4 Social security tax withheld</td>
</tr>
<tr>
<td>3</td>
<td>Medicare wages and tips</td>
<td>5 Medicare wages and tips</td>
<td>6 Medicare tax withheld</td>
<td>6 Medicare tax withheld</td>
</tr>
<tr>
<td>4</td>
<td>Social security tips</td>
<td>7 Social security tips</td>
<td>8 Allocated tips</td>
<td>8 Allocated tips</td>
</tr>
<tr>
<td>5</td>
<td>Advance EIC payment</td>
<td>9 Advance EIC payment</td>
<td>10 Dependent care benefits</td>
<td>10 Dependent care benefits</td>
</tr>
<tr>
<td>6</td>
<td>Nonqualified plans</td>
<td>11 Nonqualified plans</td>
<td>12a See instructions for box 12</td>
<td>12a See instructions for box 12</td>
</tr>
<tr>
<td>7</td>
<td>State Correction Information</td>
<td>13 State Correction Information</td>
<td>14 State Correction Information</td>
<td>14 State Correction Information</td>
</tr>
<tr>
<td>8</td>
<td>Local Correction Information</td>
<td>15 Local Correction Information</td>
<td>16 Local Correction Information</td>
<td>16 Local Correction Information</td>
</tr>
</tbody>
</table>

**State Correction Information**

<table>
<thead>
<tr>
<th>Item</th>
<th>Previous reported</th>
<th>Correct information</th>
<th>Previously reported</th>
<th>Correct information</th>
</tr>
</thead>
<tbody>
<tr>
<td>15</td>
<td>State</td>
<td>15 State</td>
<td>15 State</td>
<td>15 State</td>
</tr>
<tr>
<td>16</td>
<td>Employer’s state ID number</td>
<td>Employer’s state ID number</td>
<td>Employer’s state ID number</td>
<td>Employer’s state ID number</td>
</tr>
<tr>
<td>17</td>
<td>State wages, tips, etc.</td>
<td>16 State wages, tips, etc.</td>
<td>16 State wages, tips, etc.</td>
<td>16 State wages, tips, etc.</td>
</tr>
<tr>
<td>18</td>
<td>State income tax</td>
<td>17 State income tax</td>
<td>17 State income tax</td>
<td>17 State income tax</td>
</tr>
</tbody>
</table>

**Locality Correction Information**

<table>
<thead>
<tr>
<th>Item</th>
<th>Previous reported</th>
<th>Correct information</th>
<th>Previously reported</th>
<th>Correct information</th>
</tr>
</thead>
<tbody>
<tr>
<td>18</td>
<td>Local wages, tips, etc.</td>
<td>18 Local wages, tips, etc.</td>
<td>18 Local wages, tips, etc.</td>
<td>18 Local wages, tips, etc.</td>
</tr>
<tr>
<td>19</td>
<td>Local income tax</td>
<td>19 Local income tax</td>
<td>19 Local income tax</td>
<td>19 Local income tax</td>
</tr>
<tr>
<td>20</td>
<td>Locality name</td>
<td>20 Locality name</td>
<td>20 Locality name</td>
<td>20 Locality name</td>
</tr>
</tbody>
</table>

Note: Only complete money fields that are being corrected (except MQGE).
Form W-3c

The Transmittal of Corrected Income and Tax Statements, Form W-3c, is used to accompany copies of Form W-2c, sent to the Social Security Administration. This form can also be used to correct a previously filed Form W-3.

Privately Printed Forms

Employers may use their own forms by obtaining specifications for the private printing of Forms W-2 from any IRS center or district office. To the extent that the privately printed forms meet the specifications, the employer may use them without prior approval of the IRS.

SELF-STUDY QUIZ 4–7.

1. The Marquat Company deducts union dues from its employees’ paychecks each month during the year and sends them to the local union office. How should the company report this deduction on the employees’ Forms W-2?

2. Gringle’s terminated 10 of its employees on July 15. The company informed each employee that it may rehire them again during its peak season in September. When should the company furnish each employee with a W-2 statement?

3. While preparing her 2005 personal income tax return, Connie Becker, an employee of Trident Mills, discovered that she had lost her Form W-2. What procedures should the company follow to prepare a new Form W-2 for Becker?
RETURNS EMPLOYERS MUST COMPLETE

Employers must file returns reporting the amount of wages paid and the amount of taxes withheld at designated times, beginning with the first quarter in which taxable wages are paid. Rules that require different returns for different types of employees further complicate the accounting tasks and payroll procedures. Figure 4–14 briefly summarizes the major returns completed by employers.

The most recent information with regard to withholding, deposit, and payment and reporting of federal income taxes, FICA taxes, and FUTA taxes is available in Circular E, Employer’s Tax Guide. This circular is sent to employers prior to the start of the new year and is also available at district offices of the IRS.

INFORMATION RETURNS

The IRS requires employers to file information returns to report compensation paid to certain individuals who are not employees. These returns allow the IRS to determine if taxpayers are reporting their true income. Figure 4–15 briefly summarizes the major information returns required by the IRS. The employer sends copies of the returns to the payee by the end of January. These forms can be sent to the contractors electronically as long as they agree in advance to this method of delivery.

To transmit each type of Form 1099 to the IRS, the employer uses Form 1096, Annual Summary and Transmittal of U.S. Information Returns. Employers use a separate Form 1096 to transmit each type of information return. For example, one Form 1096 is used to transmit all Forms 1099-MISC (see Figure 4–16, on page 4-32), and another Form 1096 is used to transmit all Forms 1099-INT. The employer files Form 1096 and all accompanying forms to the IRS on or before the last day of February of the year following the payment. For returns filed electronically, the due date is March 31. Penalties previously listed for late submission of Forms W-2 also apply to the Form 1099 series (see page 4-27).

**FIGURE 4–14**

<table>
<thead>
<tr>
<th>Major Returns Filed by Employers</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Form 941, Employer’s Quarterly Federal Tax Return</strong> For reporting federal income taxes withheld during the calendar quarter and the employer and employee portions of the FICA taxes. Form 941 is illustrated in Chapter 3.</td>
</tr>
<tr>
<td><strong>Form 941-M, Employer’s Monthly Federal Tax Return</strong> For reporting federal income taxes withheld and FICA taxes on a monthly basis. The IRS may require monthly returns and payments of taxes from employers who have not complied with the requirements for filing returns or the paying or depositing of taxes reported on quarterly returns. You are not required to file this return unless notified by the IRS.</td>
</tr>
<tr>
<td><strong>Form 942, Employer’s Quarterly Tax Return for Household Employees</strong> For reporting federal income taxes withheld as a result of voluntary withholding agreements between employers and their domestic employees. Form 942 is also completed by employers who are liable for FICA taxes on wages paid to domestic workers.</td>
</tr>
<tr>
<td><strong>Form 943, Employer’s Annual Tax Return for Agricultural Employees</strong> For reporting the withholding of federal income taxes and FICA taxes on wages paid to agricultural workers. Form 943 is used for agricultural employees even though the employer may employ nonagricultural workers.</td>
</tr>
<tr>
<td><strong>Form 945, Annual Return of Withheld Federal Income Tax</strong> Used to report tax liability for nonpayroll items such as backup withholding and withholding on gambling winnings, pensions, and annuities, and deposits made for the year. Backup withholding occurs when an individual receives taxable interest, dividends, and certain other payments and fails to furnish the payer with the correct taxpayer identification numbers. Payers are then required to withhold 28 percent of those payments. Backup withholding does not apply to wages, pensions, annuities, or IRAs.</td>
</tr>
</tbody>
</table>

**IRS CONNECTION**

The IRS estimates that self-employed taxpayers are underpaying their taxes by at least $81 billion. These nonwage workers are not caught because payers do not always report these payments to the IRS.
INDEPENDENT CONTRACTOR PAYMENTS

Payments made to independent contractors (individuals or partnerships) of at least $600 must be reported on Form 1099-Miscellaneous Income. This does not apply to contractors who are incorporated unless the payments are medical or health-care related. Since payments to these independent contractors are not generated by payroll departments, the accounts payable departments usually complete the appropriate 1099 Forms.

Form 1099-MISC can also be provided electronically to any recipient who has consented to receive the form in this manner.

BACKUP WITHHOLDING

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. This withholding must continue until the number is reported. Failure to withhold will result in the payer being held liable by the IRS for the 28 percent withholding.

**Nonpayroll Reporting**

Payroll income tax withholdings are reported on Form 941, while nonpayroll items are reported on Form 945, *Annual Return of Withheld Federal Income Tax*. Nonpayroll items include backup withholdings and withholdings on pensions, IRAs, gambling winnings, and military retirement pay. Generally, all income tax withholdings that are reported on Form 1099 or Form W-2G belong on Form 945.

**ELECTRONIC FILING FORM W-2 AND INFORMATION RETURNS**

If employers file 250 or more Forms W-2 or other information returns (for each type of information return), they must use electronic filing instead of paper forms. Filing Forms W-2 does not require approval of the medium by the Social Security Administration. The employer must complete *Form 4419, Application for Filing Information Returns Electronically*, and file it with the IRS.

**WITHHOLDING STATE INCOME TAX**

In addition to federal income taxes, many states also have income tax withholding requirements. The situation is further complicated if an employer has employees in several states.
This requires employers to know how much tax to withhold, what types of employees and payments are exempt, and how to pay the tax.

In general, state income taxes should be withheld based on where the services are performed unless there is a reciprocal agreement between the states. If there is no such agreement and the employee works in one state and lives in another, the laws of both states must be considered.

There are three different methods of withholding:

1. **Full taxation**—both resident’s state and work state calculate the taxes without any credits.
2. **Leftover taxation**—pay the full tax to the work state, and then pay the rest to the resident state.
3. **Reciprocity**—withhold only for the work state or resident state depending on the reciprocal agreement between the states.1

Employers must also be informed about each state’s regulations regarding:

1. The required frequency of making wage payments.
2. The acceptable media of payment.
3. The maximum interval between the end of a pay period and the payday for that period.
4. The time limits for making final wage payments to employees who are discharged, laid off, quit, or go on strike.
5. How often to inform employees of the deductions made from their wages.
6. The maximum amount of unpaid wages to pay the surviving spouse or family of a deceased worker.

Wage-bracket tables and percentage method formulas are used in many states to determine the amount of state income taxes to withhold from their employees’ wages. Each state also determines for state income tax purposes the taxability status of the various fringe benefits discussed in this chapter. Even though most states do not tax deductions made for cafeteria plans and 401(k) accounts, some states do not allow for the tax sheltering of these deductions from employees’ wages. Once again, it is the employers’ responsibility to know the laws of the states in which they conduct business.

Most states having income tax laws require employers to withhold tax from both nonresidents and residents, unless a reciprocal agreement exists with one or more states to the contrary. For example, a reciprocal agreement may exist between two states where both states grant an exemption to nonresidents who work in each of those states.

Even though there is no law requiring an employer to withhold income tax from the employee’s home state if the employer has no physical presence in that state, most employers do this as a courtesy to their out-of-state employees.

**State Income Tax Returns and Reports**

Payroll managers should be familiar with four main types of state income tax returns or reports:

1. **Periodic withholding returns** on which you report the wages paid and the state tax withheld during the reporting period. Figure 4–17 shows the Employer Deposit Statement of Income Tax Withheld used by employers in Pennsylvania. Depending on the amount of state income taxes withheld for each quarterly period, employers may be required to pay the taxes semimonthly, monthly, or quarterly. Some states require employers to deposit their withheld income taxes through electronic funds transfer (EFT).
2. **Reconciliation returns** that compare the total amount of state tax paid as shown on the periodic returns with the amounts of state tax declared to have been withheld from

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employees' wages. Figure 4–18 shows The Employer Quarterly Reconciliation Return of Income Tax Withheld for use by employers in Pennsylvania. Employers who have computer systems may submit their information on magnetic media.

3. Annual statements to employees showing the amount of wages paid during the year and the state tax withheld from those wages.
4. **Information returns** used to report payments to individuals that are not subject to withholding and/or are not reported on the annual employee wage and tax statements. See Figure 4–15 for a listing of the major information returns.

Since the requirements for transmitting returns and reports vary from state to state, 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. Because federal regulations require filing of information returns on magnetic media, many states permit employers to submit wage information on magnetic disk or tape. Also, many states take part in the Combined Federal/State Filing Program, which enables employers to file information returns with the federal government and authorize release of the information to the applicable state. To participate in this program, employers must first obtain permission from the IRS.

**Withholding Local Income Taxes**

In addition to state income tax laws, many cities and counties have passed local income tax legislation requiring employers to deduct and withhold income taxes or license fees on salaries or wages paid. In Alabama, several cities have license fee ordinances that require the withholding of the fees from employees' wages. Certain employees in Denver, Colorado, are subject to the withholding of the Denver Occupational Privilege Tax from their compensation. In Kentucky, a number of cities and counties impose a license fee (payroll tax).

Figure 4–19 shows the coupon that must be completed by employers in Philadelphia. All must withhold the city income tax from compensation paid their employees. Depending upon the amount of taxes withheld, employers may be required to make deposits weekly, monthly, or quarterly. For any late payments of the tax, the city imposes a penalty on the underpayment. Employers must file annual reconciliation returns by the end of February, reporting the amount of taxes deducted during the preceding calendar year.

**KEY TERMS**

- Annualizing wages (p. 4-16)
- Backup withholding (p. 4-30)
- Defined contribution plan (p. 4-9)
- Drawing account advances (p. 4-5)
- Earned income credit (EIC) (p. 4-19)
- Gross-up supplementals (p. 4-19)
- Information returns (p. 4-30)
- Percentage method (p. 4-14)
- Personal allowance (p. 4-9)
- Quarterly averaging (p. 4-16)
- Reciprocal agreement (p. 4-33)
- Special withholding allowance (p. 4-10)
- Standard deduction (p. 4-14)
- Supplemental wage payments (p. 4-17)
- Wage and tax statements (p. 4-24)
- Wage-bracket method (p. 4-14)
- Wages (p. 4-4)

**Figure 4–19**

*Philadelphia Wage Tax Coupon*

**Monthly Wage Tax**

*Account No.: 36666666*

*From: 12/1*

*To: 12/31*

*Period: 12/1-12/31*

*Philadelphia Revenue Department*

*P.O. Box 9999*

*Philadelphia, PA 19101-9999*

*Tax Due: ____________*

*Make checks payable to: CITY OF PHILADELPHIA*

*Tax Due for Month of December 2005*

*Additional Information:*

*Amount of Tax Due: ____________*

*Due Date: 1/31/2006*
QUESTIONS FOR REVIEW

NOTE: Use Tax Tables A and B at the back of this textbook and the tax regulations presented in this chapter to answer all questions and solve all problems.

1. How is the amount of a fringe benefit that is taxable to an employee determined?
2. To what extent are cash tips treated as remuneration subject to federal income tax withholding?
3. For each of the following kinds of wage payments, indicate whether or not the wages are exempt from the withholding of federal income taxes:
   a. Three weeks’ vacation pay.
   b. Weekly advance to a sales representative for traveling expenses to be incurred.
   c. Weekly wages paid the housekeeper in a college fraternity.
   d. Monthly salary received by Rev. Cole Carpenter.
   e. Payments under a worker’s compensation law for sickness or injury.
4. What is a personal allowance? What was the amount of a personal allowance for 2004?
5. On July 15, William Mitchell amended his Form W-4 to increase the number of withholding allowances from four to seven. Mitchell asked for a refund of the amount of overwithheld income taxes from January 1 to July 15 when the number of allowances was only four. Should Mitchell be reimbursed for the income taxes overwithheld before the effective date of the amended Form W-4?
6. Under what conditions may employees be exempt from the withholding of federal income taxes during 2005? How do such employees indicate their no-tax-liability status?
7. Under what conditions must employers submit copies of Form W-4 to the IRS?
8. Commencing in June, Slade Exon is eligible to receive monthly payments from a pension fund. What procedure should Exon follow if he does not wish to have federal income taxes withheld from his periodic pension payments?
9. Rhonda Gramm is single, and her wages are paid weekly. Under the percentage method, what is the amount of Gramm’s one weekly withholding allowance? Howard Heinz, married, claims two withholding allowances, and his wages are paid semimonthly. What is the total amount of his semimonthly withholding allowances?
10. What are the penalties imposed on employees for filing false information on Form W-4?
11. The Baucus Company has just completed the processing of its year-end payroll and distributed all the weekly paychecks. The payroll department is now computing the amount of the annual bonus to be given each worker. What methods may be used by the company in determining the amount of federal income taxes to be withheld from the annual bonus payments?
12. From what source do employers obtain the funds needed to make advance EIC payments to their eligible employees?
13. Orrin D’Amato, single, participates in his firm’s pension retirement plan. This year his modified adjusted gross income will be about $70,000. How much of his compensation may D’Amato contribute to an IRA this year without paying federal income taxes on the contribution?
14. For what purpose do employers complete Form W-3?

MATCHING QUIZ

1. Personal allowance  
2. Taxable tips  
3. Backup withholding  
4. Form W-5  
5. Roth IRA  
6. Standard deduction  
7. Pretax salary reductions  
8. Form 1096  
9. Nontaxable fringe benefits  
10. Flexible reporting  

A. Earned Income Credit Advance Payment Certificate  
B. Annual nondeductible contributions of up to $3,000  
C. Annual summary and transmittal of U.S. information returns  
D. Allows employers to use any basis as the time period for payment of noncash fringe benefits  
E. $3,100 deduction in computing taxable income  
F. Withholdings from gross pay that reduce the amount of pay subject to federal income tax  
G. Qualified employee discounts  
H. Amount of money used to reduce an individual’s adjusted gross income to taxable income  
I. Withhold federal income taxes of 28 percent of payments made  
J. $20 or more in a month
QUESTIONS FOR DISCUSSION

1. Alex Oberstar, a cook in the Lagomarsino Company cafeteria, is furnished two meals each day during his eight-hour shift. Oberstar’s duties require him to have his meals on the company's premises. Should the cash value of Oberstar’s meals be included as part of his taxable wages? Explain.

2. The Solomon Company ordinarily pays its employees on a weekly basis. Recently, one of the employees, Bernard Nagle, was sent from the home office on a three-week trip. Nagle has now returned to the office, and you are preparing a single check covering his three-week services. Should you withhold federal income taxes on the total gross earnings for the three-week period or should you compute the federal income taxes as if Nagle were receiving three separate weekly wage payments?

3. Investigate your state’s income tax withholding law (or that of some other state assigned by your instructor), and find the answers to the following questions:
   a. Who must withhold the tax?
   b. How are covered employers and covered employees defined?
   c. Are there any reciprocal agreements the state has entered into? If so, describe them.
   d. How is the withholding rate determined?
   e. What payments are subject to withholding?
   f. What payments are not subject to withholding?
   g. Are there any employee withholding exemptions?
   h. What methods of withholding are permitted?
   i. Describe each of the returns required by the state.
   j. What kinds of information must be retained by employers in their withholding tax records?
   k. What penalties are imposed for failure to comply with the withholding law?
   l. Are any employers required to deposit their withheld income taxes through electronic funds transfer (EFT)? If so, what requirements does the state impose?

4. Janice Sikorski, one of your firm’s workers, has just come into the payroll department and says to you: “I am thinking of amending my Form W-4 so that an additional $10 is withheld each week. That way I will get a fat refund next year. What do you think of my idea?” How would you reply to Sikorski?

5. Anita Leland, a waitress in the Atlantis Casino, reported tips of $467 to her employer last year. Two months after she filed her federal income tax return, Leland received a letter from the IRS informing her that she had earned $5,260 in tips rather than the $467 reported and that she owed the government $1,872.94 in back taxes.
   a. How is the IRS able to determine the amount of tips received by a waitress in a casino?
   b. If the IRS is correct in its determination of the tips received, is Atlantis subject to a penalty for not having withheld payroll taxes on all the tips Leland received during the year?

6. John Engles, an ex-employee, is entitled to a taxable fringe benefit during the first part of this year. Because he wasn’t paid any wages this year, can his employer report the taxable fringe benefit on Form 1099?

15. Why must some employers file Form 1096?

16. What is the penalty for filing W-2s with mismatched names and social security numbers?

17. What formula is used to “gross-up” supplemental payments in order to cover the taxes on the supplemental payments?

18. What is the maximum contribution that an employer can make to an employee’s SIMPLE account?

19. What is the maximum amount that an employee can shelter into a 401(k) plan?

20. How is the special period rule for the reporting of fringe benefits applied?
PRACTICAL PROBLEMS

4-1. LO 4.

Joseph English is a waiter at the Delphi Lounge. In his first weekly pay in March, he earned $120.00 for the 40 hours he worked. In addition, he reports his tips for February to his employer ($450.00), and the employer withholds the appropriate taxes for the tips from this first pay in March.

Calculate his net take-home pay assuming the employer withheld federal income tax (wage-bracket, married, 2 allowances), social security taxes, and state income tax (2%).

4-2. LO 4.

Use the percentage method to compute the federal income taxes to withhold from the wages or salaries of each employee.

<table>
<thead>
<tr>
<th>Employee No.</th>
<th>Employee Name</th>
<th>Marital Status</th>
<th>Withholding Allowances</th>
<th>Gross Wage or Salary</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Amoroso, A.</td>
<td>M</td>
<td>4</td>
<td>$1,610 weekly</td>
</tr>
<tr>
<td>2</td>
<td>Finley, R.</td>
<td>S</td>
<td>0</td>
<td>$825 biweekly</td>
</tr>
<tr>
<td>3</td>
<td>Gluck, E.</td>
<td>S</td>
<td>5</td>
<td>$9,630 quarterly</td>
</tr>
<tr>
<td>4</td>
<td>Quinn, S.</td>
<td>M</td>
<td>8</td>
<td>$925 semimonthly</td>
</tr>
<tr>
<td>5</td>
<td>Treave, Y.</td>
<td>M</td>
<td>3</td>
<td>$1,975 monthly</td>
</tr>
</tbody>
</table>

4-3. LO 4.

Use (a) the percentage method and (b) the wage-bracket method to compute the federal income taxes to withhold from the wages or salaries of each employee.

<table>
<thead>
<tr>
<th>Employee Name</th>
<th>Marital Status</th>
<th>Withholding Allowances</th>
<th>Gross Wage or Salary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Astin, N.</td>
<td>S</td>
<td>2</td>
<td>$475 weekly</td>
</tr>
<tr>
<td>Copeland, S.</td>
<td>S</td>
<td>1</td>
<td>$960 weekly</td>
</tr>
<tr>
<td>Jensen, R.</td>
<td>M</td>
<td>6</td>
<td>$1,775 biweekly</td>
</tr>
<tr>
<td>Schaffer, H.</td>
<td>M</td>
<td>4</td>
<td>$1,480 semimonthly</td>
</tr>
<tr>
<td>Yelm, T.</td>
<td>M</td>
<td>9</td>
<td>$5,380 monthly</td>
</tr>
</tbody>
</table>

4-4. LO 4.

Eaton Enterprises uses the wage-bracket method to determine federal income tax withholding on its employees.

Determine the amount to withhold from the wages paid each employee.

<table>
<thead>
<tr>
<th>Employee Name</th>
<th>Marital Status</th>
<th>Withholding Allowances</th>
<th>Gross Wage or Salary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hal Bower</td>
<td>M</td>
<td>1</td>
<td>W $1,350</td>
</tr>
<tr>
<td>Ruth Cramden</td>
<td>S</td>
<td>1</td>
<td>W $590</td>
</tr>
<tr>
<td>Gil Jones</td>
<td>S</td>
<td>3</td>
<td>W $675</td>
</tr>
<tr>
<td>Teresa Kern</td>
<td>M</td>
<td>6</td>
<td>M $4,090</td>
</tr>
<tr>
<td>Ruby Long</td>
<td>M</td>
<td>2</td>
<td>M $2,730</td>
</tr>
<tr>
<td>Katie Luis</td>
<td>M</td>
<td>8</td>
<td>S $955</td>
</tr>
<tr>
<td>Susan Martin</td>
<td>S</td>
<td>1</td>
<td>D $96</td>
</tr>
<tr>
<td>Jim Singer</td>
<td>S</td>
<td>4</td>
<td>S $2,610</td>
</tr>
<tr>
<td>Martin Torres</td>
<td>M</td>
<td>4</td>
<td>M $3,215</td>
</tr>
</tbody>
</table>
The names of the employees of the Western Music Shop are listed on the following payroll register. Employees are paid weekly. The marital status and the number of allowances claimed are shown on the payroll register, along with each employee's weekly salary, which has remained the same all year. Complete the payroll register for the pay period ending December 23, the 51st weekly payday. The state income tax rate is 2% of total earnings, the city income tax rate is 1.5% of the total gross earnings, and the wage-bracket method is used for federal income taxes.

### WESTERN MUSIC SHOP
### PAYROLL REGISTER

<table>
<thead>
<tr>
<th>EMPLOYEE NAME</th>
<th>MARITAL STATUS</th>
<th>NO. OF W/H ALLOW.</th>
<th>TOTAL EARNINGS</th>
<th>DEDUCTIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(a) FICA</td>
</tr>
<tr>
<td>Bennet, Marvin</td>
<td>M</td>
<td>3</td>
<td>180000</td>
<td>OASDI</td>
</tr>
<tr>
<td>Green, Robert</td>
<td>S</td>
<td>1</td>
<td>28500</td>
<td>OASDI</td>
</tr>
<tr>
<td>Herd, Ben</td>
<td>M</td>
<td>0</td>
<td>1550</td>
<td>OASDI</td>
</tr>
<tr>
<td>Larson, Beverly</td>
<td>S</td>
<td>3</td>
<td>32425</td>
<td>OASDI</td>
</tr>
<tr>
<td>Maston, Roberta</td>
<td>S</td>
<td>1</td>
<td>37500</td>
<td>OASDI</td>
</tr>
<tr>
<td>Nash, Tim</td>
<td>S</td>
<td>2</td>
<td>558.50</td>
<td>OASDI</td>
</tr>
<tr>
<td>Stelt, Harold</td>
<td>S</td>
<td>1</td>
<td>470.50</td>
<td>OASDI</td>
</tr>
<tr>
<td>Zelder, Nadine</td>
<td>M</td>
<td>3</td>
<td>38000</td>
<td>OASDI</td>
</tr>
</tbody>
</table>

**Totals**

Compute the employer's FICA taxes for the pay period ending December 12.

OASDI Taxes
- OASDI taxable earnings: $ \_
- OASDI taxes: $ \_

HI Taxes
- HI taxable earnings: $ \_
- HI taxes: $ \_

4-6

The Damerly Company (a California employer) wants to give a holiday bonus check of $250 to each employee. Since it wants the check amount to be $250, it will need to gross up the amount of the bonus. Calculate the withholding taxes and the gross amount of the bonus to be made to John Rolen if his cumulative earnings for the year are $46,910. Besides being subject to social security taxes and federal income tax (supplemental rate), a 6 percent California income tax must be withheld on supplemental payments.
4–7. LO 4, 6.  

The names of the employees of Cox Security Systems and their regular salaries are shown in the following payroll register. Note that Hill and Van Dyne are paid monthly on the last pay day, while all others are paid weekly.

In addition to the regular salaries, the company pays an annual bonus based on the amount of earnings for the year. For the current year, the bonus amounts to 8 percent of the annual salary paid to each employee. The bonus is to be paid along with the regular salaries on December 30, but the amount of the bonus and the amount of the regular salary will be shown separately on each employee's earnings statement. Assume that all employees received their regular salary during the entire year.

Prepare the payroll for the pay period ending December 30, showing the following for each employee:
- Use the wage-bracket method to withhold federal income tax from the regular salaries.
- Withhold a flat 25 percent on the annual bonus.
- Total salaries and bonuses are subject to a 2 percent state income tax and a 1 percent city income tax.

<table>
<thead>
<tr>
<th>EMPLOYEE NAME</th>
<th>MARITAL STATUS</th>
<th>NO. OF W/H ALLOW.</th>
<th>REGULAR</th>
<th>SUPP'L.</th>
<th>TOTAL</th>
<th>OASDI</th>
<th>HI</th>
<th>FIT</th>
<th>SIT</th>
<th>CIT</th>
<th>NET PAY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hill, J. Harvey</td>
<td>M</td>
<td>5</td>
<td>5 5 0 0 0 00</td>
<td></td>
<td></td>
<td></td>
<td>OASDI</td>
<td>HI</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Van Dyne, Joyce S.</td>
<td>M</td>
<td>2</td>
<td>2 8 5 0 0 00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Abbott, Leslie N.</td>
<td>S</td>
<td>1</td>
<td>5 2 0 0 00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Burgener, Russel L.</td>
<td>M</td>
<td>4</td>
<td>4 6 5 0 00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Noblet, Thomas D.</td>
<td>M</td>
<td>2</td>
<td>3 8 0 0 00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Short, Frank C.</td>
<td>S</td>
<td>1</td>
<td>3 5 0 0 00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Toban, Harriette O.</td>
<td>M</td>
<td>2</td>
<td>5 7 5 0 00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wyeth, Amy R.</td>
<td>S</td>
<td>0</td>
<td>4 2 5 0 00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>OASDI</td>
<td>HI</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Compute the employer's FICA taxes for the pay period ending December 30.

- OASDI Taxes
  - OASDI taxable earnings: $______
  - OASDI taxes: $______

- HI Taxes
  - HI taxable earnings: $______
  - HI taxes: $______

(M)* indicates monthly pay.
During the quarter ending December 31 of the current year, Cox Security Systems had 13 weekly paydays and three monthly paydays.

Using the data given in Problem 4–7, complete the following form to show:

a. Total earnings paid during the quarter, including both the regular and the supplemental earnings.

b. Total amount of FICA taxes withheld during the quarter.

c. Total amount of federal income taxes withheld during the quarter.

d. Total amount of state income taxes withheld during the quarter.

e. Total amount of city income taxes withheld during the quarter.

f. Total net amount paid each employee during the quarter.

<table>
<thead>
<tr>
<th>EMPLOYEE NAME</th>
<th>(a) TOTAL EARNINGS</th>
<th>(b) FICA</th>
<th>(c) FIT</th>
<th>(d) SIT</th>
<th>(e) CIT</th>
<th>(f) NET PAY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hill, J. Harvey</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Van Dyne, Joyce S.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Abbott, Leslie N.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Banger, Russel L.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Noblet, Thomas D.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Short, Frank C.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Toban, Harriette O.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wyeth, Amy R.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
The employees of Evergreen Garden Center are paid weekly. The names of five employees of the company are given on the following payroll register. The payroll register also shows the marital status and number of withholding allowances claimed and the total weekly earnings for each worker. Assume that each employee is paid the same weekly wage on each payday in 2005. Also shown below is the wage-bracket table for advance earned income credit (EIC) payments for a weekly payroll period. Each employee listed on the payroll register has completed a Form W-5 indicating that the worker is not married. Complete the payroll register for the weekly period ending November 18, 2005. The state income tax rate is 1.5 percent on total earnings and the wage-bracket tables are used for federal income tax.

<table>
<thead>
<tr>
<th>EMPLOYEE NAME</th>
<th>MARITAL STATUS</th>
<th>NO. OF WH. ALLOW.</th>
<th>TOTAL EARNINGS</th>
<th>OASDI</th>
<th>HI</th>
<th>(a) FICA</th>
<th>(b) FIT</th>
<th>(c) S/I</th>
<th>(d) ADVANCE EIC PAYMENT</th>
<th>(e) NET PAY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allen, R.</td>
<td>S</td>
<td>4</td>
<td>2 2 9 00</td>
<td></td>
<td></td>
<td>$130</td>
<td>$135</td>
<td>$27</td>
<td>$360</td>
<td>$370</td>
</tr>
<tr>
<td>Dilts, Y.</td>
<td>S</td>
<td>1</td>
<td>4 1 2 00</td>
<td></td>
<td></td>
<td>$130</td>
<td>$135</td>
<td>$27</td>
<td>$360</td>
<td>$370</td>
</tr>
<tr>
<td>Martin, E.</td>
<td>S</td>
<td>2</td>
<td>2 1 5 00</td>
<td></td>
<td></td>
<td>$130</td>
<td>$135</td>
<td>$27</td>
<td>$360</td>
<td>$370</td>
</tr>
<tr>
<td>Roselli, T.</td>
<td>S</td>
<td>3</td>
<td>3 7 6 00</td>
<td></td>
<td></td>
<td>$130</td>
<td>$135</td>
<td>$27</td>
<td>$360</td>
<td>$370</td>
</tr>
<tr>
<td>Whitman, Q.</td>
<td>S</td>
<td>1</td>
<td>1 2 5 00</td>
<td></td>
<td></td>
<td>$130</td>
<td>$135</td>
<td>$27</td>
<td>$360</td>
<td>$370</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$650</td>
<td>$675</td>
<td>$164</td>
<td>$1140</td>
<td>$1170</td>
</tr>
</tbody>
</table>

**WEEKLY Payroll Period**

<table>
<thead>
<tr>
<th><strong>SINGLE or HEAD OF HOUSEHOLD</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Wages—</strong> (a) FICA</td>
</tr>
<tr>
<td><strong>At least</strong></td>
</tr>
<tr>
<td>$0 $5 $0</td>
</tr>
<tr>
<td>5 10 1</td>
</tr>
<tr>
<td>10 15 2</td>
</tr>
<tr>
<td>15 20 3</td>
</tr>
<tr>
<td>20 25 4</td>
</tr>
<tr>
<td>25 30 5</td>
</tr>
<tr>
<td>30 35 6</td>
</tr>
<tr>
<td>35 40 7</td>
</tr>
<tr>
<td>40 45 8</td>
</tr>
<tr>
<td>45 50 9</td>
</tr>
<tr>
<td>50 55 10</td>
</tr>
<tr>
<td>55 60 11</td>
</tr>
<tr>
<td>60 65 12</td>
</tr>
</tbody>
</table>

4–10.

The Mattola Company is giving each of its employees a holiday bonus of $100 on December 24 (a nonpayday).

a. What will be the gross amount of each bonus if each employee pays a state income tax of 2.8% (besides the other payroll taxes)? $_______

b. What would the net amount of each bonus check be if the company did not gross up the bonus? $_______

4–9. LO 4, 7.

The Mattola Company is giving each of its employees a holiday bonus of $100 on December 24 (a nonpayday).

a. What will be the gross amount of each bonus if each employee pays a state income tax of 2.8% (besides the other payroll taxes)? $_______

b. What would the net amount of each bonus check be if the company did not gross up the bonus? $_______
4-11. LO 4.

Joe Kohlhepp (age 48) is employed by King Company and is paid a salary of $42,640. He has just decided to join the company’s Simple Retirement Account (IRA form) and has a few questions. Answer the following for Joe:

a. What is the maximum that he can contribute into this retirement fund? $______

b. What would be the company’s contribution? $______

c. What would be his weekly take-home pay with the retirement contribution deducted (married, 2 allowances, wage-bracket method, and a 2.3 percent state income tax on total wages)? $______

d. What would be his weekly take-home pay without the retirement contribution deduction? $______

4-12. LO 9.

During the fourth quarter of 2005, there were seven biweekly paydays on Friday (October 7, 21; November 4, 18; December 2, 16, 30) for Emerald City Repair. Using the forms supplied below and on pages 4-44–45, complete the following for the fourth quarter:


b. Employer’s Quarterly Federal Tax Return, Form 941. The form is signed by you.


Quarterly Payroll Data

<table>
<thead>
<tr>
<th>Total Earnings</th>
<th>OASDI</th>
<th>HI</th>
<th>FIT</th>
<th>SIT</th>
<th>EIC Payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>$18,725.00</td>
<td>$1,160.95</td>
<td>$271.53</td>
<td>$1,701.00</td>
<td>$1,310.75</td>
<td>$1,757.00</td>
</tr>
</tbody>
</table>

Employer’s OASDI $1,160.95
Employer’s HI $271.53
Federal Deposit Liability Each Pay $ 401.28
To be deposited on or before __________
To be deposited on or before ______________

<table>
<thead>
<tr>
<th>Date</th>
<th>Name</th>
</tr>
</thead>
</table>

**4–12. (continued)**

---

**EMERALD CITY REPAIR**
10 SUMMIT SQUARE
CITY, STATE 00000-0000

---

**Federal Tax Deposit Coupon**
Form 8109
Form 941 (Rev. January 2004)

Employer’s Quarterly Federal Tax Return

See separate instructions revised January 2004 for information on completing this return.

Please type or print.

| OMB No. 1545-0029 |

Enter state code for state in which deposits were made only if different from state in address to the right (see page 2 of separate instructions).

<table>
<thead>
<tr>
<th>Name (as distinguished from trade name)</th>
<th>Date quarter ended</th>
</tr>
</thead>
<tbody>
<tr>
<td>EMERALD CITY REPAIR</td>
<td>DEC. 31, 2005</td>
</tr>
<tr>
<td>10 SUMMIT SQUARE</td>
<td></td>
</tr>
</tbody>
</table>

If address is different from prior return, check here ▶

IRS Use

<table>
<thead>
<tr>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
</tr>
</thead>
<tbody>
<tr>
<td>11</td>
<td>11</td>
<td>11</td>
<td>11</td>
<td>11</td>
<td>11</td>
<td>11</td>
</tr>
</tbody>
</table>

A If you do not have to file returns in the future, check here ▶ and enter final wages paid ▶

B If you are a seasonal employer, see Seasonal employers on page 1 of the instructions and check here ▶

1 Number of employees in the pay period that includes March 12th ▶

2 Total wages and tips, plus other compensation

3 Total income tax withheld from wages, tips, and sick pay

4 Adjustment of withheld income tax for preceding quarters of this calendar year

5 Adjusted total of income tax withheld (line 3 as adjusted by line 4)

6 Taxable social security wages

6a × 12.4% (.124) = Taxable social security wages

6b Taxable social security tips

6c × 12.4% (.124) = Taxable social security tips

6d Taxable Medicare wages and tips

7a × 2.9% (.029) = Taxable Medicare wages and tips

7b Total social security and Medicare taxes (add lines 6b, 6d, and 7b)

8 If wages are not subject to social security and/or Medicare tax

9 Adjustment of social security and Medicare taxes (see instructions for required explanation)

Sick Pay $ ± Other $ ± Fractions of Cents $ =

10 Adjusted total of social security and Medicare taxes (line 8 as adjusted by line 9)

11 Total taxes (add lines 5 and 10)

12 Advance earned income credit (EIC) payments made to employees (see instructions)

13 Net taxes (subtract line 12 from line 11). If $2,500 or more, this must equal line 17, column (d) below (or line D of Schedule B (Form 941))

14 Total deposits for quarter, including overpayment applied from a prior quarter

15 Balance due (subtract line 14 from line 13). See instructions

16 Overpayment. If line 14 is more than line 13, enter excess here ▶ $

For Privacy Act and Paperwork Reduction Act Notice, see back of Payment Voucher.

Cat. No. 17001Z

FORM 941 (Rev. 1-2004)
During the first week of 2006, the Payroll Department of the Figley Corporation is preparing the Forms W-2 for distribution to its employees along with their payroll checks on January 7. In this problem, you will complete six of the forms in order to gain some experience in recording the different kinds of information required.

Assume each employee earned the same weekly salary for each of the 52 paydays in 2005.

**Company Information:**

- Address: 4800 River Road
- Telephone number: (215) 373-0017
- Fax number: (215) 373-0010
- Pennsylvania State identification number: 46-3-1066
- Federal identification number: 13-7490972
- Philadelphia identification number: 4731895

**Income Tax Information:**

*The wage-bracket method is used to determine federal income tax withholding. Calculate the annual federal income tax withheld by using the weekly wage-bracket table and multiply the answer by 52. The other taxes withheld are shown below.*

**Employee Data**

<table>
<thead>
<tr>
<th>Name</th>
<th>Single, 1 allowance</th>
<th>Payroll Data</th>
<th>Annual Taxes Withheld</th>
</tr>
</thead>
<tbody>
<tr>
<td>Patricia A. Grimes</td>
<td>Single, 1 allowance</td>
<td>$415 per week</td>
<td>Social security tax withheld</td>
</tr>
<tr>
<td>54 Gradison Place</td>
<td>SS#: 376-72-4310</td>
<td>Deduction for 401(k) plan: $50/week</td>
<td>Medicare tax withheld</td>
</tr>
<tr>
<td>Philadelphia, PA 19113-4054</td>
<td></td>
<td></td>
<td>State income tax withheld</td>
</tr>
<tr>
<td>Roberta P. Kurtz</td>
<td>Married, 1 allowance</td>
<td>$485 per week</td>
<td>Social security tax withheld</td>
</tr>
<tr>
<td>56 Andrews Court, Apt. 7</td>
<td>SS#: 272-33-8804</td>
<td>Dependent care payment: $950</td>
<td>Medicare tax withheld</td>
</tr>
<tr>
<td>Philadelphia, PA 19103-3356</td>
<td>$70/week—401(k)</td>
<td></td>
<td>State income tax withheld</td>
</tr>
</tbody>
</table>

**Payroll Data**

- Deduction for 401(k) plan: $50/week
- Dependent care payment: $950
- Union dues withheld: $102
- Advance EIC payments: $16 per week
- Educational assistance payments (job-required): $675

**Annual Taxes Withheld**

- Social security tax withheld
- Medicare tax withheld
- State income tax withheld
- Local income tax withheld
- FICA taxes withheld

**Payroll Data**

<table>
<thead>
<tr>
<th>Name</th>
<th>Single, 0 allowances</th>
<th>Payroll Data</th>
<th>Annual Taxes Withheld</th>
</tr>
</thead>
<tbody>
<tr>
<td>David P. Markle</td>
<td>Single, 0 allowances</td>
<td>$365 per week</td>
<td>Social security tax withheld</td>
</tr>
<tr>
<td>770 Camac Street</td>
<td>SS#: 178-92-3316</td>
<td>Union dues withheld: $102</td>
<td>Medicare tax withheld</td>
</tr>
<tr>
<td>Philadelphia, PA 19101-3770</td>
<td>$70/week—401(k)</td>
<td></td>
<td>State income tax withheld</td>
</tr>
<tr>
<td>Harold W. Rasul</td>
<td>Married, 7 allowances</td>
<td>$1,350</td>
<td>Social security tax withheld</td>
</tr>
<tr>
<td>338 North Side Avenue</td>
<td>SS#: 269-01-6839</td>
<td>Cost of group-term life insurance exceeding $50,000: $262.75</td>
<td>Medicare tax withheld</td>
</tr>
<tr>
<td>Philadelphia, PA 19130-6638</td>
<td>$100/week—401(k)</td>
<td>Cost of group-term life insurance exceeding $50,000: $262.75</td>
<td>State income tax withheld</td>
</tr>
</tbody>
</table>

**Annual Taxes Withheld**

- Social security tax withheld
- Medicare tax withheld
- State income tax withheld
- Local income tax withheld
- FICA taxes withheld

**Payroll Data**

- Deduction for 401(k) plan: $50/week
- Dependent care payment: $950
- Union dues withheld: $102
- Advance EIC payments: $16 per week
- Educational assistance payments (job-required): $675

**Annual Taxes Withheld**

- Social security tax withheld
- Medicare tax withheld
- State income tax withheld
- Local income tax withheld
- FICA taxes withheld

**Payroll Data**

<table>
<thead>
<tr>
<th>Name</th>
<th>Single, 1 allowance</th>
<th>Payroll Data</th>
<th>Annual Taxes Withheld</th>
</tr>
</thead>
<tbody>
<tr>
<td>Angelo Zickar</td>
<td>Single, 1 allowance</td>
<td>$390 per week</td>
<td>Social security tax withheld</td>
</tr>
<tr>
<td>480-A Hopkinson Tower</td>
<td>SS#: 337-99-8703</td>
<td>Educational assistance payments (job-required): $675</td>
<td>Medicare tax withheld</td>
</tr>
<tr>
<td>Philadelphia, PA 19101-3301</td>
<td>$50/week—401(k)</td>
<td></td>
<td>State income tax withheld</td>
</tr>
</tbody>
</table>

**Annual Taxes Withheld**

- Social security tax withheld
- Medicare tax withheld
- State income tax withheld
- Local income tax withheld
- FICA taxes withheld
W-2 Wage and Tax Statement 2005

Copy A For Social Security Administration—Send this entire page with Form W-3 to the Social Security Administration; photocopies are not acceptable.

<table>
<thead>
<tr>
<th>a. Control number</th>
<th>22222</th>
<th>Void</th>
</tr>
</thead>
<tbody>
<tr>
<td>b. Employer identification number</td>
<td></td>
<td></td>
</tr>
<tr>
<td>c. Employer's name, address, and ZIP code</td>
<td></td>
<td></td>
</tr>
<tr>
<td>d. Employee's social security number</td>
<td></td>
<td></td>
</tr>
<tr>
<td>e. Employee's first name and initial</td>
<td>Last name</td>
<td></td>
</tr>
<tr>
<td>f. Employee's address and ZIP code</td>
<td></td>
<td></td>
</tr>
<tr>
<td>15 State</td>
<td>Employer's state ID number</td>
<td>16 State wages, tips, etc.</td>
</tr>
<tr>
<td>18 Local wages, tips, etc.</td>
<td>19 Local income tax</td>
<td>20 Locality name</td>
</tr>
</tbody>
</table>

Do Not Cut, Fold, or Staple Forms on This Page — Do Not Cut, Fold, or Staple Forms on This Page
### W-2 Wage and Tax Statement 2005

**For Social Security Administration**—Send this entire page with Form W-3 to the Social Security Administration; photocopies are not acceptable.

---

<table>
<thead>
<tr>
<th>Date</th>
<th>Name</th>
</tr>
</thead>
</table>

---

#### Column 1: Employee's Information

- **Control number**: 22222
- **Void**: [Blank]
- **For Official Use Only**: [Blank]
- **OMB No. 1545-0008**: [Blank]

#### Column 2: Employer's Information

- **Control number**: 22222
- **Void**: [Blank]
- **For Official Use Only**: [Blank]
- **OMB No. 1545-0008**: [Blank]

### Column 3: Wage and Tax Information

- **Wages, tips, other compensation**: [Blank]
- **Social security wages**: [Blank]
- **Medicare wages and tips**: [Blank]
- **Social security tips**: [Blank]
- **Advance EIC payment**: [Blank]
- **Dependent care benefits**: [Blank]
- **Nonqualified plans**: [Blank]
- **Social security tax withheld**: [Blank]
- **Medicare tax withheld**: [Blank]
- **Allocated tips**: [Blank]
- **Local income tax**: [Blank]

---

**Note:** For Privacy Act and Paperwork Reduction Act Notice, see separate instructions.
4–13. (continued)

**Form W-2 Wage and Tax Statement 2005**

*Copy A* For Social Security Administration—Send this entire page with Form W-3 to the Social Security Administration; photocopies are not acceptable.

<table>
<thead>
<tr>
<th>a. Control number</th>
<th>22222</th>
<th>Void</th>
<th>For Official Use Only</th>
<th>OMB No. 1545-0008</th>
</tr>
</thead>
</table>
| b. Employer identification number | 1 | Wages, tips, other compensation | $ | 2 | Federal income tax withheld | $
| c. Employer’s name, address, and ZIP code | 3 | Social security wages | $ | 4 | Social security tax withheld | $
| d. Employee’s social security number | 5 | Medicare wages and tips | $ | 6 | Medicare tax withheld | $
| e. Employee’s first name and initial | 7 | Social security tips | $ | 8 | Allocated tips | $
| f. Employee’s address and ZIP code | 9 | Advance EIC payment | $ | 10 | Dependent care benefits | $
| g. Employee’s state ID number | 11 | Nonqualified plans | $ | 12a | See instructions for box 12 | $
| h. Employer’s state ID number | 12b | | | | |
| i. Employer’s state ID number | 12c | | | | |
| j. Employer’s state ID number | 12d | | | | |

**Form W-2 Wage and Tax Statement 2005**

*Copy A* For Social Security Administration—Send this entire page with Form W-3 to the Social Security Administration; photocopies are not acceptable.

<table>
<thead>
<tr>
<th>a. Control number</th>
<th>22222</th>
<th>Void</th>
<th>For Official Use Only</th>
<th>OMB No. 1545-0008</th>
</tr>
</thead>
</table>
| b. Employer identification number | 1 | Wages, tips, other compensation | $ | 2 | Federal income tax withheld | $
| c. Employer’s name, address, and ZIP code | 3 | Social security wages | $ | 4 | Social security tax withheld | $
| d. Employee’s social security number | 5 | Medicare wages and tips | $ | 6 | Medicare tax withheld | $
| e. Employee’s first name and initial | 7 | Social security tips | $ | 8 | Allocated tips | $
| f. Employee’s address and ZIP code | 9 | Advance EIC payment | $ | 10 | Dependent care benefits | $
| g. Employee’s state ID number | 11 | Nonqualified plans | $ | 12a | See instructions for box 12 | $
| h. Employer’s state ID number | 12b | | | | |
| i. Employer’s state ID number | 12c | | | | |
| j. Employer’s state ID number | 12d | | | | |

**Do Not Cut, Fold, or Staple Forms on This Page — Do Not Cut, Fold, or Staple Forms on This Page**
4–13. (concluded)

**Form W-3 Transmittal of Wage and Tax Statements**

<table>
<thead>
<tr>
<th>a</th>
<th>Control number</th>
<th>33333</th>
<th>For Official Use Only</th>
</tr>
</thead>
<tbody>
<tr>
<td>b</td>
<td>Kind of Payer</td>
<td></td>
<td>OMB No. 1545-0008</td>
</tr>
<tr>
<td></td>
<td>Military</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>CT-1</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Medicare</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Third-party</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>sick pay</td>
<td></td>
<td></td>
</tr>
<tr>
<td>c</td>
<td>Total number of Forms W-2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>d</td>
<td>Establishment number</td>
<td></td>
<td></td>
</tr>
<tr>
<td>e</td>
<td>Employer identification number</td>
<td></td>
<td></td>
</tr>
<tr>
<td>f</td>
<td>Employer's name</td>
<td></td>
<td></td>
</tr>
<tr>
<td>g</td>
<td>Employer's address and ZIP code</td>
<td></td>
<td></td>
</tr>
<tr>
<td>h</td>
<td>Other EIN used this year</td>
<td></td>
<td></td>
</tr>
<tr>
<td>i</td>
<td>State</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Employer's state ID number</td>
<td></td>
<td></td>
</tr>
<tr>
<td>j</td>
<td>Local wage, tips, etc.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>k</td>
<td>State wage, tips, etc.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>l</td>
<td>State income tax</td>
<td></td>
<td></td>
</tr>
<tr>
<td>m</td>
<td>Local income tax</td>
<td></td>
<td></td>
</tr>
<tr>
<td>n</td>
<td>Contact person</td>
<td></td>
<td></td>
</tr>
<tr>
<td>o</td>
<td>Telephone number</td>
<td></td>
<td></td>
</tr>
<tr>
<td>p</td>
<td>Fax number</td>
<td></td>
<td></td>
</tr>
<tr>
<td>q</td>
<td>E-mail address</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Under penalties of perjury, I declare that I have examined this return and accompanying documents, and, to the best of my knowledge and belief, they are true, correct, and complete.

**Signature**

**Title**

**Date**

Form **W-3 Transmittal of Wage and Tax Statements**

Send this entire page with the entire Copy A page of Form(s) W-2 to the Social Security Administration. Photocopies are not acceptable.

**Do not** send any payment (cash, checks, money orders, etc.) with Forms W-2 and W-3.
CONTINUING PAYROLL PROBLEM

Refer to the partially completed payroll register which you worked on at the end of Chapter 3. You will now determine the amount of income tax to withhold for each employee, proceeding as follows:

1. In the appropriate columns of your payroll register, record the marital status and number of withholding allowances claimed for each employee, using the information provided.
2. Record the payroll deductions for the SIMPLE plan that the employer has established for participating employees.

<table>
<thead>
<tr>
<th>Time Card No.</th>
<th>Marital Status</th>
<th>No. of Allowances</th>
<th>SIMPLE Deductions</th>
</tr>
</thead>
<tbody>
<tr>
<td>11</td>
<td>S</td>
<td>1</td>
<td>$20</td>
</tr>
<tr>
<td>12</td>
<td>S</td>
<td>0</td>
<td>50</td>
</tr>
<tr>
<td>13</td>
<td>M</td>
<td>2</td>
<td>40</td>
</tr>
<tr>
<td>21</td>
<td>M</td>
<td>4</td>
<td>50</td>
</tr>
<tr>
<td>22</td>
<td>S</td>
<td>2</td>
<td>20</td>
</tr>
<tr>
<td>31</td>
<td>M</td>
<td>3</td>
<td>40</td>
</tr>
<tr>
<td>32</td>
<td>M</td>
<td>6</td>
<td>50</td>
</tr>
<tr>
<td>33</td>
<td>S</td>
<td>1</td>
<td>60</td>
</tr>
<tr>
<td>51</td>
<td>M</td>
<td>5</td>
<td>30</td>
</tr>
<tr>
<td>99</td>
<td>M</td>
<td>7</td>
<td>80</td>
</tr>
</tbody>
</table>

All of the employees are participating and their weekly contributions are listed below. The tax deferral on these deductions applies only to the federal income tax.

3. Record the amount of federal income taxes using the wage-bracket method.
4. Record the state income taxes on the gross weekly earnings for each employee. The rate is 3.07 percent for the state of Pennsylvania.
5. Record the city income taxes on the gross weekly earnings of each employee. The rate is 1 percent for the city of Pittsburgh residents.

CASE PROBLEMS

C1. Answering Employees’ Questions About Wage Reporting.

During the past week, one of your newly employed payroll associates dropped into your office to ask several questions regarding wage reporting for federal income and social security tax purposes. If you were the payroll supervisor, how would you answer each of the following questions raised by your associate?

1. I just noticed that the social security number is wrong on three of the employees’ W-2 forms. How do I go about correcting the forms? Will the employees be penalized for filing incorrect forms?

2. Eileen Huang informed me today that we had withheld too much medicare tax from her pay last year. She is right! What forms do I use to make the correction?

3. You asked me last week to locate one of our former employees, Warren Bucks. I can’t seem to track him down. What should I do with his Form W-2?

4. Is it okay to use titles like “M.D.” and “Esq.” when I keyboard data in the W-2 forms?

C2. Classified as an Employee and Independent Contractor.

The Yeager Company pays John Kerr a salary as an employee and also fees for work he does as an independent contractor. Does this violate IRS rules?
Net activities

URLs are subject to change. Please visit the Bieg Payroll Accounting Web site: http://bieg.swlearning.com for updates.

1. The IRS has an automatic withholding calculator:
   http://www.irs.gov/individuals/article/0,,id=96196,00.html
   Here are some things that are needed to calculate appropriate withholding for you:
   • Have your most recent pay stubs handy.
   • Have your most recent income tax return handy.
   • Fill in all information that applies to your situation.
   • Estimate values, if necessary, remembering that the results can only be as accurate as the input you provide.
   a. Why would you want to increase or decrease the number of your withholding allowances?
   Using the calculator:
   b. What would you have to do to increase the amount of your tax refund at the end of the year?
   c. What would you have to do to increase the amount of your paycheck during the year?

2. Do you qualify for the advance earned income credit?
   http://www.irs.gov/individuals/page/0,,id%3D13712,00.html
   a. What are the requirements for receiving the advance earned income credit?
   b. How do employees receive their advance earned income credit if qualified?

3. Go to:
   http://www.eftps.gov
   a. How long does it take a taxpayer to enroll in the electronic federal tax payment system (EFTPS)?
   b. What are the advantages of the EFTPS?

4. Go to:
   http://www.irs.gov/businesses/display/0,,il%3D2&genericId%3D10063,00.html
   a. Who can use the TeleFile system?
   b. Why would a business want to use the TeleFile system?

5. Go to:
   http://www.ssa.gov/pubs/10022.html
   a. How is self-employment income treated differently from income from an employer?
   b. How do you report self-employment income?