

Payroll 101:**An Introduction to Payroll and Taxes**

As a new employer, you probably have questions about what it means to “do payroll.” This document will provide you with an introduction to payroll processing and some background about your obligations as an employer.

There are three main things you need to do related to payroll:

1. Pay your employees: calculate gross pay and taxes withheld each pay period
2. Pay taxes: pay taxes withheld from employees’ paychecks as well as tax liabilities you incur as an employer to the appropriate government agencies, such as the IRS or your state’s department of revenue
3. File tax forms: these must be dealt with every quarter. Even if you’ve paid everything you owe, you still have to file tax forms that report your liabilities.

This introduction is designed to get you comfortable with the assistance our service provides and to familiarize you with some common payroll jargon.

Part I: What are payroll taxes?

Payroll taxes are those taxes withheld from your employees’ paychecks, as well as those taxes you pay as an employer based on the wages you pay your employees. These include:

- Social Security and Medicare
- Federal and state unemployment
- Personal income tax (federal and state)
- Miscellaneous other state taxes

Most payroll taxes, such as income tax, apply to all earnings. However, some taxes have what is called a *wage cap*—the maximum annual earnings that are subject to the tax, per employee. These caps may be changed by the governing agency from time to time (typically annually).

Summary of the most common payroll taxes:

Tax Name	Tax Rate	Who Pays	2005 Wage Cap
Social Security (SS)	6.2%	Employee and Employer	\$90,000
Medicare	1.45%	Employee and Employer	unlimited
Personal Income Tax (PIT)	Varies based on projected annual income	Employee	unlimited
Federal Unemployment (FUTA)	0.8%	Employer	\$7,000
State Unemployment Insurance (SUI)	Varies based on employer’s <i>experience</i> rate	Employer in all states; some states have employee contribution	Varies by state

Social Security and Medicare

Social Security and Medicare taxes are paid by both employer and employee. As an employer, you withhold the employee's part of the taxes and also pay a matching amount.

The employee tax rate (amount withheld) for Social Security is 6.2%. The employer tax rate for Social Security is also 6.2% (12.4% total). This is a tax with a wage cap, which means that the tax is calculated only up to a maximum dollar amount of wages per employee each year. For 2005, the wage cap for Social Security is \$90,000.

The employee tax rate (amount withheld) for Medicare is 1.45%. The employer tax rate for Medicare tax is also 1.45% (2.9% total). There is no wage cap for Medicare tax, which means the tax is paid on all of the wages that the employee earns. (The exception is exempt wages—see "Special Tax Exemptions, " on page 3.)

Personal Income Tax

The amount of federal income tax withheld from employees' paychecks depends on their marital status, the number of withholding allowances (exemptions) they claim on Form W-4, and their projected annual income.

In addition, all but nine states have a personal income tax (exceptions are AK, FL, NV, NH, TN, TX, SD, WY, and WA). It may be a flat tax rate (as in Illinois), regardless of projected income, or a graduated tax rate based on annual income, like the federal income tax.

In some states, employees also pay local tax (to cities, school districts, or counties) through their paycheck.

Form W-4. An employee reports several items on Form W-4:

- *Filing Status.* This is the marital status that dictates which tax table will be used to calculate income tax withholding. For federal income taxes, there are four filing status options: single, married filing jointly, head of household, and married filing separately.
- *Withholding Allowances.* Also called *exemptions*, withholding allowances reduce taxable income by a designated amount per allowance. The IRS updates allowance amounts periodically. Factors such as number of dependents influence how many allowances an employee will claim.
- *Additional Amount to be Withheld.* This amount is added to the income tax calculated for each paycheck. It is on top of the amount of income tax withholding based on the employee's filing status and withholding allowances. An employee working multiple jobs might choose to have an additional amount withheld to compensate for understatement of annualized wages (and therefore understatement of his real tax rate) by each employer.

The W-4 includes several worksheets intended to help the employee arrive at the most accurate projection of tax liability possible. Some states have similar forms for state tax liability.

Federal Unemployment (FUTA)

The Federal Unemployment Tax Act (FUTA), along with the state unemployment systems, provides for payments of unemployment compensation to workers who have lost their jobs. For 2005, the effective FUTA tax rate is 0.8%. The tax applies to the first \$7,000 employers pay to each employee as wages during the year, so your maximum FUTA liability per employee is \$56.00 per year.

However, if any of your employees are exempt from State Unemployment Insurance (for example, they are Directors or Officers), your FUTA tax may be higher.

State Unemployment Insurance (SUI)

All states maintain a reserve for unemployment that is funded through an unemployment insurance tax. In most cases, SUI is paid only by the employer. Employees in some states, such as New Jersey and Pennsylvania, also contribute to SUI through their paychecks.

Most states have established a starting SUI rate for new employers. (Wherever possible, we provide this rate to you.) After a designated period of time, employers are assigned an *experience rate*, which may be higher or lower than the new employer rate depending on the employer's reserve account balance. You will receive a notice from the state if your rate changes.

Other payroll taxes

Some states administer disability insurance (SDI) or workers compensation as a tax collected through payroll. Many states also have a tax paid jointly with SUI that is used to fund job training programs. Where applicable, we calculate these taxes for you.

Special Tax Exemptions

Some types of employees are exempt from one or more payroll taxes, which means that they do not pay those taxes. For example, a minor working for a parent who is a sole proprietor does not have to pay social security, Medicare, or FUTA.

In addition, certain portions of regular employees' wages may be exempt from one or more payroll taxes. For example, *tax-sheltered* or *pretax* insurance plans save both the employer and the employee money by exempting premium amounts from all federal taxes and some state taxes. Some fringe benefits, like S-Corporation owners' health insurance, are also taxed differently from regular wages.

If your company is a not-for-profit 501(c)3 corporation, you do not pay FUTA at all—regardless of who your employees are.

Part II: Paying Taxes

As an employer, you send tax payments to the IRS and to your state agencies either electronically or using a form provided by the tax agency. Before we cover the timing of tax deposit due dates or deposit frequency, we'll acquaint you with some common payroll terms.

Constructive Receipt

You become liable for payroll taxes on the date you pay your employees, regardless of when they did the work associated with that paycheck. This rule is known as *constructive receipt*. If you only pay employees on Fridays, you only report a tax liability on Fridays, even if employees earn wages every day of the week.

A common point of confusion is when work is performed in one tax period, but employees are paid in a different tax period. The IRS only tracks when employees are paid, not the span of time when the money is earned.

Example:

Tom's Market pays employees every two weeks. Employees receive a paycheck on January 6th 2006, which covers work performed during the pay period December 15-December 31st 2005. In which month does the tax liability for this payroll fall?

Answer: Tom's payroll is considered part of his January 2006 tax liability, even though the pay period fell completely in December 2005.

Lookback Period

This is a reference period used by the IRS to determine your federal tax payment due dates. The IRS evaluates your tax liability during this twelve-month period and determines whether you are a monthly or a semi-weekly depositor (see below) for the coming year.

All new employers are monthly depositors.

Deposit Period

Refers to the span of time during which tax liabilities accumulate for each deposit due date.

Payment Coupon

The form with which a payroll deposit is submitted. For federal tax deposits, the payment coupon is Form 8109. When you pay electronically, you don't need a payment coupon.

Federal Tax Deposit Schedules

The following deposit schedules apply to all federal taxes other than FUTA.

Monthly depositors: You are a federal monthly depositor in 2005 if your company's federal tax liability during the lookback period (7/1/03-6/30/04) was less than \$50,000. This is why all new employers are monthly depositors. Monthly depositors pay taxes for a given month by the 15th of the next month. For example, June taxes are due by July 15th. (However, if the 15th falls on a weekend or bank holiday, the taxes are due the next banking day.)

Semi-weekly depositors: If your lookback liability is greater than \$50,000, you are a semi-weekly depositor. You pay taxes three banking days after the end of any semi-weekly period in which you accrued a liability. The IRS divides the week into two periods: (1) Wednesday, Thursday, and Friday, and (2) Saturday, Sunday, Monday and Tuesday. Taxes accrued during the Wednesday-Friday period are due on the following Wednesday, and taxes accrued during the Saturday-Tuesday period are due on the following Friday.

In some cases, when a bank holiday (such as July 4th or Christmas) occurs during the week, semi-weekly depositors have an extra day to make their tax payment.

Exceptions to the Deposit Schedule Rules

There are two main exceptions to the monthly and semi-weekly tax deposit requirements, as follows.

Next-Day Deposit Rule: If you accrue \$100,000 or more in federal tax liability at any point during a deposit period, you must remit taxes on the next banking day. This could result from a single payroll, or it could result from multiple payrolls within a single deposit period (month or semi-week). For example, if you are a monthly depositor and pay a one-time bonus to employees that results in more than \$100,000 in liability on a single day, you must pay the amount due immediately. You also become a semi-weekly depositor until your lookback liability falls below the \$50,000 threshold again.

Quarterly exemption: If your federal tax liability is less than \$2,500 for a quarter, regardless of your deposit schedule, there is an option of paying taxes due with your tax filing at the end of the quarter, instead of making deposits during the quarter.

Paying FUTA and SUI

Unlike other federal taxes, FUTA (federal unemployment tax) is paid on the last day of the month following the end of each quarter:

- April 30 (for Q1)
- July 31 (for Q2)
- October 31 (for Q3)
- January 31 (for Q4)

If you accrue less than \$500 of FUTA liability in a quarter, you do not need to make a deposit until the following quarter.

Like FUTA, SUI is also paid once per quarter to your state.

State Withholding Schedules

Like the IRS, states have established deposit schedules for paying income tax you've withheld from your employees' paychecks. When you register with the state revenue agency they notify you of your state deposit schedule.

State Unemployment Insurance

Like FUTA, state unemployment insurance (SUI) taxes are remitted once a quarter, regardless of the employer's size. In addition, other taxes administered by the state's unemployment commission, such as Arizona's Job Training Tax or New York's Re-employment tax, tend to be paid jointly with the SUI tax on a quarterly schedule. In states such as Florida and Nevada, where there are no state taxes withheld from employees' wages, SUI is the only payroll tax employers pay, so all employers pay taxes quarterly.

Part III: Payroll Tax Reporting and Forms

Now that you've given all your employees accurate paychecks and paid all the payroll taxes you owe, you've got one more responsibility: filing tax forms. This section provides an overview of the types of form filings required of all employers.

Federal forms

Form 941. All employers file this tax form every quarter with the IRS. It compares federal payroll taxes owed with taxes paid during the quarter to determine whether your payments were timely and whether you have a balance due.

Form 940. All employers who pay FUTA file this tax form at year end with the IRS. Like Form 941, it compares FUTA tax liability with FUTA tax payments to determine whether your deposits were timely and whether you have a balance due.

Form W-2. All employers provide Form W-2 to each employee at year end as an earnings record for income tax filing purposes. You are also responsible for filing Form W-2 with the Social Security Administration.

State Forms

Wage Reports report wages paid to each employee for a given quarter. They are sometimes combined with a quarterly *contribution report* that calculates SUI tax owed and is typically accompanied by the SUI payment at quarter end. Most states require both a wage report and a contribution report each quarter, either as separate forms or as a combined form. (California is one exception; only a wage report is filed each quarter.) Many states also require a quarterly reconciliation for state income tax.

Annual Reconciliations. Some states require filing an annual reconciliation for income tax at the end of the year. This may or may not be accompanied by copies of employees' W-2's.

Cities, counties, or school districts that assess tax may also require quarterly or annual forms and may require copies of W-2's. Check with each agency to which you pay tax.