Section 1: Payroll Laws and Taxes

Section Objectives

1. Explain the major federal laws relating to employee earnings and withholding.
Who Is an Employee?
Who is an employee?

An employee is a person who is hired by and works under the control and direction of the employer.
Characteristics of an Employee

- Works under the control and direction of the employer
- Uses tools or equipment provided by the employer
- Works certain hours that are set by the employer
This text addresses issues related to employees but not to independent contractors.
QUESTION:

Who is an independent contractor?

ANSWER:

An independent contractor is one who is paid by a company to carry out a specific task or job but is not under the direct supervision or control of the company.
Characteristics of an Independent Contractor

- Does not work under the direct supervision or control of the company
- Furnishes his or her own tools or equipment
- Sets his or her own working hours
### How do employees differ from independent contractors?

<table>
<thead>
<tr>
<th>Employee</th>
<th>Independent Contractor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Works under the control and direction of the employer</td>
<td>Does not work under the direct supervision or control of the company</td>
</tr>
<tr>
<td>Uses tools or equipment provided by the employer</td>
<td>Furnishes his or her own tools or equipment</td>
</tr>
<tr>
<td>Works certain hours that are set by the employer</td>
<td>Sets his or her own working hours</td>
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</tbody>
</table>
Federal Employee Earnings and Withholding Laws
Objective 1

Explain the major federal laws relating to employee earnings and withholding.
The Fair Labor Standards Act
The Fair Labor Standards Act of 1938

- Also referred to as the Wage and Hour Law
- Applies only to firms engaged directly or indirectly in interstate commerce
- Sets a minimum hourly rate of pay and maximum hours of work per week to be performed at the regular rate of pay

Employees who work beyond 40 hours a week are entitled to “time and a half.”
Time and a half is the rate of pay for an employee’s work in excess of 40 hours a week.

It is one and one-half times the regular hourly rate of pay.
Social Security Tax
What is social security tax?

Social security tax is a tax imposed by the Federal Insurance Contributions Act (FICA) and collected on employee earnings to provide retirement and disability benefits.
Social Security Tax

The amount of social security tax is determined by:

- rate
- earnings up to a calendar year earnings base

As of 2005

- 6.2%
- $90,000

The rate (6.2 percent) has remained constant in recent years.
The earnings base has increased each year.
Medicare Tax
What is the Medicare tax?

Medicare tax is a tax levied on employees and employers to provide medical care for the employee and the employee’s spouse after each has reached age 65.
Medicare Tax

The amount of Medicare tax is determined by:

- rate
- earnings

The rate (1.45%) has remained constant in recent years.

The Medicare tax does not have an earnings base limit.
Employee Earnings

- Medicare tax (1.45%)
- Social security tax (6.2% up to an earnings base limit)
Let’s assume an employee earns $100,000 in the calendar year.

**FICA**

Employee (withheld) \(6.2\% \times $90,000\) = $5,580.00

**Medicare**

Employee (withheld) \(1.45\% \times $100,000\) = $1,450.00
Social Security Tax and Medicare Tax

<table>
<thead>
<tr>
<th>Employee</th>
<th>Earnings</th>
<th>Social Security Tax</th>
<th>Medicare Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee 1</td>
<td>$50,000</td>
<td>$3,100.00</td>
<td>$3,100.00</td>
</tr>
<tr>
<td>Employee 2</td>
<td>$90,000</td>
<td>$5,580.00</td>
<td>$5,580.00</td>
</tr>
<tr>
<td>Employee 3</td>
<td>$100,000</td>
<td>$5,580.00</td>
<td>$5,580.00</td>
</tr>
</tbody>
</table>

$50,000 \times 6.2\% = $3,100.00
$90,000 \times 6.2\% = $5,580.00
$90,000 \times 6.2\% = $5,580.00
### Social Security Tax and Medicare Tax

<table>
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<tr>
<th>Employee</th>
<th>Earnings</th>
<th>Social Security Tax</th>
<th>Medicare Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee 1</td>
<td>$50,000</td>
<td>$725.00</td>
<td>$725.00</td>
</tr>
<tr>
<td>Employee 2</td>
<td>$90,000</td>
<td>$1,305.00</td>
<td>$1,305.00</td>
</tr>
<tr>
<td>Employee 3</td>
<td>$100,000</td>
<td>$1,450.00</td>
<td>$1,450.00</td>
</tr>
</tbody>
</table>

**Chart:**
- **Social Security Tax**
- **Medicare Tax**

- **Employee 1:**
  - Social Security Tax: $725.00
  - Medicare Tax: $725.00

- **Employee 2:**
  - Social Security Tax: $1,305.00
  - Medicare Tax: $1,305.00

- **Employee 3:**
  - Social Security Tax: $1,450.00
  - Medicare Tax: $1,450.00

**Calculations:**
- $50,000 \times 1.45\% = $725.00
- $90,000 \times 1.45\% = $1,305.00
- $100,000 \times 1.45\% = $1,450.00
Federal Income Tax
Federal Income Tax

Employers are required to withhold an estimated amount of federal income tax from the employee’s earnings.
Gross Wages

Employee Earnings

- Medicare tax (1.45%)
- Social security tax (6.2% up to an earnings base limit)
- Federal income tax
State and Local Taxes
State and Local Taxes

● Most states, and many local governments, may require employers to withhold income taxes from employees’ earnings to prepay the employees’ state and local income taxes.

● The rules are generally almost identical to those governing federal income tax withholding.
Employer’s Payroll Taxes and Insurance Costs
Employer’s Payroll Taxes and Insurance Costs

- Employers withhold social security and Medicare taxes from employees’ earnings.
- In addition, employers pay social security and Medicare taxes on their employees’ earnings.
- Employers are also required to pay:
  - Federal unemployment tax
  - State unemployment tax
  - Workers’ compensation insurance
Social Security Tax
The employer matches the social security tax withheld from the employee’s earnings.
Medicare Tax
The employer matches the Medicare tax withheld from the employee’s earnings.

Employee Earnings

- Medicare tax (1.45%)
- Social security tax (6.2% up to an earnings base limit)
- Federal income tax
Let’s assume an employee earns $100,000 in the calendar year.

<table>
<thead>
<tr>
<th>FICA Tax</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee (withheld)</td>
<td>6.2% x $90,000 = $5,580.00</td>
</tr>
<tr>
<td>Employer</td>
<td>6.2% x $90,000 = $5,580.00</td>
</tr>
<tr>
<td>Total</td>
<td>12.4%</td>
</tr>
</tbody>
</table>
Federal Unemployment Tax
Federal unemployment taxes (FUTA) are taxes levied by the federal government against employers to benefit unemployed workers.
State Unemployment Tax
State unemployment taxes (SUTA) are taxes levied by the state government against employers to benefit unemployed workers.
State Unemployment Taxes

- The FUTA and SUTA tax rates are applied to a taxable earnings base.
- This text assumes that the taxable earnings base is $7000.
Unemployment Rate Taxes

- The federal tax rate is 6.2 percent.
- This can be reduced by the state tax rate (5.4 percent for many states).
### The SUTA-FUTA Connection

<table>
<thead>
<tr>
<th>SUTA tax rate</th>
<th>5.0%</th>
<th>4.8%</th>
<th>5.4%</th>
</tr>
</thead>
<tbody>
<tr>
<td>FUTA tax rate</td>
<td>6.2%</td>
<td>6.2%</td>
<td>6.2%</td>
</tr>
<tr>
<td>(Less) SUTA tax rate</td>
<td>(5.0)</td>
<td>(4.8)</td>
<td>(5.4)</td>
</tr>
<tr>
<td>Net FUTA tax rate</td>
<td>1.2</td>
<td>1.4</td>
<td>0.8</td>
</tr>
<tr>
<td>Total taxes</td>
<td>6.2%</td>
<td>6.2%</td>
<td>6.2%</td>
</tr>
</tbody>
</table>
Employee Earnings

Gross Wages

- social security tax (6.2% up to an earnings base limit)
- Medicare tax (1.45%)
- federal income tax
- unemployment taxes (6.2% up to a taxable earnings base)
Workers’ Compensation Insurance
Workers’ compensation insurance is the insurance that protects employees against losses from job-related injuries or illnesses, or compensates their families if death occurs in the course of employment.
Employee Records
Required by Law
Employee Records Required by Law

Federal laws require that certain payroll records be maintained. For each employee the employer must keep a record of:

- Employee’s name, address, social security number, and date of birth
- Hours worked each day and week, and wages paid at the regular and overtime rates (certain exceptions exist for employees who earn salaries)
- Cumulative wages paid during the year
- Amount of income tax, social security tax, and Medicare tax withheld for each pay period
- Proof that the employee is a United States citizen or has a valid work permit
The overtime rate payable to employees who work more than 40 hours a week is called _________________.

The ________________ provides retirement and disability benefits to workers and their dependents.

The Social Security Act provides _________________.

The Medicare tax does not have a(n) _________________.

Complete the following sentences:
Employers withhold social security tax at a rate of 6.2% and Medicare tax at a rate of 1.45%.

Federal and state unemployment taxes are levied against employers to benefit unemployed workers.

Workers’ compensation insurance protects employees against losses from job-related injuries or illnesses.
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