Section 1: Payroll Laws and Taxes

Section Objectives

1. Explain the major federal laws relating to employee earnings and withholding.
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
Objective 1

Explain the major federal laws relating to employee earnings and withholding.
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.”
Social Security Tax

The amount of social security tax is determined by:

- rate
- earnings up to a calendar year earnings base

As of 2007

- 6.2%
- $97,500

The rate (6.2 percent) has remained constant in recent years.

The earnings base has increased each year.
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.

As of 2005

- 1.45%
- total earnings
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

- 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

- The FUTA and SUTA tax rates are applied to a taxable earnings base.

- This text assumes that the taxable earnings base is $7000.
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.
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
Section 2: Calculating Earnings and Taxes

Section Objectives

2. Compute gross earnings of employees.
3. Determine employee deductions for social security tax.
4. Determine employee deductions for Medicare tax.
5. Determine employee deductions for income tax.
6. Enter gross earnings, deductions, and net pay in the payroll register.
Objective 2  Compute Gross Earnings of Employees

The first step in preparing payroll is to compute the gross wages or salary for each employee. There are several ways to compute earnings.

- Hourly rate basis
- Salary basis
- Commission basis
- Piece-rate basis
The gross pay for hourly employees for the week ended January 6 is determined as follows:

<table>
<thead>
<tr>
<th>Total hours</th>
<th>Rate of pay</th>
<th>Gross pay</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alicia Martinez 40 hours X $ 10.00 = $400.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jorge Rodriguez 40 hours X $ 9.50 = $380.00</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
George Dunlap earns $9.00 per hour. He worked 45 hours. He is paid 40 hours regular rate of pay and 5 hours at time and a half.

Therefore, Dunlap’s gross pay adds up to:

Regular earnings: \(40 \text{ hours} \times \$9.00\) = \$360.00

Overtime earnings: \(5 \text{ hours} \times \$13.50\) = \$67.50

Gross Pay \(\underline{\$427.50}\)
Recall that federal law requires employers to make three deductions from employees’ gross pay:

- FICA (social security) tax
- Medicare tax
- Federal income tax withholding
Objective 3 Determine employee deductions for social security tax.

Tax-exempt Wages

- Earnings in excess of the base amount ($97,500 as of 2005) are not subject to FICA withholding.
- If an employee works for more than one employer during the year, the FICA tax is deducted and matched by each employer.
- When the employee files a federal income tax return, any excess FICA tax withheld from the employee’s earnings is refunded by the government or is applied to payment of the employee’s federal income taxes.
To compute the Medicare tax to withhold from the employee’s paycheck, multiply the wages by the Medicare tax rate, 1.45 percent.

<table>
<thead>
<tr>
<th>Employee</th>
<th>Gross pay</th>
<th>Tax rate</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alicia Martinez</td>
<td>$400.00</td>
<td>X 1.45%</td>
<td>= $5.80</td>
</tr>
<tr>
<td>Jorge Rodriguez</td>
<td>380.00</td>
<td>X 1.45%</td>
<td>= $5.51</td>
</tr>
<tr>
<td>George Dunlap</td>
<td>427.50</td>
<td>X 1.45%</td>
<td>= $6.20</td>
</tr>
<tr>
<td>Cecilia Wu</td>
<td>560.00</td>
<td>X 1.45%</td>
<td>= $8.12</td>
</tr>
<tr>
<td><strong>Total Medicare tax</strong></td>
<td></td>
<td></td>
<td><strong>$25.63</strong></td>
</tr>
</tbody>
</table>
The amount of federal income tax to withhold from an employee’s earnings depends on the:

- Earnings during the pay period
- Length of the pay period
- Marital status
- Number of withholding allowances
Withholding Allowances

In the simplest circumstances, a taxpayer claims a withholding allowance for:

- The taxpayer
- A spouse who does not also claim an allowance
- Each dependent for whom the taxpayer provides more than half the support during the year

As the number of withholding allowances increases, the amount of federal income tax withheld decreases.
QUESTION:

What is the Employee’s Withholding Allowance Certificate, Form W-4?

ANSWER:

The Employee’s Withholding Allowance Certificate, Form W-4 is a form used to claim exemption (withholding) allowances.
Computing Federal Income Tax Withholding

- The wage-bracket table method is the most common way to compute the federal income tax withholding.

- The wage-bracket tables are in *Publication 15, Circular E.*
Cecilia Wu is married, claims two withholding allowances, and earned $560 for the week.

<table>
<thead>
<tr>
<th>At least But less than</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
</tr>
</thead>
<tbody>
<tr>
<td>520</td>
<td>42</td>
<td>34</td>
<td>22</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>530</td>
<td>43</td>
<td>35</td>
<td>23</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>540</td>
<td>45</td>
<td>36</td>
<td>24</td>
<td>21</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>550</td>
<td>46</td>
<td>37</td>
<td>29</td>
<td>22</td>
<td>16</td>
<td>10</td>
<td>4</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>560</td>
<td>48</td>
<td>39</td>
<td>30</td>
<td>23</td>
<td>17</td>
<td>11</td>
<td>5</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

The tax to withhold is $30; this is where the row and column intersect.

1. Go to the table for married persons paid weekly.
2. Find the line covering wages between $560 and $570. Find the column for two withholding allowances.
Other Deductions Required by Law

- Most states and some local governments require employers to withhold state and local income taxes from earnings.
- In some states employers are also required to withhold unemployment tax or disability tax.
- The procedures are similar to those for federal income tax withholding.
- Apply the tax rate to the earnings, or use withholding tables.
Voluntary Deductions

There are many payroll deductions not required by law but made by agreement between the employee and the employer.

Some examples are:

- Group life insurance
- Group medical insurance
- Company retirement plans
- Bank or credit union savings plans or loan repayments
- United States savings bonds purchase plans
- Stocks and other investment purchase plans
- Employer loan repayments
- Union dues
### PAYROLL REGISTER

<table>
<thead>
<tr>
<th>NAME</th>
<th>NO. OF ALLOW.</th>
<th>MARITAL STATUS</th>
<th>CUMULATIVE EARNINGS</th>
<th>NO. OF HRS.</th>
<th>RATE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Martinez, Alicia</td>
<td>1</td>
<td>M</td>
<td></td>
<td>40</td>
<td>10.00</td>
</tr>
<tr>
<td>Rodriguez, Jorge</td>
<td>1</td>
<td>S</td>
<td></td>
<td>40</td>
<td>9.50</td>
</tr>
<tr>
<td>Dunlap, George</td>
<td>3</td>
<td>S</td>
<td></td>
<td>45</td>
<td>9.00</td>
</tr>
<tr>
<td>Wu, Cecil</td>
<td>2</td>
<td>M</td>
<td></td>
<td>40</td>
<td>14.00</td>
</tr>
<tr>
<td>Booker, Cynthia</td>
<td>1</td>
<td>S</td>
<td>480.00</td>
<td>40</td>
<td>480.00</td>
</tr>
</tbody>
</table>

Enter the employee’s name (Column A), number of withholding allowances and marital status (Column B), and rate of pay (Column E).
Completing the Payroll Register

The Cumulative Earnings column (Column C) shows the total earnings for the calendar year before the current pay period. Since this is the first payroll period for the year, there are no cumulative earnings prior to the current pay period.
Completing the Payroll Register

The Taxable Wages columns show the earnings subject to taxes for social security (Column J), Medicare (Column K), and FUTA (Column L). Only the earnings at or under the earnings limit are included in these columns.

<table>
<thead>
<tr>
<th>NAME</th>
<th>SOCIAL SECURITY</th>
<th>MEDICARE</th>
<th>FUTA</th>
<th>SOCIAL SECURITY</th>
<th>MEDICARE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Martinez, Alicia</td>
<td>400.00</td>
<td>400.00</td>
<td>400.00</td>
<td>24.80</td>
<td>5.80</td>
</tr>
<tr>
<td>Rodriguez, Jorge</td>
<td>380.00</td>
<td>380.00</td>
<td>380.00</td>
<td>23.56</td>
<td>5.51</td>
</tr>
<tr>
<td>Dunlap, George</td>
<td>427.50</td>
<td>427.50</td>
<td>427.50</td>
<td>26.51</td>
<td>6.19</td>
</tr>
<tr>
<td>Wu, Cecil</td>
<td>560.00</td>
<td>560.00</td>
<td>560.00</td>
<td>34.72</td>
<td>8.12</td>
</tr>
<tr>
<td>Booker, Cynthia</td>
<td>480.00</td>
<td>480.00</td>
<td>480.00</td>
<td>29.76</td>
<td>6.96</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>2,247.50</strong></td>
<td><strong>2,247.50</strong></td>
<td><strong>2,247.50</strong></td>
<td><strong>139.35</strong></td>
<td><strong>32.58</strong></td>
</tr>
</tbody>
</table>
Completing the Payroll Register

The Deductions columns show the withholding for social security tax (Column M), Medicare tax (Column N), federal income tax (Column O), and medical insurance (Column P).

<table>
<thead>
<tr>
<th>AND ENDING</th>
<th>January 6, 20--</th>
<th>PAID</th>
<th>January 8, 20--</th>
</tr>
</thead>
<tbody>
<tr>
<td>NAME</td>
<td>SOCIAL SECURITY</td>
<td>MEDICARE</td>
<td>INCOME TAX</td>
</tr>
<tr>
<td>Martinez, Alicia</td>
<td>24.80</td>
<td>5.80</td>
<td>19.00</td>
</tr>
<tr>
<td>Rodriguez, Jorge</td>
<td>23.56</td>
<td>5.50</td>
<td>34.00</td>
</tr>
<tr>
<td>Dunlap, George</td>
<td>26.51</td>
<td>6.19</td>
<td>23.00</td>
</tr>
<tr>
<td>Wu, Cecil</td>
<td>34.72</td>
<td>8.12</td>
<td>30.00</td>
</tr>
<tr>
<td>Booker, Cynthia</td>
<td>29.76</td>
<td>6.96</td>
<td>49.00</td>
</tr>
<tr>
<td>(A)</td>
<td>139.35</td>
<td>32.58</td>
<td>155.00</td>
</tr>
<tr>
<td>(M)</td>
<td>(M)</td>
<td>(N)</td>
<td>(O)</td>
</tr>
</tbody>
</table>
Completing the Payroll Register

Subtract the deductions (Columns M, N, O, and P) from the gross earnings (Column H). Enter the results in the Net Amount column (Column Q). This is the amount paid to each employee.
Payroll Computations, Records, and Payment

Section 3: Recording Payroll Information

Section Objectives

7. Journalize payroll transactions in the general journal.

8. Maintain an earnings record for each employee.
Recording Payroll

Recording payroll information involves two separate entries:

1. Record the payroll expense
2. Pay the employees
The information in the register is used for recording the payroll expense.
A separate liability account is set up for each deduction.
Most businesses pay their employees by check or by direct deposit.

By using these methods, the business avoids the inconvenience and risk involved in dealing with currency.
Paying by Check

Paychecks may be written on

- the firm’s regular checking account, or
- a payroll bank account.
Many businesses write payroll checks from a separate payroll bank account. This is a two-step process.

1. A check is drawn on the regular bank account for the total amount of net pay and deposited in the payroll bank account.

2. Individual payroll checks are issued from the payroll bank account.
A popular method of paying employees is the direct deposit method.

The bank electronically transfers net pay from the employer’s account to the personal account of the employee.

On payday the employee receives a statement showing gross earnings, deductions, and net pay.
An individual earnings record is a record that contains information needed to compute earnings and complete tax reports.
The earnings records are totaled monthly and at the end of each calendar quarter. This provides information needed to make tax payments and file tax returns.

<table>
<thead>
<tr>
<th>DATE</th>
<th>HOURS</th>
<th>REGULAR</th>
<th>OVERTIME</th>
<th>TOTAL</th>
<th>CUMULATIVE</th>
<th>SOCIAL</th>
<th>MEDICARE</th>
<th>INC.</th>
<th>OTHER</th>
<th>NET PAY</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/06</td>
<td>1/08</td>
<td>40</td>
<td>400.00</td>
<td>400.00</td>
<td>800.00</td>
<td>24.80</td>
<td>5.80</td>
<td>19.00</td>
<td>350.40</td>
<td>350.40</td>
</tr>
<tr>
<td>1/13</td>
<td>1/15</td>
<td>40</td>
<td>400.00</td>
<td>400.00</td>
<td>800.00</td>
<td>24.80</td>
<td>5.80</td>
<td>19.00</td>
<td>350.40</td>
<td>350.40</td>
</tr>
<tr>
<td>1/20</td>
<td>1/22</td>
<td>40</td>
<td>400.00</td>
<td>400.00</td>
<td>1200.00</td>
<td>24.80</td>
<td>5.80</td>
<td>19.00</td>
<td>350.40</td>
<td>350.40</td>
</tr>
<tr>
<td>1/27</td>
<td>1/29</td>
<td>40</td>
<td>400.00</td>
<td>400.00</td>
<td>1600.00</td>
<td>24.80</td>
<td>5.80</td>
<td>19.00</td>
<td>350.40</td>
<td>350.40</td>
</tr>
<tr>
<td>January</td>
<td>1,600.00</td>
<td>1,600.00</td>
<td>1,600.00</td>
<td>1,600.00</td>
<td>99.20</td>
<td>23.20</td>
<td>76.00</td>
<td>1,401.60</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
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