

Paycheck Tax Deductions

If you're like most people, the amount of your first paycheck was somewhat of a surprise – and not in a good way.

Unless you are considered an “independent contractor” (more on that below), your employer is required by law to withhold estimated taxes from each paycheck.

These taxes include:

- **Social Security and Medicare** – These taxes are used to support programs for the elderly. Social Security taxes take 6.2% of your earnings and Medicare taxes take 1.45% of **your** earnings. The good news is that there is a threshold beyond which you no longer pay Social Security tax on money earned beyond the threshold. The bad news is that you must make well over \$100,000 per year in order to cross that threshold.
- **Federal Income Tax** – Paid to the federal government, these taxes range between 10% and 35%.
- **State Income Tax** – Paid to your state government, this tax varies by state. Rates typically range between 3% and 7% of your income *after* paying federal taxes. Some states have no state income tax at all, and some states charge up to 10% for very high earners.
- **City Tax** – A few large cities charge their own income-based taxes. Rates are typically between 1% and 3% of income, and may also vary depending on whether you only work in the city or live and work there.

Your employer knows how much to deduct for withholding based on both your income and your “Personal Allowances” as listed on your federal W-4 form. Your employer will supply this short, easy to understand form when you begin work. One warning – if you have more than one job, make sure you complete the “Multiple Jobs Worksheet” on page two of the form. Otherwise, you may have too little tax withheld and end up owing money when you file your tax return. You can update your W-4 form with your employer at any time.

At the end of the year, your employer will provide a “W-2 Wage and Tax Statement” that lists all of the deductions that were taken from your paycheck. You use this form to complete the 1099 income tax form.



Independent Workers

If you work from home or can set your own hours, you may be considered an independent contractor for tax purposes. In this scenario, you will receive your entire gross pay with no tax deductions, but you are responsible for paying all of your own taxes. In fact, you may even have to pay quarterly estimated taxes.

Tax rates for independent workers are the same as other workers, but with one major exception – Social Security and Medicare. In a typical employment situation, the worker pays 6.2% of earnings for Social Security and 1.35% for Medicare.

In reality, these rates are only one-half of the actual tax since the employer pays the other half. If you are an independent contractor, you are responsible for both halves of each tax, yielding a grand total of 15.3% of your income. While you are permitted to deduct the additional “employer” half of your tax as a business expense, the effective rate continues to be significantly higher than a traditionally employed worker.

At the end of the year, your employer will provide a “1099 MISC” form listing your income. This form is also supplied to the Internal Revenue Service. Independent workers must also complete a “Schedule C” form in addition to a standard 1099 form.

If you either owe money when filing taxes or your get money back, it may be helpful to make adjustments to your W-4 form – there's no benefit to having more withheld than is necessary.



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