

American Payroll Association Compliance Update

Payroll Tax Cut Extended for Two Months

On December 23, only hours after passage in the U.S. House and Senate by unanimous consent, President Obama signed the Temporary Payroll Tax Cut Continuation Act of 2011 into law (TPTCCA – H.R. 3765, Pub. L. No. 112-78). The TPTCCA continues the social security tax rate paid by employees in 2011 (4.2%) for wages paid in the first two months of 2012.

It does not continue several expiring payroll-related tax breaks, including adoption assistance expansion and qualified mass transit and van pool benefit parity with employer-provided parking. It also does not reinstate the 0.2% FUTA surtax. On the other hand, the TPTCCA does extend emergency unemployment insurance benefits for the long-term unemployed and keeps payments to doctors providing services to Medicare patients at current levels.

Continuation of 4.2% social security tax rate

Prior to January 1, 2011, the employee social security tax withholding rate was 6.2% on the first \$106,800 (the social security wage base in 2009 and 2010) of an employee's income. In addition, the employer's social security tax was also 6.2% on the first \$106,800 of an employee's income. Self-employed individuals paid 12.4% in social security self-employment taxes on all their self-employment income up to the same threshold. In December 2010, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRA 2010) reduced the employee social security tax rate to 4.2% for 2011 and left the employer tax rate at 6.2%.

Temporary reduction in employee-paid payroll taxes. The TPTCCA provides that employees will continue to pay 4.2% in social security tax during the first two months of 2012. This means that employees will pay 4.2% on wages paid in January and February 2012 up to the \$110,100 wage base.

Also, employees covered by the Railroad Retirement Tax Act will see a reduction in their Tier I withholding tax rate from 6.2% to 4.2%.

The TPTCCA does not change the employer's social security tax rate, which remains at 6.2% on the first \$110,100 in wages during 2012 – for a maximum employer tax of \$6,826.20.

Some payroll service and software providers may have already released 2012 system updates that reinstated the 6.2% employee social security tax rate. And they may not have issued patches to those updates continuing the 4.2% employee social security tax rate by the time some payroll departments process their first 2012 payroll. For example, some payroll professionals may have processed the first 2012 payroll as soon as December 27, 2011, for a pay date of January 3, 2012. In this circumstance, the self-adjusting feature that most payroll systems have for social security and Medicare taxes will make the adjustment for most employees with the first payroll *after* the 4.2% rate has been reinstated.

EXAMPLE: The first 2012 payroll for Larry's employer, We Pay Correctly, is January 6 and was processed on January 3. We Pay Correctly's payroll system provider was not able to implement, test, and provide the updated system before the first 2012 payroll was processed. Therefore, the 6.2% employee social security tax rate was used for the January 6 payroll, and the 4.2% employee tax rate will be implemented with the

January 20 payroll. In this situation, Larry's \$1,500 wages for the January 6 payroll had \$93.00 withheld for social security tax using the old rate – 6.2%. When the January 20 payroll is processed with the 4.2% tax rate, We Pay Correctly will deduct social security tax in the amount of \$33.00. The self-adjusting feature will calculate the correct year-to-date (YTD) social security tax of \$126.00 on year-to-date wages ($2 \times \$1,500 \times 4.2\%$) and subtract the previously withheld tax to ensure that the YTD withholding is correct ($\$126.00 - \$93.00 = \$33.00$). Larry's next wage payment (February 3) will have a \$63.00 ($\$1,500 \times 4.2\%$) social security tax deduction.

Effective date and implementation issues

The first 2012 payroll. The late enactment of the TPTCCA made it difficult for many employers to ensure they would correctly calculate social security tax withholding for the first payroll of 2012. Therefore, the IRS is asking employers to update their payroll systems as soon as possible, but not later than January 31, 2012. For any social security tax overwithheld during January because of the rate change, employers should make an adjustment in employees' pay as soon as possible, but not later than March 31, 2012 [IR-2011-124, 12-23-11; www.irs.gov/newsroom/article/0,,id=251650,00.html].

'Self-adjust' may not work if no pay is issued. While most payroll systems have a "self-adjust" feature that makes sure each employee's YTD social security (and Medicare) wages and taxes bear the proper percentage relationship to each other, this feature generally works only if a wage payment is being made to an employee. So, if an employer did not have the 4.2% rate programmed for the first payroll of 2012, the employer pays employees and withholds social security tax at the wrong rate, and any of these employees is not paid after the 4.2% rate is implemented (e.g., they were

terminated or resigned), then the employer will have to review its payroll records and issue checks to refund the excess social security tax to those employees. Otherwise, the employer will have reconciliation problems at the end of the first quarter (the tax liability calculated on Form 941 will be less than its tax deposits) and at year-end (social security tax withheld will not be 4.2% of social security wages).

Questions payroll professionals must consider in this situation are:

- Will the self-adjusting feature find these employees and issue refunds?
- Will the system indicate individuals for whom YTD social security tax is not 4.2% of YTD social security wages?

Employers may not move excess social security tax to YTD federal income tax withholding. If an employee is paid in 2012 before the employer implements the reduced social security tax rate for employees in 2012 (4.2% vs. 6.2%), and if the employee is not paid after the employer implements the new rate, the IRS has been asked, “May the employer move the employee’s excess social security tax withholding to the employee’s YTD federal income tax withholding accumulator (and report this accordingly on Forms 941, W-2, and W-3)?”

No, the employer may not do this, according to John Tuzynski, Chief of Employment Tax Operations for the Internal Revenue Service. In answering this question when the 4.2% rate was first implemented in January 2011, he said, “There is no provision in the law under which the employer can simply move social security tax withholding to federal income tax withholding.” The refund should be made “as soon as possible, but not later than March 31, [2012].”

Impact on Forms W-2 and 941. The IRS has yet to indicate how the TPTCCA

will impact Forms W-2 and 941. If the 4.2% employee social security tax rate is extended through December 31, 2012, APA believes there will be no impact other than the change to the social security tax rate from 12.4% to 10.4% on the draft Form 941 released in August 2011. In addition, APA believes that if the 4.2% employee social security tax rate is extended through December 31, 2012, no changes will need to be made to the 2012 W-2 form that was released recently.

Additional income tax for high earners to prevent extra benefit

The TPTCCA includes a new “recapture” provision, which applies only to those employees who receive more than \$18,350 in wages during January and February 2012 (\$18,350 represents two months of the full-year social security wage base of \$110,100). This provision imposes an additional income tax on these higher-income employees of 2% of the amount of wages they receive during the two-month period that is in excess of \$18,350 but not more than \$110,100. It prevents high wage earners from gaining an extra benefit from the reduced employee social security tax rate.

This additional recapture tax is an add-on to income tax liability that the employee would otherwise pay for 2012 and is not subject to reduction by credits or deductions. The recapture tax would be payable in 2013 when the employee files his or her income tax return for the 2012 tax year. It would not be paid through income tax withholding, although an employee in this situation may submit an amended Form W-4 to his or her employer to increase withholding to account for the anticipated additional income tax. *Note:* If Congress passes a full-year extension of the payroll tax cut, APA believes that the recapture provision would be repealed at the same time because it would no longer be necessary.

What happens in March 2012?

Under the TPTCCA, the employee social security tax rate is scheduled to increase to 6.2% for all wages paid beginning on March 1, 2012. However, as part of the TPTCCA negotiations, various Senators and Representatives stated that they would revisit continuing the 4.2% employee social security tax rate beyond February 29, 2012, and for the remainder of the year. Watch for further information from APA on an extension of the 4.2% social security tax rate beyond February 29, 2012.

Impact on 2012 reconciliations

The possibility that an employee's wages may be subject to two social security tax rates in 2012 will require separate accumulators for both tax rates to ensure the correct calculation of the 2012 social security tax. With separate accumulators, a close examination of the social security wage to social security tax reconciliation with every pay period will be necessary to ensure correct calculations.

Expiring provisions

The TPTCCA did not extend the following provisions, which expired on December 31, 2011.

Increased adoption tax credit and adoption assistance program exclusion.

Taxpayers who adopt children can receive a tax credit for qualified adoption expenses. A taxpayer may also exclude from income adoption expenses paid by an employer. The Economic Growth and Tax Relief Reconciliation Act of 2001 provided an income exclusion of \$10,000 per adopted child (indexed to \$13,360 for 2011) for an employer's adoption assistance program. The Patient Protection and Affordable Care Act of 2010 expanded these benefits by \$1,000 and extended them to December 31, 2010. The Tax

Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRA 2010) extended the credit and income exclusion, along with the \$1,000 expansion, through 2011. The \$1,000 expansion of the exclusion expired on December 31, 2011. With the expiration of the expansion, the 2012 adoption exclusion is \$12,650.

Parity for mass transit benefits. TRA 2010 extended through 2011 the American Recovery and Reinvestment Act's March 2009 increase in the monthly income exclusion for employer-provided mass transit and vanpool benefits to equal the exclusion for employer-provided parking benefits. In 2010 and 2011, this monthly limit was \$230. Because this provision was not extended, however, the mass transit and vanpool benefit monthly limit reverted to \$125 in January 2012 (the limit prior to March 1, 2009, of \$120 adjusted for inflation).

FUTA Surtax. The 0.2% Federal Unemployment Tax Act (FUTA) surtax was extended to June 30, 2011, by the Worker, Homeownership, and Business Assistance Act of 2009. The permanent gross FUTA tax rate is 6.0%. The 0.2% surtax was added in 1976 and had been in effect through multiple extensions since then. The last time it was extended was from January 1, 2010, to June 30, 2011. Before expiration of the 0.2% surtax on June 30, 2011, the net FUTA tax employers paid after taking credit for up to 5.4% of state unemployment taxes paid was 0.8%. With the expiration of the surtax, the net FUTA rate was reduced to 0.6% on FUTA taxable wages paid beginning July 1, 2011 ($0.8\% - 0.2\% = 0.6\%$).

Congress did not push legislation through to extend the surtax before it expired, and the surtax was not extended retroactively as part of the TPTCCA. Congress is considering comprehensive unemployment insurance reform efforts, which may be enacted in 2012.

With the expiration of the surtax for 2011, employers needed to separately track FUTA taxable wages paid before July 1, and FUTA taxable wages paid after June 30. Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*, for 2011 was revised to require separate reporting of wages subject to the surtax and those not subject to the surtax. With no surtax in effect for the third and fourth quarters of 2011, employers determined their FUTA tax liability and deposit requirement for the third and fourth quarters based on a net FUTA rate of 0.6%.

NO EFFECT ON FUTA CREDIT REDUCTION – The expiration of the FUTA surtax has no impact on how much employers will have to pay in FUTA tax because of the reduced credit they get for state taxes paid in states that have outstanding loans from the Federal Unemployment Account. In 2011, 20 states and the Virgin Islands had outstanding loans when the credit reduction determination was made in November and are in credit reduction status for 2011.