

the tax already withheld on wages, or he may combine the \$250 tips with the weekly wages of \$425 and withhold on the aggregate (\$675). Assuming the employee is single and files one withholding allowance, the withholding on tips of \$250, using the wage bracket method, would be determined as follows:

Regular salary (weekly payroll)	\$425.00
Tips	<u>250.00</u>
Aggregate amount	<u>\$675.00</u>
Income tax withholding on aggregate amount	\$102.00
Less tax already withheld from regular wages	<u>48.00</u>
Income tax to be withheld on tips	<u>\$ 54.00</u>

The employer should withhold from the employee's weekly wages \$102.00 for income tax and \$51.64 for employee social security tax ($0.0765 \times \$675$, until combined tips and wages exceed the OASDI social security wage base). The employer will pay employer social security tax on \$425 of wages until the OASDI social security wage base limit is reached.

An employer may, at his option, withhold income tax in respect of tips reported by an employee to the employer on an estimated basis. If an employer wants wage payments to be regular amounts each pay period, he should choose the estimated basis since its use will result in a proration of tips. An employer who makes the election determines the withholding according to the following steps:⁶⁴

- (1) The amount of tips that will be reported by the employee to the employer in a calendar quarter must be estimated for each such employee.
- (2) The withholding amount must be determined by assuming that the estimated tips for the quarter constitute the actual tips in the quarter, and that such tips will be paid ratably (in terms of payroll periods) during the quarter. Such pro rata withholding amount is then deducted from each wage payment (exclusive of tips) that is under the control of the employer to be paid to the employee during the calendar quarter.
- (3) Adjustments must be made to conform the amount of tax withheld on the estimated basis to the amount required to be withheld on the actual tips. If an adjustment is necessary, the additional tax required to be withheld may be deducted from any payment of wages (exclusive of tips) under the employer's control during the quarter and within the first 30 days following the quarter or from additional funds made

available to the employer by the employee for such purpose within such period.

Example: The Dalton Restaurant pays Simms, a waiter, a salary of \$300 per week. For the first quarter of 1997, the restaurant estimates that Simms will receive \$3,900 in tips. Thus, the restaurant will withhold income taxes on \$300 of tips per week (\$3,900 divided by 13 weeks). Assume that Simms is married and claims one withholding allowance. The withholding each week on the estimated tip income (using the wage bracket method and treating the tips as additional regular wages) is \$45.00 (\$65.00 on the total of the salary and tips minus \$20.00 on the \$300 of salary). In addition, \$22.95 ($0.0765 \times \300) of social security taxes will be withheld on account of the tips. If Simms were to actually report \$4,020 of tips for the quarter, FITW and social security taxes would have to be withheld with respect to the \$120 of the excess of actual tips over estimated tips from salary due Simms during the quarter or within the first 30 days of the next quarter.

The initial estimate of tips for each employee must be made on the basis of the facts and circumstances surrounding the employment of that employee. However, if a number of employees are employed under substantially the same working conditions, an initial estimate established for one of the employees may be used for others in the same group.⁶⁵

If the estimated amount continues to differ substantially from the actual amount and no unusual factors are involved, the employer must make an adjustment to the estimate.⁶⁶

The employer must be prepared to disclose to the IRS District Director the factors on which he relied in making the estimate, and his reasons for believing that the estimate was reasonable.⁶⁷

[3] Computation of Social Security Tax

[a] In General. The Federal Insurance Contributions Act (FICA) provides for a federal system of old-age, survivors', disability (OASDI), and hospital insurance (Medicare). The system is financed through social security taxes (OASDI and Medicare taxes). Except for income from tips (explained at § 5.21[2][d]), social security taxes are collected from both the employer and the employee.

The employee social security tax is withheld from wages in the same manner as income tax is withheld, except that withholding allowances are not permitted for social security taxes.⁶⁸ In addition, there is a ceiling on the amount of wages subject to social security tax.⁶⁹

[b] Employee Social Security Tax. The employee social

⁶⁴ Reg § 31.3402(h)(1)-1(b).

⁶⁵ Reg § 31.3402(h)(1)-1(b)(2)(i).

⁶⁶ Reg § 31.3402(h)(1)-1(b)(2)(ii).

⁶⁷ Reg § 31.3402(h)(1)-1(b)(2)(iii).

⁶⁸ Reg § 31.3102-1.

⁶⁹ Reg § 31.3121(a)(1)-1.

security tax is computed by applying to the wages received by the employee the rate in effect at the time such wages are received.⁷⁰ The tax attaches at the time of receipt of the wages by the employee. In general, wages are received by an employee at the time they are actually or constructively paid (with certain exceptions—see § 1.40 for further details) by the employer to the employee.

[c] Annual Wage Limitation. The amount of wages subject to social security tax is limited to the first \$65,400 of wages paid to each employee during calendar 1997 with respect to the OASDI portion of the social security tax and to all such wages with respect to the Medicare portion of the tax.⁷¹ The following table shows the tax rates for 1980 through 1998 and the annual wage limitation (ceiling).

In	Employers and employees each pay	On earnings up to
1980	6.13%	\$25,900
1981	6.65%	\$29,700
1982	6.70%	\$32,400
1983	6.70%	\$35,700
1984	7.00%	\$37,800
1985	7.05%	\$39,600
1986	7.15%	\$42,000
1987	7.15%	\$43,800
1988	7.51%	\$45,000
1989	7.51%	\$48,000
1990	7.65%	\$51,300
1991	7.65%	\$53,400 ⁷²
1992	7.65%	\$55,500 ⁷³
1993	7.65%	\$57,600 ⁷⁴
1994	7.65%	\$60,600 ⁷⁵
1995	7.65%	\$61,200 ⁷⁶
1996	7.65%	\$62,700 ⁷⁷
1997	7.65%	\$65,400 ⁷⁸
1998	7.65%	\$68,400 ⁷⁹

[d] Rate of Tax. The rate of tax consists of two parts, the first for old-age, survivors', and disability insurance (OASDI), and the second for hospital insurance (Medicare). The OASDI tax for 1997 is 6.20% for wages up to \$62,700, and the Medicare tax is 1.45% for all wages. Thus, wages up

to the first \$65,400 are subject to a combined tax of 7.65%, and any excess wages, are subject only to the 1.45% Medicare tax.

In collecting employee tax, the employer should disregard any fractional part of a cent of such tax unless it amounts to 0.5¢ or more, in which case it should be rounded to 1¢.⁸⁰

If the employee social security tax on reported tips (see discussion of tips at § 5.21[2][d]) exceeds the amount of social security tax that can be collected by the employer from the employee's wages (exclusive of tips) under the control of the employer, the employee is responsible for the payment of the excess.⁸¹

[e] Employer Social Security Tax. The employer social security tax is determined by applying the rate in effect at the time of payment to the wages paid by the employer.⁸² The employer rates for 1997 are 6.2% for the OASDI portion of the social security tax on the first \$65,400 of wages paid to each employee and 1.45% for the Medicare portion of the social security tax on all such wages.

[f] Employment by More Than One Employer. If an employee works for two or more employers (other than a successor employer or related corporations) during the calendar year, the annual wage limitations apply separately to the remuneration received from each employer (i.e., wages paid by each employer up to the annual wage limit are subject to the OASDI and Medicare portions of the social security tax; amounts paid in excess of the OASDI limit are subject to the Medicare portion of the tax.⁸³

An employee who had too much OASDI and/or Medicare taxes withheld because of having more than one employer is entitled to a refund or credit of the amount of the overpayment. For most people, the refund is obtained by filing Form 1040 and showing the excess amount of social security tax withholding as a tax payment. If the employee is not required to file a return, he may claim a refund on Form 843. No credit can be obtained on account of Medicare taxes paid since Medicare taxes apply to all wages paid to an employee after 1993.

An employer may not obtain a refund of any portion of the

⁷⁰ IRC § 3101; Reg § 31.3101-1.

⁷¹ Reg § 31.3121(a)(1)-1, Dept of HHS, *Social Security Handbook*, Pub No 65-008, § 1301 (1993); Circular E, Employer's Tax Guide, IRS Pub No 15 (Jan 1997).

⁷² The wage base for the Medicare tax is \$125,000; wages in excess of the OASDI wage base up to \$125,000 are subject to the 1.45% Medicare tax.

⁷³ The wage base for the Medicare tax is \$130,200; wages in excess of the OASDI wage base up to \$130,200 are subject to the 1.45% Medicare tax.

⁷⁴ The wage base for the Medicare tax is \$135,000; wages in excess of the OASDI wage base up to \$135,000 are subject to the 1.45% Medicare

tax.

⁷⁵ Wages in excess of the OASDI base are subject to the 1.45% Medicare tax. After 1993, there is no wage limit with respect to the Medicare tax.

⁷⁶ *Id.*

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ Reg § 31.3102-1(c).

⁸¹ Reg § 31.3102-3.

⁸² Reg § 31.3111-1.

⁸³ Reg § 31.3121(a)(1)-1.

employer social security tax on the wages of an employee during the calendar year who has previously received, is receiving, or will receive wages from another employer during that year, the total of which exceeds or will exceed the annual wage limit unless the other employer is a predecessor employer under IRC § 3121(a)(1).

Example: Benson was employed by the Wilder Company for the first seven months of calendar year 1997 and was paid a salary of \$12,500 per month. Of the \$87,500 of salary paid to Benson by the Wilder Company, the first \$65,400 was subject to the OASDI tax of 6.20%, and all \$87,500 was subject to the Medicare tax of 1.45%. Subsequently, Benson went to work for the Gold Company for a salary of \$10,000 per month, and Benson worked for Gold Company for the remaining five months of 1997. All \$50,000 of salary received by Benson from Gold Company was subject to the OASDI and Medicare taxes. Because the annual OASDI wage limitation is applied separately to the taxable wages paid by each employer (not the aggregate), Gold Company cannot obtain a refund of the employer social security taxes, even though Wilder Company had already paid employer OASDI taxes on the annual wage limitation amount with respect to Benson. Benson, however, can claim an income tax credit for the excess employee social security taxes withheld. For Benson, the excess social security taxes for 1997 are \$3,100 (0.062 times the \$50,000 of salary received from the Gold Company). The last \$22,100 of wages paid by the Wilder Company was not subject to the OASDI tax, so no excess withholding occurred with respect to this amount.

[g] Wages Paid by Predecessor Attributed to Successor. If an employer (hereinafter referred to as the successor employer) during any calendar year acquires all or substantially all of the property used in the trade or business of a predecessor employer or a unit of the business of such employer, the successor may count the taxable wages paid by the predecessor to a continuing employee for purposes of the total wage limitations.⁸⁴ A continuing employee is an individual who was employed by the predecessor and remains employed by the successor. For example, if an employee was paid taxable wages of \$15,400 by the predecessor in 1997, the year in which its business was sold to the successor, not more than \$50,000 (\$65,400 minus \$15,400) paid to the employee by the successor is subject to employer OASDI taxes. However, this rule has no impact on Medicare taxes on wages paid after 1993 since all wages paid after 1993 are subject to Medicare taxes.

The method of acquisition is immaterial. The acquisition may occur as a result of the incorporation of a business by a sole proprietor or a partnership, the continuance without interruption of the business of a previously existing partnership by a new partnership or by a sole proprietorship, or a purchase or any other transaction that results in a successor-predecessor relationship.⁸⁵ For example, the IRS ruled that a limited partnership would be treated as a successor employer where the subsidiaries of a corporation transferred most of their assets in three lines of business to a single limited partnership in which 13 of the subsidiaries were the general partners.⁸⁶ The limited partnership absorbed the businesses and assets in a number of ways, including statutory mergers, transfers of assets, and liquidations. Thus, the wages paid by the subsidiaries to employees transferred to the limited partnership can be counted in determining the maximum amount of wages subject to social security taxes. In another example, a corporation that was awarded a contract for the management, operation, and maintenance of a government facility and continued as the employer to virtually all the employees of the previous contractor was ruled to be a successor employer.⁸⁷ Thus, it was permitted to count wages paid by the previous contractor for purposes of the social security tax and FUTA tax wage limits.

[h] Concurrent Employment by Related Corporations With Common Paymaster. When two or more related corporations concurrently employ the same individual and pay him through a common paymaster that is one of the related corporations, the corporations are considered a single employer. The corporations will pay, in total, no more social security taxes than a single employer would. Each corporation is considered to have paid only the wages it actually disburses to that employee.⁸⁸

The common paymaster is responsible for filing information and tax returns and issuing Forms W-2 with respect to the wages it is considered to have paid.⁸⁹ (See § 6.42 for a detailed discussion of the common paymaster rules.)

[4] Completing Form 941

[a] In General. Form 941, Employer's Quarterly Federal Tax Return, is used to report the FITW tax withheld, including backup withholding from wages, tips, supplemental unemployment compensation benefits, and sick pay, as well as both the employer and employee portions of OASDI and Medicare taxes.⁹⁰

⁸⁴ IRC § 3121(a).

⁸⁵ *Id.*

⁸⁶ Ltr Rul 9315007.

⁸⁷ Ltr Rul 9228042. See Letter Ruling 9349013 for an additional example of an application of the successor employer rules.

⁸⁸ IRC § 3121(s); Reg § 31.3121(s)-1.

⁸⁹ *Id.*

⁹⁰ Reg § 31.6011(a)-4; Circular E, Employer's Tax Guide, IRS Pub No 15 (Jan 1997).

Fact Pattern for Filled-In Form 941

The Red Sail Restaurant employs seven individuals. The first five are waiters and waitresses and receive tips. The last two are cooks and management personnel and do not receive tips. The weekly wages received by the seven employees are as follows:

Thompson	\$300
Brewer	200
Malone	175
Zee	250
Cathart	250
Wilson	500
Jonnel	700

Meals furnished to the employees on the business premises are furnished for the employer's convenience and are not subject to employment taxes.⁹¹

It is assumed that the waiters and waitresses receive the same amount of tip income in each weekly pay period. For the third quarter of 1997, the wages paid, marital status, reported tips, withholding allowances claimed on Forms W-4, and FITW for all seven employees are as follows:

Employee	Tips	Wages	3rd Quarter			FITW
			Taxable Wages	Marital Status	Withholding Allowances	
Thompson	\$1,170	\$3,900	\$5,070	M	2	\$325.00
Brewer	936	2,600	3,536	S	1	338.00
Malone	988	2,275	3,263	M	3	-0-
Zee	1,066	3,250	4,316	S	1	455.00
Cathart	858	3,250	4,108	M	2	169.00
Wilson	-0-	6,500	6,500	S	1	780.00
Jonnel	-0-	9,100	9,100	M	4	741.00
	<u>\$5,018</u>	<u>\$30,875</u>	<u>\$35,893</u>			<u>\$2,808.00</u>

⁹¹ IRC § 119.