Investigating payroll tax and federal income tax withholding

Students analyze W-4 forms and pay stubs in order to better understand payroll taxes and federal income tax withholding.

Learning goals

Big idea

Payroll and income taxes are withheld from employees’ pay by their employers, and Form W-4 is used to determine how much income tax is withheld.

Essential questions

- How can you calculate how much money will be withheld for taxes from your paycheck?
- What’s the purpose of Form W-4?

Objectives

- Identify what types of taxes are deducted from a paycheck
- Complete a Form W-4 and claim federal income tax withholding allowances

What students will do

- Read a handout on taxes.
- Apply their understanding to interpreting sample Form W-4s and pay stubs.

KEY INFORMATION

Building block:

- Financial knowledge and decision-making skills

Grade level: High school (9-12)

Age range: 13-19

Topic: Earn (Getting paid, Paying taxes)

School subject: CTE (Career and technical education), Math, Social studies or history

Teaching strategy: Cooperative learning, Simulation

Bloom’s Taxonomy level: Understand, Analyze

Activity duration: 45–60 minutes

STANDARDS

Council for Economic Education
Standard I. Earning income

Jump$tart Coalition
Employment and income - Standard 3
Financial decision-making - Standards 1 and 2

To find this and other activities, go to: consumerfinance.gov/teach-activities
Preparing for this activity

□ Print copies of all student materials for each student, or prepare for students to access them electronically.

□ While it’s not necessary, completing the “Becoming familiar with taxes” activity before this one may make it more meaningful.

What you’ll need

THIS TEACHER GUIDE

▪ Investigating payroll taxes and federal income tax withholding (guide)
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STUDENT MATERIALS

▪ Investigating payroll taxes and federal income tax withholding (worksheet)
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▪ Understanding paycheck deductions (handout)
  cfpb_building_block_activities_understanding-paycheck-deductions_handout.pdf

Exploring key financial concepts

When you get your first paycheck, the terms and the amounts on the pay stub may not be easy to understand. You may wonder why your take-home pay is different from what you expected, based on what you earned. This may be your first direct experience with paying payroll and income taxes.

Because it would be difficult for people to pay everything they owe in federal taxes at one time, employers take a portion out of each employee’s paycheck for payroll taxes and income tax. To estimate how much should be taken out, employees complete Form W-4. The Internal Revenue Service (IRS) suggests that people complete a new Form W-4 each year and when their personal or financial situation changes, such as if they get married or have a child.

Employers send the amounts withheld for taxes to the federal government, which uses these funds to provide for national programs such as defense, foreign affairs, law enforcement, and

TIP

Because terms and laws related to taxes change, students should be encouraged to always look for the most up-to-date information.
interest on the national debt. In addition to the federal government, most states and some local municipalities require their residents to pay a personal income tax.

Teaching this activity

Whole-class introduction

- Distribute the “Investigating payroll taxes and federal income tax withholding” worksheet and the “Understanding paycheck deductions” handout.
- Be sure students understand key vocabulary:
  - **Federal income tax:** The federal government collects taxes based on the earnings of individuals and businesses, called an income tax. The federal income tax pays for national programs such as defense, foreign affairs, law enforcement, and interest on the national debt.
  - **Form W-4: Employee’s Withholding Allowance Certificate:** A form that the employee completes and the employer uses to determine the amount of income tax to withhold.
  - **Gross income:** Total pay before taxes and other deductions are taken out.
  - **Income tax:** Federal, state, and local taxes on income, both earned (salaries, wages, tips, commissions) and unearned (interest, dividends). Includes both personal and business or corporate income taxes. Not all states and localities have income taxes.
  - **Medicare:** A health insurance program for people who are 65 or older, certain younger people with disabilities, and people with permanent kidney failure requiring dialysis or a transplant; financed by deductions from wages and managed by the federal Social Security Administration.
  - **Net income:** Amount of money you bring home in your paycheck after taxes and other deductions are taken out; also called take-home pay.
  - **Payroll tax:** Taxes taken from your paycheck, including Social Security and Medicare taxes.
  - **Social Security:** Provides benefits for retired workers and people with disabilities, as well as the unmarried children, surviving spouses, or former spouses (in certain cases) of both.

TIP

Visit CFPB’s financial education glossary at consumerfinance.gov/financial-education-glossary/.
- **State income tax:** Most states and some local municipalities require their residents to pay a personal income tax. Generally, states use one of two methods to determine income tax: the graduated income tax or the flat rate income tax. Both methods first require you to figure your taxable income.

- **Tax deduction:** An amount (often a personal or business expense) that reduces income subject to tax.

- **Taxes:** Required payments of money to governments, which use the funds to provide public goods and services for the benefit of the community as a whole.

- **Tax refund:** Money owed to taxpayers when their total tax payments are greater than the total tax. Refunds are received from the government.

- **Withholding (“pay-as-you-earn” taxes):** Money that employers withhold from employees’ paychecks. This money is deposited for the government and is credited against employees’ tax liability when they file their returns. Employers withhold money for federal income taxes, Social Security and Medicare taxes, and state and local income taxes in some states and localities.

**Group or individual work**

- Students will read the “Understanding paycheck deductions” handout.

- Students can work individually or with a partner to answer the reading questions on the worksheet.

- Students can then work individually or with a partner to apply their understanding of tax withholding as they complete the worksheet.

**Wrap-up**

Bring students back together to discuss what they learned about taxes.

**Suggested next steps**

Consider searching for other CFPB activities that address the topic of earning, including making money, getting paid, or paying taxes.
Measuring student learning

Students’ responses will give you a sense of their understanding of tax withholdings. This answer guide provides possible responses for the “Investigating payroll taxes and federal income tax withholding” worksheet. Keep in mind that students’ answers may vary. The important thing is for students to have reasonable justification for their answers.

Answer guide

1. Based on the example in the handout, how much income tax do employers withhold from employee pay?
   - □ 6.20 percent of gross income
   - □ 1.45 percent of gross income
   - □ 7.65 percent of gross income
   - □ Employers use the information on Form W-4 to compute income tax withholding.

2. Payroll tax consists of which taxes? (Check all that apply.)
   - □ Income tax
   - □ Social Security tax
   - □ Sales tax
   - □ Medicare tax

3. The amount of federal income tax you pay is based on:
   - □ How much money you make
     - □ An amount set by the government (it’s the same for everyone)
     - □ What your house is worth
     - □ How old you are

4. Based on the example in the handout, what’s the total tax rate for the payroll taxes?
   - □ 6.20 percent
   - □ 10 percent
   - □ 7.65 percent
   - □ 1.45 percent
5. Who completed the Form W-4? Sadie Omozusi

6. Is the taxpayer married or single? Single

7. How many allowances does the taxpayer claim? 0

8. Complete the fields on the blank Form W-4 for Paulo based on the information in the scenario.

See completed form. Note: While the form here shows that Paulo chose 1 withholding allowance in line 5, students may select 0 or 1.

9. If Paulo claimed 0 as his withholding allowance, how would that affect his federal tax withholding and his take-home pay? His federal tax withholding would increase and his take-home pay would decrease.

10. Why might a single person with no children choose 1 instead of 0 as the withholding allowance? Answers will vary. For example: They need a higher take-home pay; they have deductions and exemptions that will reduce the taxes they owe.

11. What’s the total amount of payroll taxes (Social Security and Medicare) being withheld? $59.21

12. What’s the total amount of federal tax being withheld? $60.45