

Understanding paycheck deductions

What you earn (based on your wages or salary) is called your gross income.

Employers withhold (or deduct) some of their employees' pay in order to cover payroll taxes and income tax. Money may also be deducted, or subtracted, from a paycheck to pay for retirement or health benefits. The amount of money you actually take home (after tax withholding and other deductions are taken out of your paycheck) is called your net income, or take-home pay. More information is available from the Internal Revenue Service (IRS) at https://apps.irs.gov/app/understandingTaxes/hows/tax_tutorials/mod01/tt_mod01_01.jsp.

Payroll tax

The federal government determines the percentages employees will pay for payroll taxes. The payroll taxes taken from your paycheck include Social Security and Medicare taxes, also called FICA (Federal Insurance Contributions Act) taxes. The Social Security tax provides retirement and disability benefits for employees and their dependents. The Medicare tax provides medical benefits to people age 65 or older, certain younger people with disabilities, and people with permanent kidney failure requiring dialysis or a transplant. Employers pay part of these payroll taxes.

A CLOSER LOOK AT PAYROLL TAXES

As an example, let's say the payroll tax rates are as follows:	Percent	If an employee earns \$1,000 in their paycheck, the payroll taxes are:	Amount
Social Security tax rate:	6.20 percent	Social Security tax:	\$62.00
Medicare tax rate:	1.45 percent	Medicare tax:	\$14.50
Total payroll taxes:	7.65 percent	Total payroll taxes:	\$76.50

The employer withholds \$76.50 from this employee's paycheck and sends it to the government.

Note

There's a maximum annual amount of Social Security tax that can be withheld per employee. Because this amount changes annually, students should research the latest Social Security cap. There's no salary limit for the Medicare tax.

Income tax

If you are an employee, you will have to pay income taxes. The government will determine how much you owe based on the amount of money you receive from earned income (salaries, wages, tips, commissions) and unearned income (interest, dividends).

Federal income tax rates are the same across the country. Some states and localities also have state and local income tax.

Form W-4: An Employee's Withholding Allowance Certificate is how you let your employer know how much money to withhold from your paycheck for federal income taxes. This amount depends on allowances for things such as your marital status (because married and unmarried people pay different amounts of taxes) or if you have dependent children. It also varies based on the number of withholding allowances you claim, any additional amount you want the employer to withhold, and any exemptions from withholding that you claim. It's helpful to understand how the number of withholding allowances impacts the amount of tax withheld from your paycheck.

For example, imagine that Gemma is single and earns \$500 per week. Look at what happens if she claims zero, one, or two withholding allowances.

Withholding allowances	0	1	2
Amount of tax withheld	\$61	\$49	\$38

As you can see, as the number of allowances increases, the amount of federal income tax withheld decreases.

Here's a W-4 form for Malik Matthews. He's single and has no dependents. Notice how he completed his W-4 form to show that he is single and is claiming one allowance.

Form W-4 Department of the Treasury Internal Revenue Service		Employee's Withholding Allowance Certificate <small>▶ Whether you're entitled to claim a certain number of allowances or exemption from withholding is subject to review by the IRS. Your employer may be required to send a copy of this form to the IRS.</small>		OMB No. 1545-0074 20XX	
1 Your first name and middle initial Malik		Last name Matthews		2 Your social security number	
Home address (number and street or rural route) 456 Pine Street			3 <input checked="" type="checkbox"/> Single <input type="checkbox"/> Married <input type="checkbox"/> Married, but withhold at higher Single rate. <small>Note: If married filing separately, check "Married, but withhold at higher Single rate."</small>		
City or town, state, and ZIP code Anytown, Any State XXXXX			4 If your last name differs from that shown on your social security card, check here. You must call 800-772-1213 for a replacement card. <input type="checkbox"/>		
5 Total number of allowances you're claiming (from the applicable worksheet on the following pages)				5 1	
6 Additional amount, if any, you want withheld from each paycheck				6 \$	
7 I claim exemption from withholding for 2019, and I certify that I meet both of the following conditions for exemption. <ul style="list-style-type: none"> • Last year I had a right to a refund of all federal income tax withheld because I had no tax liability, and • This year I expect a refund of all federal income tax withheld because I expect to have no tax liability. If you meet both conditions, write "Exempt" here ▶				7	
Under penalties of perjury, I declare that I have examined this certificate and, to the best of my knowledge and belief, it is true, correct, and complete.					
Employee's signature (This form is not valid unless you sign it.) ▶ <i>Malik Matthews</i>					
8 Employer's name and address (Employer: Complete boxes 8 and 10 if sending to IRS and complete boxes 8, 9, and 10 if sending to State Directory of New Hires.)				9 First date of employment	
				10 Employer identification number (EIN)	
For Privacy Act and Paperwork Reduction Act Notice, see page 4.					
				Cat. No. 10220Q Form W-4 (20XX)	

Note: W-4 instructions can be found at <https://www.irs.gov/pub/irs-pdf/fw4.pdf>.

Other deductions

In addition to withholding federal and state taxes (such as income tax and payroll taxes), other deductions may be taken from an employee's paycheck and some can be withheld from your gross income. These are known as "pretax deductions" and include contributions to retirement accounts and some health care costs. Because pretax deductions are subtracted from a person's gross income, this reduces the amount of earnings they need to pay taxes on.

Example

Karli Pinker earns \$3,000 a month as an office manager in a doctor's office. In addition to payroll taxes (using the example payroll tax rates in the earlier example) and income tax withholding, her employer withholds \$75 each paycheck for her private retirement account. Karli gets paid twice per month. She is single and claims one withholding allowance.

Review Karli's paystub to see how her net income is calculated as follows:

Gross income (per paycheck)	\$1,500.00
Social Security tax (6.20 percent of gross income)	-\$93.00
Medicare tax (1.45 percent of gross income)	-\$21.75
Income tax (per IRS withholding tables and Form W-4)	-\$141.00
Retirement	-\$75.00
Net income	\$1,169.25

Karli's gross income in each paycheck is \$1,500, but the net income she receives in each paycheck is \$1,169.25. Her employer sends \$255.75 ($\$93 + \$21.75 + \141) to the federal government and \$75 to a private retirement fund for her.

💰 What happens to the tax money withheld from your paycheck?

Employers send the money that they deduct for taxes to the federal government, and, in many cases, to the state government as well. The government uses this tax revenue to provide public goods and services for the benefit of the community as a whole. For example, federal tax money pays for national programs such as defense, foreign affairs, law enforcement, and interest on the national debt.