

## **Congress passes payroll tax cut extension through 2012**

March 7, 2012

On February 17, Congress passed H.R. 3630, the “Middle Class Tax Relief and Job Creation Act of 2012” (the Act) and sent it to the President for his signature. The Act extends the 2-percentage-point payroll tax cut through the end of 2012, and also repeals a number of estimated tax shifts for large corporations. Here are highlights of the tax changes in this new law.

### **Payroll Tax Cut Extended Through End of 2012**

The Federal Insurance Contributions Act (FICA) imposes two taxes on employers, employees, and self-employed workers—one for Old Age, Survivors and Disability Insurance (OASDI; commonly known as the Social Security tax), and the other for Hospital Insurance (HI; commonly known as the Medicare tax). For remuneration received during 2011 the “payroll tax holiday period,” namely calendar-year 2011, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the 2010 Tax Relief Act, P.L. 111-312) reduced the employee OASDI tax rate under the FICA tax by two percentage points from 6.2% to 4.2%. Similarly, for self-employment income for tax years beginning in 2011, the Act reduced the OASDI tax rate under the SECA tax by two percentage points from 12.4% to 10.4%.

In December of 2011, when Congress couldn't agree on how to fund a full-year extension of the payroll tax cut that applied for 2011, it passed the “Temporary Payroll Tax Cut Continuation Act of 2011” (the TTCA, P.L. 112-78), providing for a two-month extension of the payroll tax cut that applied for 2011, and a parallel extension of a lower SECA tax rate on self-employment income. More specifically, under the TTCA, the reduced employee OASDI tax rate of 4.2% under the FICA tax, and the equivalent employee portion of the RRTA tax, was extended to apply to covered wages paid in the first two months of 2012. The TTCA also provided for recapture of any benefit a taxpayer may have received from the reduction in the OASDI tax rate, and the equivalent employee portion of the RRTA tax, for remuneration received during the first two months of 2012 in excess of \$18,350 (i.e., two-twelfths of the 2012 wage base of \$110,100). The recapture would have been accomplished by a tax equal to 2% of the amount of wages (and railroad compensation) received during the first two months of 2012 that exceed \$18,350. The recapture provision would have applied only if the temporary payroll tax cut terminated on Feb. 29, 2012.

For tax years beginning in 2012, the TTCA also provided that the OASDI rate for a self-employed individual remained at 10.4%, for self-employment income of up to \$18,350 (reduced by wages subject to the lower OASDI rate for 2012).

**New law.** The Act provides that the “payroll tax holiday period” means calendar years 2011 and 2012. (Sec. 601(c) of the 2010 Tax Relief Act, as amended by Act Sec. 1001(a)) Thus, the 2-percentage point payroll tax reduction and the 2-percentage point reduction in the OASDI tax under the SECA tax for the self-employed will apply through

Dec. 31, 2012. As a result, for 2012, employees will pay only 4.2% Social Security tax on wages up to \$110,100 (wage base for 2012) and self-employed individuals will pay only 10.4% Social Security self-employment taxes on self-employment income up to \$110,100.

**Observation:** The maximum savings for 2012 will be \$2,202 (2% of \$110,100) per taxpayer. If both spouses earn at least as much as the wage base, the maximum savings will be \$4,404.

Additionally, the Act repeals the TTCA recapture provisions applying to taxpayers with wages exceeding \$18,350 over the first two months of 2012. (Sec. 601(g) of the 2010 Tax Relief Act, as amended by TTCA Sec. 101(a), repealed by Act Sec. 1001(b))

### **Coordination of Payroll Tax Cut With Self-Employment Tax**

Under pre-2010-Tax-Relief Act law, for computing the income tax of an individual, Code Sec. 164(f) allowed an above-the-line deduction equal to 50% of the amount of the SECA tax imposed on the individual's self-employment income for the tax year.

Also, under pre-2010-Tax-Relief Act law, under Code Sec. 1402(a)(12), a taxpayer is allowed a deduction in computing net earnings from self-employment equal to: (1) net earnings from self-employment as determined before taking the Code Sec. 1402(a)(12) deduction into account, multiplied by (2) one-half the sum of the OASDI tax rate and the HI tax rate. This deduction is allowed in computing net earnings from self-employment in lieu of the Code Sec. 164(f) above-the-line deduction of one-half of the self-employment tax. Thus, the Code Sec. 164(f) deduction can't be taken in computing self-employment tax liability. The Code Sec. 1402(a)(12) deduction is designed to put the self-employed in the same position as employees in that they don't have to pay self-employment tax on about half of the amount of the tax itself.

Sec. 601(b)(2) of the 2010 Tax Relief Act provided that the Code Sec. 164(f) income tax deduction allowed for tax years beginning in 2011 is computed at the rate of 59.6% of the OASDI tax paid, plus one half of the HI tax paid.

The revised percentage (59.6%) replaced the rate of one half (50%) allowed under pre-2010 Tax Relief Act law for this portion of the deduction. The revised percentage was necessary to continue to allow the self-employed taxpayer to deduct the full amount of the employer portion of SECA taxes. The employer OASDI tax rate remained at 6.2%, while the employee portion fell to 4.2%. Thus, the employer share of total OASDI taxes is 6.2 divided by 10.4, or 59.6% of the OASDI portion of SECA taxes.

However, under Sec. 601(b)(1) of the 2010 Tax Relief Act, the two-percentage-point reduction is not taken into account in determining the Code Sec. 1402 SECA tax deduction allowed for determining the amount of the net earnings from self-employment for the taxable year. Thus, the deduction for 2011 remained at 7.65% of self-employment income (determined without regard to the deduction).

For tax years beginning in 2012, Sec. 601(f) of the 2010 Tax Relief Act, as amended by TTCA Sec. 101, provided that the OASDI rate for a self-employed individual remained at 10.4% for self-employment income of up to \$18,350 (reduced by wages subject to the lower OASDI rate for 2012). Related rules for 2011 concerning coordination of a self-employed individual's deductions in determining net earnings from self-employment and income tax also applied, except that the income tax deduction allowed for the OASDI portion of SECA tax paid for tax years beginning in 2012 would have been computed at the rate of 59.6% of the OASDI tax paid on self-employment income of up to \$18,350 (6.2% employer share of total OASDI taxes divided by 10.4%, equalled 59.6% of the OASDI portion of SECA taxes for the first \$18,350 of self-employment income). For self-employment income in excess of this amount, the deduction would have been equal to half of the OASDI portion of the SECA tax paid.

**New law.** The Act repeals the special rules in the TTCA dealing with coordination with the deduction for employment taxes. (Sec. 601(f) of the 2010 Tax Relief Act, as amended by TTCA Sec. 101(a), repealed by Act Sec. 1001(b))

**Observation:** Thus, since the “payroll tax holiday period” under the Act is calendar years 2011 and 2012, the rules in Sec. 601(b) of the 2010 Tax Relief Act relating to coordination of the payroll tax cut with deductions with employment taxes continue to apply for all of 2012. Under these rules:

- The Code Sec. 164(f) income tax deduction allowed for tax years beginning in 2012 is computed at the rate of 59.6% of the OASDI tax paid, plus one half of the HI tax paid.
- The two-percentage-point reduction is not taken into account in determining the Code Sec. 1402 SECA tax deduction allowed for determining the amount of the net earnings from self-employment for 2012. Thus, the deduction for 2012 remains at 7.65% of self-employment income (determined without regard to the deduction).

### **Many Accelerations in Estimated Tax Payments for Large Corporations Are Repealed**

Generally, corporations must pay estimated income tax for each tax year in 4 equal installments due on the 15th day of the 4th, 6th, 9th, and 12th month of the tax year. However, in the past, Congress has on many occasions modified the estimated tax payment schedule for large corporations (those with assets of at least \$1 billion, determined as of the end of the preceding tax year). Typically, these provisions boosted large corporations' estimated tax payments due in the fourth quarter of particular years by a certain percentage, while decreasing their payments by a corresponding amount in the first quarter of the following years. The timing shifts permitted Congress to satisfy certain budgetary requirements.

Under recent such shifts in estimated tax payments for large corporations:

- Payments due in July, August or September of 2012, were to have been increased to 100.5% of the payment otherwise due;
- Payments due in July, August, or September, 2014, were to have been increased to 174.25% of the payment otherwise due;
- Payments due in July, August or September, 2015, were to have been increased to 163.75% of the payment otherwise due;
- Payments due in July, August, or September 2016 were to have been increased to 103.5% of the payment otherwise due; and
- Payments due in July, August or September, 2019, were to have been increased to 106.50% of the payment otherwise due.

**New law.** All of the above shifts in estimated tax payments for large corporations are repealed. (Act Sec. 7001) Thus, large corporations will be required to make estimated tax payments in 2012, 2014, 2015, 2016, and 2019, as if the prior legislation shifting the estimated tax payments had never been enacted or amended. (Conference Agreement)