Low-income taxpayers face increased withholding in 2011 despite 2% payroll tax cut

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One of the most prominent features of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 Tax Relief Act, P.L. 111-312) is the one-year “payroll tax holiday” for 2011—a two-percentage-point reduction in payroll tax for employees. According to an IRS news release, this reduction will cause the take-home pay of millions of workers to increase in 2011. (IR 2010-124) However, the corresponding termination of the making work pay credit (MWPC) largely negates any positive effect of the payroll tax reduction on many workers' paychecks, and even subjects some low-income workers to greater withholding than they faced in 2010.

> **Observation:** Not only will some low-income taxpayers face greater withholding, but many will face higher tax liabilities because the 2010 MWPC was worth more to them than the 2-percentage-point drop in payroll tax for 2011.

Background on the payroll tax cut. For remuneration received during 2011, the 2010 Tax Relief Act reduces the employee OASDI tax rate under the FICA tax by two percentage points to 4.2%. Similarly, for self-employment income for tax years beginning in 2011, the 2010 Tax Relief Act reduces the OASDI tax rate under the SECA tax by two percentage points to 10.4% percent. As a result, for 2011, employees will pay only 4.2% Social Security tax on wages up to $106,800, and self-employed individuals will pay only 10.4% Social Security self-employment taxes on self-employment income up to $106,800.

> **Observation:** The maximum reduction in FICA tax for an individual employee is $2,136 ($106,800 × .02). For a married couple, each with wages of $106,800 or more, the maximum reduction is $4,272.

Background on the MWPC. The American Recovery and Reinvestment Act of 2009 (ARRA, P.L. 111-5) created the MWPC. It provided for a credit against income tax to an eligible individual in an amount equal to the lesser of (1) 6.2% of earned income, or (2) $400 ($800 in the case of a joint return). The credit was incorporated into the 2010 withholding tables and was effectively received by employees incrementally through a reduction in the amount withheld from their paychecks. It was phased out for taxpayers with modified adjusted gross income over $75,000, and was fully eliminated at $95,000 ($150,000-$190,000 for married taxpayers).

> **Observation:** Because the credit rate (6.2%) is the same as the social security tax rate, the credit can be thought of as offsetting social security tax for up to $6,451.61 in income ($6,451.62 × .062 = $400) for taxpayers with incomes below the phase-out levels.

Changes for 2011 income tax withholding. Withholding for income taxes has increased for almost all taxpayers in 2011. This is attributable to a number of changes, notably including the expiration of the MWPC. For instance, a taxpayer who received the full $400 credit and is subject to weekly withholding will see an increase in his withholding of approximately $7.69 per week ($400 / 52 = $7.69).

> **Illustration :** In 2010, the amount of income tax withheld for a single taxpayer with wages (after subtracting withholding allowances) of $250 per week was $15.90. In 2011, it's $23.30—an increase of almost 47%. If the taxpayer was married, the weekly income tax withholding for 2010 was zero, and $9.80 in 2011. Although the income tax withholding for a single taxpayer with wages of $1,000 per week also went up, from $159.10 in 2010 to $165.40 in 2011, this is a less dramatic 3.9% increase.

Effect of the 2% OASDI reduction. In general, for 2011, taxpayers with incomes below $20,000 will pay more tax and have higher withholding than in 2010, whereas taxpayers with greater incomes will enjoy reductions. ($20,000 × .02 = $400)

> **Illustration :** Adding the effects of OASDI, a single taxpayer with wages of $250 per week had $31.40 withheld from each paycheck in 2010, which will rise to $33.80 in 2011. However, if the single taxpayer instead made $1,000 per week, his withholding would drop from $221.10 per week in 2010 to $207.40 in 2011.

> **Observation:** A taxpayer who receives wages of $35,000 per year ($673.07 per week) will see some reduction in his weekly withholding from 2010 to 2011—from $121.09 to $115.03. However, this reduction may well be less than the taxpayer anticipated.

Thus, for 2011, low-income taxpayers are hit hardest by the increased income tax withholding. For taxpayers with higher incomes, the loss of the MWPC is mitigated by the 2-point OASDI reduction. However, this reduction is only in effect for 2011. Absent Congressional action, the increase will have a greater impact in 2012 on all taxpayers who received any benefit from the MWPC.

Withholding for pension recipients. Although withholding is optional for retired pension recipients, many retirees opt to have taxes withheld as a matter of convenience. Retired taxpayers were not eligible for the MWPC, but the income tax withholding tables in 2010 nonetheless reflected the credit and reduced the amount withheld from retirees' payments. IRS provided a separate withholding table in 2010 with adjustments to make withholding tax calculations more accurate for pension recipients, effectively providing for an additional payment to offset the MWPC, but use of the table was optional.

As explained above, income tax withholding has substantially increased for 2011 due to, among other things, the expiration of the MWPC. This increase is countered, for many taxpayers, by the corresponding decrease in their share of employee OASDI tax. However, since retirees don't pay FICA tax, they don't receive any benefit from the 2-point reduction. Thus, if the optional table wasn't used by the payee of the retirement income, retirees will have a substantially larger amount withheld from their pension payments in 2011 than in 2010, even though their actual tax liability on those payments should remain fairly consistent. In other words, the expiration of the MWPC has a significant effect on their tax withholdings even though it doesn't actually affect their tax liability.

The illustrations below assume that the payees did not use the optional additional withholding for pensions.

> **Illustration:** In 2010, a single retiree who received a monthly $1,000 pension had $78.25 in income tax withheld. In 2011, the withholding is $88.35—approximately a 13% increase. If the retiree is married, the withholding for 2010 would be zero, and $34.20 in 2011.

> **Illustration:** In 2010, a single retiree who received a monthly $2,000 pension had $206.15 withheld. In 2011, the withholding is $238.35—approximately a 16% increase. If the retiree is married, the withholding for 2010 would be $85.40 and $134.20 in 2011—approximately a 57% increase.

> **Recommendation:** If the withheld income tax exceeds a retiree's liability, he can claim a refund in the next year. However, some retirees may face a financial hardship due to the smaller payments. Since withholding on pensions isn't mandatory, some retirees may find it advantageous to elect to not use withholding and instead make estimated tax