

INTERNAL REVENUE SERVICE

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[REDACTED]

Dear [REDACTED]:

This letter is in response to your inquiry dated February 2, 2004, on behalf of your constituent, [REDACTED]. [REDACTED] received a raise at work. However, he now takes home less money since receiving the raise. He wants to know why.

[REDACTED] appears to be concerned about the amount of money that his employer withholds from his regular pay check. Thus, we believe it may be helpful if we explain how the withholding of federal income tax, Social Security tax, and Medicare tax from an employee's regular pay check works.

An employer must follow specific rules in the Internal Revenue Code and the Federal Tax Regulations concerning federal income tax, Social Security tax, and Medicare tax amounts to withhold whenever it pays wages to an employee. As to federal income tax withholding, these rules generally provide that the amount of income tax that an employer withholds is based on the amount of wages paid, and on the withholding allowances and marital status that an employee claims on a Form W-4, Employee's Withholding Allowance Certificate. An employee fills out and provides the Form W-4 to his employer. Using prescribed tax tables and computational procedures, the employer will then withhold the appropriate amount of federal income tax from an employee's pay.

In some cases, employees may claim fewer withholding allowances than they are entitled to claim on the Form W-4 which can result in the employer withholding too much federal income tax. In addition, employees may claim too many withholding allowances, which would result in too little income tax withheld. If the withholding is resulting in an overcollection or undercollection of tax, employees can file a new Form W-4 with the employer to change the number of allowances so that the proper amount of income tax is withheld. If employees do not correct excessive withholding by filing a

corrected Form W-4, they can get a refund of the excessive amount of tax withheld when they file their income tax returns for that tax year.

Employers must also withhold Social Security and Medicare taxes under the Federal Insurance Contributions Act (FICA) from an employee's wages. Social Security and Medicare taxes have different tax rates. The employee tax rate for Social Security is 6.2%, and the employee tax rate for Medicare is 1.45%. The Social Security tax has an annual wage base limit. So, this tax is withheld on wages paid only up to the annual wage base amount. The 2003 wage base limit for Social Security was \$87,000. For 2004, the wage base limit is \$87,900. The Medicare tax has no wage base. Thus, this tax is withheld on all wages paid. Unlike the allowances that affect the withholding of income tax amounts from an employee's regular pay check, no withholding allowances apply for Social Security and Medicare taxes. Thus, a wage increase to an employee will result in FICA withholding on that increased amount up to 7.65%.

Other factors, beside changes in income tax withholding or FICA, can affect the amount an employee will take home from his regular pay after receiving a wage increase. For example an employee may:

- Elect to change the amount he has withheld for retirement purposes
- Change his health insurance coverage, resulting in higher premiums
- Experience a change in withholding due to an increase in a child support obligation.

I hope this information helps explain why _____ take home pay could have declined slightly after he received a raise. Please call me at _____ or _____, ID # _____, at _____ if you have any questions.

Sincerely,

Sarah Hall Ingram
Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities)