Section 8
WHEN WAGES BECOME TAXABLE

Introduction
There is often a lapse of at least a week between the time wages are earned and the time they are actually paid. For instance, an employee who is paid biweekly works during week 1 and week 2 but is not paid until week 3.

Under IRS regulations, wages are taxable when constructively received by (actually made available to) employees, regardless of when earned. This is known as the principle of "constructive receipt."

**Problem 1:** AccountCorp pays employees weekly. Employees who work from February 5 through February 9 are paid for this work on February 13. When are these wages subject to federal income tax withholding (FITW) and FICA withholding?

**Solution 1:** On February 13. These wages are subject to FITW and FICA on the day that they are paid. Thus, taxes are withheld on February 13. The employer’s FICA tax liability also is incurred on February 13, the day that wages are actually paid to employees.

Unclaimed Checks
Say that you prepare paychecks on December 22, 2001. However, some employees are on vacation and do not claim their checks until 2002. Are the wages taxable in 2001 or 2002?

The answer is 2001. Under the rule of constructive receipt, wages are constructively (actually) received when funds are available to employees without substantial limitation. If paychecks are available to employees, but they do not pick them up, wages are taxable on the day when they could have claimed the checks.

**Problem 2:** Anthony is terminated on payday, December 31, 2001. Although his check is ready for him on that day, he does not pick it up until January 14, 2002. Should these wages be reported on Anthony’s W-2 for 2001 or 2002?
SOLUTION 2: Generally speaking, the wages should be reported on Anthony’s W-2 for 2001 because the paycheck was available to him in that year. It was his choice to take receipt on January 14, 2002.

PROBLEM 3: ABC Corp. failed to prepare a paycheck for new hire Margaret on December 31, 2001. The employer discovered the error on December 31, but did not prepare her paycheck until January 3, 2002. Should the company include these wages in Margaret’s taxable income for 2001 or 2002?

SOLUTION 3: These wages should be included in her taxable income for 2002—the year in which they were made available to her.

Selecting the Correct Annual Tax Rate

The federal income tax and/or FICA tax rates and limits generally change every year. For instance, in 2000, OASDI was 6.2% of the first $76,200 in wages. In 2001, the rate is 6.2% of the first $80,400.

Because the federal income tax and FICA tax rates and limits can and often do change every year, the rule of constructive receipt is particularly important at the end of the year.

EXAMPLE: Connie is paid $80,400 from January 1, 2001, through December 25, 2001. From December 26, 2001, to December 31, 2001, she earns $1,000 but is not paid until January 3, 2002. The $1,000 paid in 2002 is subject to the full 7.65% FICA tax, even though her last $1,000 in wages earned during 2001 exceeded the 2001 maximum OASDI wage limit of $80,400.

The rule of constructive receipt is important for another reason. Each employee’s federal and state income tax liability is based on wages paid for the year. The higher the wage amount reported on an employee’s W-2, the more federal and state income tax the employee owes.

PROBLEM 4: Edward’s year-to-date FICA taxable wages on December 15, 2001, were $80,400. He earned an additional $500 from December 15 through December 31, but was not paid this $500 until January 3, 2002. How much of the $500 payment is subject to FICA (OASDI and HI)?
SOLUTION 4: The full $500 is subject to the FICA tax rate of 7.65% (combined OASDI and HI taxes) because the wages were not received until 2002.

PROBLEM 5: Ricardo’s year-to-date FICA taxable wages as of December 26, 2001, were $51,000. He earned an additional $500 from December 26 through December 31 but was not paid the $500 until January 3, 2002. What amount does the employer report on Ricardo’s 2001 Form W-2: $51,000 or $51,500?

SOLUTION 5: The employer reports $51,000 because the additional $500, though earned in 2001, was not paid until 2002.

**Postdating and Backdating Paychecks**

Because of the favorable or unfavorable effect that the rule of constructive receipt has on tax liability, employees and employers sometimes request that checks be postdated or backdated.

**EXAMPLE:** Under company policy, employee bonuses are payable on December 31, 2001. To help highly paid employees defer federal income tax, the employer postdates these checks to January 3, 2002, but distributes them to employees on December 30, 2001. Under the rule of constructive receipt, these wages are taxable when made available to employees (2001), regardless of the date of the paycheck. Although a check date may seem to be proof of when wages were received, the IRS can easily detect postdating by reviewing the employer’s canceled paychecks.

**PROBLEM 6:** Each January 15, HessCo pays bonuses for the previous year. All employees receiving a bonus reached their OASDI limit in 2001. To avoid withholding FICA on 2002 bonuses, HessCo backdates bonus checks to December 31, 2001, but distributes them to employees on January 14, 2002. Are these checks considered wages for 2001 or 2002?

**SOLUTION 6:** The date of the check does not alter the facts. Because bonus checks were not made available to employees until 2002, they must be treated as 2002 wages (subject to 2002 FICA and FITW rates).
**Postponing Payment of Wages**

Maureen is in a high income tax bracket in 2001 and expects to be in a lower income tax bracket in 2002. She asks her employer to pay her December 2001 wages in January 2002. What should the employer do?

Unless the company has a “formal deferred compensation plan,” taxes should not arbitrarily be deferred by postponing wage payments.

**EXAMPLE:** Wesley asks his employer to delay his November and December paychecks until January 2002. His employer agrees to delay payment of the $2,000, and he is paid in 2002 instead of 2001. Without a formal deferred compensation plan covering Wesley, his employer may be required to report and tax this $2,000 as though it were paid in 2001.

**Salary Advances and Overpayments**

Because wages are taxable when constructively received, regardless of when earned, a salary advance or overpayment of wages is taxable when paid to the employee, even though wages are not yet earned.

When an employee repays an overpayment or advance, his or her gross taxable wages will be reduced by the amount of the repayment provided the repayment occurs in the same tax year as the advance. If a salary advance is repaid in a year after the year in which the advance is paid, the repayment cannot be deducted from gross wages. Instead, the “claim-of-right rule” applies. Under the claim-of-right rule, complex reporting rules apply for both the employee and the employer. Speak to an accountant or legal advisor for more information.

**EXAMPLE:** In July, Randy receives a salary advance of $500 less withheld taxes. Randy agrees to repay the advance by having it deducted from his August paycheck, which would normally be $1,500. His employer will withhold taxes on $1,000 ($1,500 less the repaid advance of $500).
When Wages Become Taxable

**QUIZ 1  WHEN WAGES BECOME TAXABLE**

*Problem I.*

How much FICA would you withhold from the following wage payments?

1. John is paid biweekly. On January 4, 2001, he is paid $800 for the biweekly period December 20, 2000, to January 1, 2001. As of December 19, he has had year-to-date FICA tax withheld on wages of $87,200. How much FICA should be withheld from his $800 paycheck, and in which calendar year would it be withheld? $______ year ________

2. When paychecks are distributed on December 31, 2000, Margaret is ill. She picks up her paycheck for $425 on January 4, 2001. As of December 31, she has had year-to-date FICA tax withheld on $136,000. How much FICA should be withheld from her $425 paycheck, and in which calendar year would it be withheld? $______ year ________

3. Louise works out of state. Her paycheck for $375, dated December 28, 2000, is delayed in the mail so that she receives it on January 4, 2001. As of December 27, 2000, she has had year-to-date FICA tax withheld on $86,000. How much FICA should be withheld from her $375 paycheck, and in which calendar year would it be withheld? $______ year ________

4. On December 15, 2001, Jose receives a partial salary advance of $50 from which FITW and FICA are withheld. He repays it in full by having it deducted from his December 31, 2001, paycheck of $900. How much FICA should be withheld from the December 31 payment, assuming that Jose did not reach the OASDI limit in 2001? $______

5. On December 31, 2000, Tom receives a $500 paycheck postdated to January 4, 2001. How much FICA should be withheld assuming that he did not reach his FICA limit in 2000 or 2001, and in which calendar year would it be withheld? $______ year ________
Problem II.

Fill in the blanks.

1. Under IRS regulations, wages are subject to tax when _________ received.

2. Under the rule of constructive receipt, wages are taxable when funds are _________ to employees.

3. Under the rule of constructive receipt, wages are taxable when _________, regardless of when _________.

4. A wage or salary advance repayment from which FITW and FICA was withheld is _________ from gross wages before computing the amount of withholding.

Problem III.

Multiple choice. Circle the correct answer.

1. The principle that governs when wages become taxable is:
   a. Generally Accepted Accounting Principal (GAAP)
   b. cash accounting
   c. accrual accounting
   d. constructive receipt

2. On December 31, 2000, Elmer receives a paycheck dated January 4, 2001. The Social Security wage limit that applies to this payment is:
   a. $0   b. $80,400   c. $72,600   d. $76,200

3. Wages earned in 2000, but paid in 2001 are taxable at the Social Security rate of:
   a. 1.20%   b. 1.45%   c. 6.20%   d. 7.65%
**Problem 1.**

1. **$61.20 from 2001 wages**  
   Wages are taxable in the year paid—not the year earned.  
   To calculate:
   
   \[
   \text{OASDI: } \$800 \times 6.2\% = \$49.60 \\
   \text{HI: } \$800 \times 1.45\% = \$11.60 \\
   \$49.60 \left( \text{OASDI} \right) + \$11.60 \left( \text{HI} \right) = \$61.20
   \]

2. **$6.16 from 2000 wages**  
   To calculate:
   
   \$136,000 exceeds the 2000 OASDI wage limit of $80,400.  
   There is no HI wage limit, therefore $425 \times 1.45\% = \$6.16

3. **$28.69 from 2001 wages**  
   To calculate:
   
   \[
   \text{OASDI: } \$375 \times 6.2\% = \$23.25 \\
   \text{HI: } \$375 \times 1.45\% = \$5.44 \\
   \$23.25 \left( \text{OASDI} \right) + \$5.44 \left( \text{HI} \right) = \$28.69
   \]

4. **$65.03**  
   To calculate:
   
   \$900 – $50 (advance) = $850 (FICA taxable)  
   \text{OASDI: } \$850 \times 6.2\% = \$52.70  
   \text{HI: } \$850 \times 1.45\% = \$12.33  
   \$52.70 \left( \text{OASDI} \right) + \$12.33 \left( \text{HI} \right) = \$65.03

5. **$38.25 from 2000 wages**  
   To calculate:
   
   \$500 \times 7.65\% = \$38.25
Problem II.

1. constructively
2. available
3. paid, earned
4. deducted

Problem III.

1. d
2. d
3. c
QUIZ 2    WHEN WAGES BECOME TAXABLE

NOT SHOWN