Withholding Tax Explained: Types and How It's Calculated

DEFINITION:

Withholding tax is the income tax an employer deducts from an employee's paycheck.

What Is Withholding Tax?

The term "withholding tax" refers to the money that an employer deducts from an employee's gross wages and pays directly to the government. The amount withheld is a credit against the income taxes the employee must pay during the year.

The vast majority of people who are employed in the United States are subject to tax withholding.

- Withholding tax is a set amount of income tax that an employer withholds from an employee's paycheck.
- Employer's remit withholding taxes directly to the IRS in the employee's name.
- The tax withholding is a credit against the employee's annual income tax bill.
- If too much money is withheld, an employee receives a tax refund; if too little is withheld, they may have to pay the IRS more with their tax return.

Understanding Withholding Tax

Tax withholding is a way for the U.S. government to maintain its pay-as-you-go income tax system. This means taxing individuals at the source of income rather than trying to collect income tax after wages are earned.

Here's How It Works

Whenever an employee gets paid, their employer withholds a certain percentage of their paycheck as income tax. This is then paid by the employer to the Internal Revenue Service (IRS).

The amount deducted appears on the employee's paystub and the total amount deducted annually can be found on Form W-2: Wage and Tax Statement. Employers send W-2s to their employees each year to help them file their annual income tax returns.

The amount deducted depends on a number of factors. These considerations include the amount an employee earns, filing status, any withholding allowances claimed by the employee, and whether an employee requests that additional income be withheld. If merited, any excess is paid back to the employee by the IRS as a tax refund.

The IRS suggests verifying your withholding tax early in the year and whenever any changes are made to the tax law. You should also check it whenever you have changes in your lifestyle (filing status, marriage, divorce), wages, or when tax credits and deductions are changed.

State Income Taxes

The majority of U.S. states also have state income taxes and employ tax withholding systems to collect taxes from their residents. States use a combination of the IRS W-4 Form and their own worksheets, which residents fill out to establish their withholding.

Nine states do not impose income tax on residents. They are: Alaska, Florida, New Hampshire, Nevada, South Dakota, Tennessee, Texas, Washington, and Wyoming.

History of Withholding Taxes

Tax withholding first occurred in the U.S. in 1862 at the order of President Abraham Lincoln to help finance the Civil War. The federal government also implemented excise taxes for the same purpose. Tax withholding and income tax were abolished after the Civil War in 1872.

The current system was accompanied by a large tax hike when it was implemented in 1943. At the time, it was thought that it would be difficult to collect taxes without getting them from the source. Most employees are subject to withholding taxes when they are hired and fill out a W-4 Form. The form estimates the amount of taxes that will be due.

The withholding tax is one of two types of payroll taxes. The other type is paid to the government by the employer and is based on an individual employee's wages. This money contributes to funding for Social Security and federal unemployment programs (since the Social Security Act of 1935) as well as Medicare (since 1966).

Types of Withholding Taxes

There are two types of withholding tax employed by the IRS to ensure that proper tax is withheld in different situations: the U.S. resident and nonresident withholding tax.

U.S. Resident Withholding Tax

The first and more commonly discussed withholding tax is the one on U.S. residents' personal income, which every employer in the U.S. must collect. Under the current system, employers collect the withholding tax and remit it directly to the government, with employees paying the remainder of what they may owe when they file a tax return in April each year.

If too much tax is withheld, the result is a tax refund. However, if not enough tax has been held back, then the individual will owe money to the IRS.

You can easily perform a paycheck checkup using the IRS's tax withholding estimator. Tax Withholding Estimator | Internal Revenue Service This tool helps identify the correct amount of tax withheld from each paycheck to make sure that you don't owe more when you file your annual return.

To use the estimator, you'll need your most recent pay stubs, your most recent income tax return, your estimated income during the current year, and other information.

Nonresident Withholding Tax

The other type of withholding tax is levied against nonresident aliens to ensure that proper taxes are paid on income sources from within the U.S. A nonresident alien is someone who is foreign-born and has not passed the green card test or a substantial presence test.

All nonresident aliens must file Form 1040NR if they are engaged in a trade or business in the U.S. during the year. If you are a nonresident alien, there are standard IRS deduction and exemption tables to help you figure out when you should be paying U.S. taxes and which deductions you may be able to claim. If there is a tax treaty between your country and the United States, that can also affect withholding tax.

Calculating Your Withholding Tax

The IRS updates marginal tax rates annually. The rates for tax years 2024 and 2025 are highlighted in the table below:

Marginal Tax Rates for 2024

Tax Rate	Income Range Single, Married Filing Separately	Income Range Married Filing Jointly
10%	$11,600 or less	$23,200 or less
12%	$11,601 to $47,150	$23,201 to $94,300
22%	$47,151 to $100,525	$94,301 to $201,050
24%	$100,526 to $191,950	$201,051 to $383,900
32%	$191,951 to $243,725	$383,901 to $487,450
35%	$243,726 to $609,350	$487,451 to $731,200
37%	More than $609,350	More than $731,200

Source: Internal Revenue Service

Marginal Tax Rates for 2025

Tax Rate	Income Range Single, Married Filing Separately	Income Range Married Filing Jointly
10%	$11,925 or less	$23,850 or less
12%	$11,926 to $48,475	$23,851 to $96,950

Marginal Tax Rates for 2025

22%	$48,476 to $103,350	$96,951 to $206,700
24%	$103,351 to $197,300	$206,701 to $394,600
32%	$197,301 to $250,525	$394,601 to $501,050
35%	$250,526 to $626,350	$501,050 to $751,600
37%	More than $626,350	More than $751,600

Source: Internal Revenue Service

You can calculate your withholding tax by using the IRS Withholding Estimator. [Tax Withholding Estimator | Internal Revenue Service] In order to get an accurate figure, you'll need some basic information. Be sure to have the following handy when you're filling out the online form:

- Your filing status
- Your income sources
- Any additional income sources
- The end date of your most recent pay period
- Your wages per period and the year-to-date (YTD) totals
- The amount of federal income tax per pay period and the total paid year-to-date
- Whether you take the standard deduction or itemize your deductions
- The amount of any tax credits you take

The estimator tells you how much of a refund or tax bill you can expect. You can also choose an estimated withholding amount that's suitable for you.

How Much Tax Should You Have Withheld?

The amount of income tax you contribute from each paycheck depends on several factors, including total annual earnings and your filing status.

Who Qualifies for Exemption from Withholding?

Employees with no tax liability for the previous year and who expect no tax liability for the current year can use Form W-4 to instruct their employer not to deduct any federal income tax from their wage. <u>This exemption is valid for a calendar year.</u>

The Bottom Line

Payroll taxes are withheld from employee paychecks and paid by employers to fund government programs like Social Security and Medicare. This process is known as payroll tax withholding.

Why Payroll Taxes Are Withheld:

- Funding Government Programs: Payroll taxes are a crucial source of revenue for vital government programs. These include:
  - Social Security: Provides retirement, disability, and survivor benefits.
  - Medicare: Provides hospital insurance benefits.
  - Federal Unemployment Tax Act (FUTA): Helps states fund unemployment compensation programs.
  - State Unemployment Taxes: Provide income for workers who lose their jobs.

How Payroll Taxes Are Withheld:

1. Form W-4: When an employee starts a new job, they complete Form W-4, Employee's Withholding Certificate. This form provides information about their filing status, dependents, and other factors that impact their tax withholding.
2. Calculation:
   - Federal Income Tax: Employers use the information on the W-4 and IRS tax withholding tables to calculate the federal income tax to be withheld.
   - FICA Taxes (Social Security and Medicare): These are calculated based on a percentage of the employee's wages:
     - Social Security: 6.2% of wages (up to an annual wage base limit).

        - Medicare: 1.45% of all wages. An additional 0.9% applies to income above a certain threshold for employees.
    3. State and Local Income Taxes: If applicable, employers withhold state and local income taxes based on specific rates and guidelines for their location.
3. Withholding: The calculated taxes are deducted from the employee's paycheck.
4. Reporting: Employers report withheld taxes to the IRS, Social Security Administration, and state and local agencies.
5. Remitting: Employers deposit the withheld taxes with the appropriate agencies. This is typically done electronically through systems like the Electronic Federal Tax Payment System (EFTPS).