



## SOCIAL SECURITY TAXABLE WAGE LIMIT INCREASED FOR YEAR 2007

On October 18, 2006, the Social Security Administration announced an upward cost-of-living adjustment for the Social Security taxable wage limit. For year 2007, the amount of earnings taxable for Social Security (Old Age, Survivors and Disability Insurance, or "OASDI") will increase from \$94,200 to \$97,500. However, the tax rate will remain unchanged from year 2006 to 2007, at 6.2%. With this increase in taxable wages, the maximum Social Security tax payable by an employee will be \$6,045.00, an increase of \$204.60 from the current maximum tax of \$5,840.40. Employers will continue to match the employee's contribution.

Regarding Medicare tax, in 1993 the Omnibus Budget Reconciliation Act removed the taxable wage limit for the Medicare tax, for 1994 and years thereafter. Thus, for year 2007 again there will be no maximum employee contribution amount for Medicare tax. All covered wages will be subject to Medicare tax at the same 1.45% rate as in 2006. Employers will continue to match employee Medicare contributions, using the same tax rate and taxable wage amounts as the employees.

The combined rate of 7.65% (6.20% for Social Security and 1.45% for Medicare) thus continues for the year 2007, without change. This tax rate was last changed in 1990, when it went from 7.51% to 7.65%.

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## QUALIFIED PENSION PLAN CONTRIBUTION LIMITS FOR YEAR 2007

On May 26, 2001, Congress approved legislation which increased the amounts which may be contributed to 401(k) and other employer-sponsored tax-deferred retirement plans. On June 7, 2001, President Bush signed the bill into law.

The new law made extensive changes to the deferral limits for employer-sponsored tax-deferred retirement plans, superseding many cost-of-living adjustments already provided by the Internal Revenue Code. Noted below are the contribution limits of particular importance for year 2007:

	<u>2007</u>	<u>2006</u>	<u>2005</u>
--401(k)	\$15,500	\$15,000	\$14,000
--401(k) new "catch-up" substitute limit	\$20,500	\$20,000	\$18,000
--403(b) (annuity)	\$15,500	\$15,000	\$14,000
--403(b) new "catch-up" substitute limit	\$20,500	\$20,000	\$18,000
--403(b) old "catch-up" substitute limit	\$23,500	\$23,000	\$21,000
--408(k) (SEP)	\$15,500	\$15,000	\$14,000
--408(k) (SEP) new "catch-up" substitute limit	\$20,500	\$20,000	\$18,000
--408(p) (SIMPLE)	\$10,500	\$10,000	\$10,000
--408(p) new "catch-up" substitute limit	\$13,000	\$12,500	\$12,000
--457	\$15,500	\$15,000	\$14,000
--457 new "catch-up" substitute limit	\$20,500	\$20,000	\$18,000
--457 old "catch-up" substitute limit	\$31,000	\$30,000	\$28,000
--501(c)	\$15,500	\$15,000	\$14,000

Note that the statutory provisions for Section 401(k), Section 403(b), Section 408(k), and Section 457 plans, allow a "new" substitute limit of \$20,500 for "catch-up" contributions by certain individuals. An employee is eligible to make these "catch-up" contributions if the employee is otherwise eligible to make elective deferrals under the plan, and is age 50 or older. A participant who is projected to attain age 50 before the end of a calendar year is deemed to be age 50 as of January 1 of that year. However, this is an optional provision that first must be elected by the pension plan sponsor (employer).

For Section 403(b) annuity plans, there was already a special "catch-up" election for employees who have completed at least 15 years of service with a "qualified organization." Such employees were allowed to contribute an additional \$3,000 annually. Therefore, employees age 50 or older, who have completed at least 15 years of service, may contribute up to \$23,500 in 2007.

In the case of a Section 457 plan, the new "catch-up" rule does not apply during the participant's last three years before retirement, if the plan has a previous "catch-up" provision. In the final three years of employment, under the previous "catch-up" provision, the regularly applicable limit is doubled. Therefore, for such employees in their final three years, the "catch-up" limit increases to \$31,000 (\$15,500 x 2) for 2007.

For 2007, employers are required to report participants' elective pension deferrals on Form W-2 in Box 12 using codes D through H, and S. The I.R.S. indicated in Announcement 2001-93 that for employees' qualified "catch-up" contributions after 2001, employers must report the elective deferral "catch-up" contributions in the totals reported for Codes D through H, and S.

Generally, at the time of contribution, employee deferrals under the limits stated above are exempt from Federal income tax withholding, but Social Security and Medicare taxes normally apply. The contribution amounts also are includable in wages for FUTA tax purposes. However, employer-made contributions to a qualified plan, whether matching or not, are exempt from employment taxes.

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## WAGES PAID TO FAMILY MEMBERS MAY BE EXEMPT FROM FICA AND FUTA TAXES

When an employee is the son or daughter, spouse or parent of the employer, there are situations when special employment tax rules will apply.

Federal income tax withholding, however, is the same for relatives of the employer as it is for other employees. If the relative is an employee under the common-law test, then the usual federal income tax withholding applies to the wages paid.

The requirements for social security and Medicare taxes, however, depend on the age and type of work performed by the particular family member:

a.) SPOUSE - The usual social security and Medicare tax withholding applies to the wages paid to the spouse of the employer, unless the spouse's services are *not* performed in the course of the employer's trade or business, or are for domestic service in the employer's home. In either of these situations, the wages paid would be exempt. Note, however, that this exemption

does not apply to wages paid to the spouse by a corporation, partnership or an estate.

b.) SON or DAUGHTER - If the child is under age 18, wages paid by the parent are exempt from social security and Medicare tax withholding. However, if the child is 18 years or older but under age 21, wages paid by the parent are exempt only if the services are not in the course of the employer's trade or business. For these purposes, "child" includes adopted children, as well as foster children and stepchildren. As with the spouse, the exemption does not apply if the services are performed for a corporation (even if it is controlled by the child's parent), partnership (unless each partner is a parent of the child), or an estate.

c.) PARENT - Where the employer is the son or daughter, any wages paid to the parent are subject to social security or Medicare taxes, unless the services being compensated are not in the course of the son or daughter's trade or business, or are domestic service performed in the employer's home.

However, domestic service in the employer's home might NOT be EXEMPT in the following circumstances: A parent caring for a child living with the son or daughter (employer), if the child is less than age 18 or has a mental or physical condition requiring adult supervision for at least four continuous weeks in a calendar quarter. In these situations, there is no exemption if the son or daughter (employer) is widowed or divorced (and not re-married), or has a disabled spouse who is unable to care for the child due to physical or mental inability.

For federal unemployment tax (FUTA), if the employee is the spouse or parent of the employer, wages paid are exempt from FUTA. Likewise, if the employee is a son or daughter of the employer, and is under age 21, the wages paid are exempt from FUTA. However, if the employer is a corporation, a partnership (unless each partner is a parent of the child), or an estate, the FUTA exemption does not apply. As with the FICA exemption, "child" for the FUTA exemption includes a foster child, a stepchild or an adopted child, under age 21. It also includes employees who are foster parents or stepparents working for their children.

Finally, it is interesting to note that family businesses where the only regular employees are members of the owner's immediate family, are excluded from coverage by the Fair Labor Standards Act (FLSA). "Immediate" family means a parent, spouse or child. For the exemption from FLSA to apply, non-family workers may be employed only in occasional instances. If exempt from FLSA, then the federal minimum wage rate, overtime pay and other workplace standards imposed by the FLSA do not apply.

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### LIMITED LIABILITY COMPANY (LLC)

Beginning with Wyoming in 1977, every state and the District of Columbia now have adopted laws authorizing the creation of LLCs in varied forms. Generally, the LLC is seen as a hybrid between a corporation and a general partnership. It is taxed and governed similarly to a partnership, but offers limited liability for the owners ("members") similar to that offered by a corporation. The LLC often is preferred over the "S" corporation because the latter is subject to many more operational restrictions.

Since the LLC is not quite a corporation, but involves more than a partnership, a question arises as to the proper treatment of payments to LLC members for services to, or on behalf of, the LLC. For separate entities, such as corporations, a shareholder performing services for the corporation, generally is considered an employee for payroll tax purposes. However, partners in a partnership would not be treated as employees.

While the Internal Revenue Code does not specifically recognize LLCs, IRS Regulations do recognize them as "eligible entities." As an "eligible entity," an LLC may make the election to be treated as a corporation, even though unincorporated and not

subject to the usual standards designating when an unincorporated entity may be treated as a corporation. An "eligible entity," including an LLC, which has two or more members and was formed after 1996, is classified as a partnership for Federal tax purposes UNLESS it elects to be treated as an association taxable as a corporation. (The election is made by filing Form 8832, *Entity Classification Election*.) Absent the election, the members of such an LLC "partnership" are not employees, and generally are subject to Self-Employment Tax on their earnings from the "partnership."

If an LLC is treated as a corporation, members of the LLC will be treated as if they were shareholder/employees of the corporation for payroll tax purposes. The member is subject to withholding on payments for services to the LLC and would receive a Form W-2 for such payments. Distributions of the remaining LLC earnings and profits to members are treated as dividends.

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### CITY OF PHILADELPHIA TO REDUCE LOCAL TAX RATE

Effective January 1, 2007, the City of Philadelphia will reduce the local income tax withholding rate for employees who reside or work in the City. For Philadelphia residents, regardless of where they work in Pennsylvania, the withholding rate is to be reduced from 4.3010% to 4.2600%. For employees who are not residents, but who work in Philadelphia, the withholding rate will be reduced from 3.7716% to 3.7557%.

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### FLORIDA, PENNSYLVANIA AND WASHINGTON WILL INCREASE MINIMUM WAGE RATES

Beginning 1/1/2007, the **Florida** minimum wage rate will be increased from \$6.40 to \$6.67 per hour. For tipped employees, the minimum cash wage will be increased from \$3.13 to \$3.65 per hour, but the maximum tip credit amount will remain unchanged at \$3.02 per hour.

**Pennsylvania** has a two-tier minimum wage, and there will be changes to the rates on both tiers. The difference between the tiers is that the rates on one tier apply only to employers with 10 or less employees. The rates on the other tier apply to all other employers. For the tier used by employers of 10 or less full-time employees, there will be the following changes:

- effective 1/1/2007 the minimum wage rate will increase from \$5.15 to \$5.65 per hour.
- effective 7/1/2007 the minimum wage rate will increase from \$5.65 to \$6.65 per hour.
- effective 7/1/2008 the minimum wage rate will increase from \$6.65 to \$7.15 per hour.

On the tier applicable to employers of more than 10 full-time employees, there will be the following changes:

- effective 1/1/2007 the minimum wage rate will increase from \$5.15 to \$6.25 per hour.
- effective 7/1/2007 the minimum wage rate will increase from \$6.25 to \$7.15 per hour.

For both minimum wage rate tiers, the maximum tip credit rate will remain unchanged at 40%, and the training/youth minimum wage rate will remain unchanged at 85% of the regular minimum wage rate. The Training/Youth rate applies to workers under age 16.

Beginning 1/1/2007 **Washington State** will increase the minimum wage rate from \$7.63 to \$7.93 per hour. Tipped employees must be paid a direct (cash) wage of at least \$7.93 per hour because Washington does not recognize tip credit.

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