

INCOME TAX WITHHOLDING

INTRODUCTION

Employers must withhold federal and Minnesota income tax and the employee's share of the FICA tax from their employees and pay those taxes to the federal and state government. The amount of withholding is based on the wages or salary paid to the employee, and the number of withholding allowances claimed by the employee on Form W-4, Withholding Allowance Certificate, which the employee completes at the time of hiring. (Withholding Allowance Certificates are discussed later in this section.) Employers are required to withhold both federal and state income taxes and FICA tax from their employees' wages as soon as they are paid. Note that special rules may apply to the withholding of taxes on "supplemental" wages (e.g., on a bonus paid to an employee).

The Internal Revenue Service and the Minnesota Department of Revenue provide withholding tables to enable the employer to determine the appropriate withholding amount. These tables are available on the Internet from these agencies. These agencies also send periodic newsletters and/or notices to employers about changes in the law or procedures. Employers must comply with these changes.

TAX IDENTIFICATION NUMBER

All business entities that have employees must obtain a federal employer identification number. If the employer employs anyone who works in Minnesota, or any Minnesota resident, that employer must also obtain a Minnesota tax identification number. Employers should apply for their tax identification numbers before they expect to hire their first employee, to allow for adequate processing time. A penalty may be assessed for failure to apply on time.

A federal identification number is obtained by filing Form SS-4 with the Internal Revenue Service. To register for a Minnesota tax ID number and withhold Minnesota income tax, go to the Minnesota Department of Revenue website at www.revenue.state.mn.us and click on "register for a Minnesota tax ID number" on the e-Services menu. If you do not have Internet access, call Registration Services office at (651) 296-6181. Further information on the procedure for obtaining these numbers is provided in the section of the Small Business Assistance Office publication, *A Guide To Starting A Business In Minnesota* on Business Taxes or may be obtained from the Internal Revenue Service or Minnesota Department of Revenue at the address and telephone numbers provided in the Resource Directory section of the *Guide*.

Following receipt and processing of the applications for tax identification numbers, the Internal Revenue Service and the Minnesota Department of Revenue provides the employer with respective identification numbers. Employers must file Minnesota withholding tax returns electronically over the Internet, or by touchtone telephone. If the employer is not required to pay electronically and chooses to pay by check, contact the Minnesota Department of Revenue so they can mail customized payment vouchers (MW-5 forms). The employer will automatically be enrolled in the Electronic Federal Tax Payment System—EFTPS—so it can make all deposits online or by phone. Within a few days it will receive by mail EFTPS enrollment confirmation, as well as a Personal Identification Number (PIN) and complete instructions for using EFTPS. It will need to wait until it receives its EFTPS information in the mail before it can make a payment electronically. Once it receive the EFTPS Confirmation Package, it can begin making EFTPS payments.

WITHHOLDING ALLOWANCE CERTIFICATES

Federal Form W-4, Employee's Withholding Allowance Certificate, is completed by the employee at the time of hiring, and is used by the employer to determine how much tax to withhold from the employee's paycheck for both federal and state withholding if the employee is claiming the same number of Minnesota allowances as federal and the number claimed is 10 or less. Form W-4 may be obtained by contacting the Internal Revenue Service at the address and telephone number provided in the Resource Directory section of the *Guide*. Form W-4 can also be downloaded from the IRS website, www.irs.gov.

The Minnesota Department of Revenue has a new Form, W-4MN. An employee must complete form W-4MN and provide it to the employer if the employee: chooses to claim fewer Minnesota withholding allowances than for federal purposes (Minnesota allowances cannot exceed the number of federal allowances), requests additional Minnesota withholding be deducted each pay period, claims more than 10 Minnesota withholding allowances, or claims to be exempt from Minnesota income tax withholding and reasonably expects wages to exceed \$200 per week. If the employer believes the employee is not entitled to the number of allowances claimed, the employer is required to provide copies of the completed Form W-4MN to the Department of Revenue. There is an exception if the employee is a resident of a reciprocity state and has completed Form MWR. Employers must complete boxes 8 and 10 on any copies of form W-4 sent to the IRS.

Previous to 2007, employers had to routinely send the IRS any Form W-4 claiming complete exemption from withholding if \$200 or more in weekly wages was expected or claiming more than 10 allowances. Employers no longer have to routinely submit these W-4 Forms to the IRS. However, Forms W-4 are still subject to review. Employers may be directed (in written notice or in future published guidance) to send certain W-4 Forms to the IRS.

The employer should honor the employee's W-4 or W-4MN unless notified by the Internal Revenue Service or the Minnesota Department of Revenue that the form is not valid. Penalties apply to employees knowingly filing incorrect W-4 or W-4MN forms and employers who fail to provide federal or state tax authorities with W-4s when required.

FURNISHING WAGE AND TAX STATEMENT TO EMPLOYEES

The employer must issue a wage and tax statement (federal Form W-2) to each employee on or before January 31 of the following year, or within 30 days of a written request from the employee if his or her employment was terminated.

Employers may furnish Form W-2 to employees electronically provided certain criteria are met. Employers must affirmatively consent to receive the Form W-2 in an electronic format and prior to, or at the time of the consent, the employer must provide a disclosure statement containing certain disclosures. Additionally, the electronic version of Form W-2 must contain all required information and comply with applicable revenue procedures relating to substitute statements to recipients. If the statement is furnished on a website, the employer must notify the employee, via mail, electronic mail, or in person, that the statement is posted on a website and provide instructions on accessing and printing the statement.

The federal copy of Form W-2, together with Form W-3, Transmittal of Income and Tax Statements, must be filed annually with the Social Security Administration by February 28. No other forms should be sent with the W-2s. The state copy of Form W-2 must be filed with the Minnesota Department of Revenue by February 28. Information Returns (1099s) that show Minnesota tax withheld should be sent with the W-2 Forms.

Forms W-2 and W-3 may be obtained from the Internal Revenue Service at the address and telephone number provided in the Resource Directory section of the *Guide*.

DEFINITION OF EMPLOYER AND EMPLOYEE

Generally, an employer is a person or organization for whom a worker performs a service as an employee. The employer usually provides the tools and place to work and has the right to hire and discharge an employee. A person may be an employer for purposes of one kind of tax but not for another.

Generally, employees can be defined either under common law or under special statutes for special purposes. Generally speaking, a common law employee is anyone who performs services that can be controlled by an employer (what will be done and how it will be done). This is true even when the employer gives the employee freedom of action. What matters is that the employer has the legal right to control the method and result of the services.

Further information on determining whether an individual is an employee is provided in the sections of the *Guide* titled "Issues for Employers" and "Checklist for Hiring an Employee" or refer to Federal Publication 15A, *Employer's Supplemental Tax Guide*.

ISSUES FOR NONRESIDENT EMPLOYERS AND EMPLOYEES

North Dakota and Michigan Residents Working in Minnesota

Minnesota has tax reciprocity agreements with these states. Under these agreements, residents of North Dakota or Michigan who work in Minnesota are not required to have Minnesota income tax withheld from their Minnesota compensation if they complete Form MW-R, Reciprocity Exemption/Affidavit of Residency. Instead, they pay state tax to the state in which they live.

A North Dakota or Michigan resident who works in Minnesota and does not want Minnesota income tax withheld from his or her wages must complete and give to the employer Form MW-R, Reciprocity Exemption/Affidavit of Residency. The employer must retain one copy for his or her records and forward one copy to the Minnesota Department of Revenue. Form MW-R should be filled out by the employee each year by February 28 or within 30 days after they begin working or they change their residence.

The employer must send a copy of Form MW-R to the Minnesota Department of Revenue no later than March 31, or within thirty days after a new employee, or an employee who changes his or her residence, files the form with the employer.

Employees of Interstate Carrier Companies

Interstate carrier companies that have employees such as truck drivers, bus drivers or railroad workers who travel across state borders in their work must withhold state income tax for the employee's state of residence.

Interstate air carrier companies must withhold tax in any state in which an employee has his or her residence and in any state in which the employee earns more than fifty percent of his or her compensation.

Tax on Nonresident Entertainment Entities

Nonresident entertainers such as musicians, actors, dancers, athletes and public speakers may be subject to a two percent tax on the gross compensation they receive for entertainment performed in Minnesota. The tax is imposed on the entertainment entity. The person who has legal control of the payment of the compensation is responsible for withholding and depositing the tax. This tax does not apply to residents of North Dakota or Michigan due to reciprocity agreements.

More information on the nonresident entertainer tax may be obtained from the Minnesota Department of Revenue.

Minnesota Residents Employed Outside Minnesota

In Other States. An employer of a Minnesota resident who does not work in Minnesota but works in another state and who withholds federal income tax from the wages of that employee may also be required to withhold Minnesota income tax. The employer may be required to withhold taxes in the state in which the work is being performed and Minnesota if the company in the other state has Minnesota nexus. The term nexus is used in tax law to describe a situation in which a business has a presence in a state and is subject to the state's jurisdiction to tax. In general, a business has nexus if it derives income from sources within the the state, owns or leases property in the state, employs personnel in the state in activities that exceed "mere solicitation", or has capital or property in the state. Reciprocity agreements apply for the states of North Dakota and Michigan. An employer who is required to withhold both Minnesota income tax and income tax for another state should first determine the amount of income tax to be withheld for each state. If the amount of Minnesota income tax is greater than the amount to be withheld from the state in which the employee is working, the employer should send the difference to the Minnesota Department of Revenue and the remainder to the state in which the employee is working.

Outside the United States. A Minnesota resident who is transferred to a location outside the United States remains a Minnesota resident unless:

- (1) the employee is a "qualified individual" for the foreign earned income exclusion of Section 911(d)(1) of the Internal Revenue Code, and
- (2) the employee does not have an interest in any homesteaded property in Minnesota. If the employee does not meet these criteria, the employer must continue to withhold Minnesota income tax from the employee's wages.

If you are required to withhold Minnesota State tax, follow the same rules as tax withheld from employees working in Minnesota. (See the section titled “Withholding Tax Deposit and Filing Requirements” below.)

If the employee changes his or her domicile and requests that you stop withholding Minnesota income tax, send the Department of Revenue a copy of the employee’s W-4 and a letter explaining in detail why the employee thinks his or her domicile has changed.

WITHHOLDING TAX DEPOSIT AND FILING REQUIREMENTS

Overview

Both the Internal Revenue Service and the Minnesota Department of Revenue require employers to deposit withheld tax on a periodic basis, and to file periodic returns. Deposit and filing requirements are discussed below. Employers should note that for purposes of determining the frequency of payment, federal and state withholdings are totaled separately.

Deposit Requirements

Annual Requirement (Federal only). Agricultural employers who accumulate less than \$2,500 federal tax liability during the year may pay the tax and file the return annually.

Annual Requirement (Minnesota only). Minnesota employers with less than \$500 in Minnesota tax in a year may be notified by the Department of Revenue that they qualify for annual filing. If an employer is notified, and the Minnesota withholding tax exceeds \$500, the employer is required to make a deposit at the end of the month following the month in which withholding tax exceeded \$500. To make a deposit, the employer should use the Minnesota Department of Revenue’s Internet e-FILE system (www.revenue.state.mn.us) touchtone telephone (800) 570-3329, or an MW-5 Minnesota payment voucher.

Quarterly Requirement. Employers with federal deposit liability of less than \$2,500 in the current quarter or state withholdings of \$1,500 or less in the prior quarter must pay the entire amount to the Internal Revenue Service or Minnesota Department of Revenue quarterly. The payment is due the last day of the month following the end of the quarter.

General Rule for Making Deposits (Minnesota). If an employer withholds more than \$1500 in Minnesota tax during the previous quarter, the employer is required to make Minnesota deposits in the next quarter as often as it is required to make federal deposits, either monthly or semiweekly.

Monthly Requirement. New employers and employers whose total federal tax liability for the four quarters in the lookback period is \$50,000 or less are required to deposit employment taxes each month by the fifteenth day of the following month. The lookback period is the four quarters beginning July 1 of the second preceding year and ending June 30 of the prior year. Employers should consult IRS Publication 15, *Circular E*, and the Minnesota Department of Revenue Income Tax Withholding Instructions Booklet and Tax Tables for specific rules and exceptions.

Semi-weekly Requirement. Employers whose total tax liability for the lookback period is more than \$50,000 are required to deposit employment taxes on Wednesday and/or Friday, according to their payroll day. Employers should consult IRS Publication 15, *Circular E, Employer's Tax Guide*, for specific rules.

One-Day Requirement (Federal only). Employers who accumulate taxes of \$100,000 or more on any day during a deposit period are required to make the deposit by the close of the next banking day, whether they are a monthly or semi-weekly depositor.

Electronic Federal Tax Payment System (EFTPS). The EFTPS is the system sponsored by the U.S. Department of Treasury that allows taxpayers to initiate Federal tax payments electronically instead of using paper coupons. Taxpayers with aggregate Federal tax deposits exceeding \$200,000 are subject to the requirement to deposit by electronic funds transfer beginning in the second succeeding calendar year of reaching that threshold. Once that threshold has been met, and payment by electronic funds transfer has begun, the taxpayer is required to continue using EFTPS even if deposits in future years drop below the \$200,000 threshold amount.

Editor's Note. At the time the *Guide* went to press, the IRS had issued proposed regulations (REG 153340-09) which would eliminate the rules for making federal tax deposits by paper coupon because the paper coupon are no longer being maintained by the Treasury Department. Final regulations will be issued after the comment period. Usually the final regulations are very similar to the proposed regulations. Information on EFTPS can be found at www.eftps.gov or by calling the U.S. Department of Treasury customer service (800) 555-4477.

For more information or to enroll in EFTPS visit www.eftps.gov or call the EFTPS Customer Service Center toll-free at (800) 555-4477 or (800) 945-8400.

Electronic State Deposits. State tax deposits must be made electronically if state tax withholdings total more than \$10,000 in Minnesota income tax during the last two quarters of 2010 and first two quarters of 2011. Employers are also required to deposit electronically if they are required to pay any other Minnesota business tax to the Minnesota Department of Revenue electronically. For more information consult the Minnesota Income Tax Withholding Instructions Booklet and Tax Tables.

Filing Requirements

Quarterly Withholding Tax Return. Each quarter, all employers (except annual filers) must file federal Form 941, Employer's Quarterly Federal Tax Return with the Internal Revenue Service. In addition, all employers (except Minnesota annual filers) must file a Minnesota Quarterly Tax Withholding Return for the first three quarters, and a Year-End Withholding Return Reconciliation for the fourth quarter. These returns must be filed electronically via e-File Minnesota (at www.revenue.state.mn.us) or by touch tone phone (800) 570-3329.

W-2 filing. Federal Form W-3, Transmittal of Income and Tax Statements, must be filed annually with the federal copies of each employee's Form W-2 to the Social Security Administration. The state copies of each employee's Form W-2 and 1099s that show Minnesota withholding must be files with the Minnesota Department of Revenue. For requirements regarding the filing of Forms W-2 and 1099 see Withholding Tax Fact Sheets #2 and #2a on the Minnesota Department of Revenue website. The federal Form W-3 and the state copies of the W-2 must be filed no later than February 28 in the year following the taxable year, or within 30 days of going out of business.

Annual Filing. If you have been notified by the Minnesota Department of Revenue that you are an annual filer, you should not file quarterly returns. You should file an Annual Withholding Return/Reconciliation, by February 28 of the year following the end of the taxable year. The Annual Withholding Return must be filed via the Internet (e-File Minnesota) or touchtone phone.

Forms

Deposits through EFTPS require no coupon. Deposits of Minnesota taxes are made via the Internet (e-File Minnesota) by touchtone phone, or by mail using form MW-5. Quarterly returns are filed using federal Form 941, Employer's Quarterly Federal Tax Return. State returns must be filed via the Internet (e-File Minnesota) or touchtone telephone. Note that both federal and state returns must be filed, even if all amounts due have already been paid via deposits. If there is zero tax due, you must file a zero withholding tax return.

Due Dates

All federal quarterly 941 returns are due April 30, July 31, October 31 and January 31. The first three Minnesota quarterly returns are due April 30, July 31, and October 31. The Year-End withholding return reconciliation return, along with the return for annual filers are due February 28. Federal returns and deposits and state deposits and returns will be considered on time if received or postmarked on or before the due date. The postmark must be a United States postmark and must not be from a postage meter. If deposits are made electronically, refer to the specific instructions for the type of deposit.

WITHHOLDING TAX PENALTIES AND INTEREST

Both the Internal Revenue Service and the Minnesota Department of Revenue assess penalties and interest for the failure to make deposits on time, the failure to file required returns on time, and the failure to file W-2 and 1099 forms. The amount of penalty for late deposits or late filing is

based on the length of time the payment or return is late. The Internal Revenue Service imposes a penalty on failure to provide correct information on W-2 forms, and failure to provide a correct Taxpayer Identification Number.

Any person responsible for paying withholding tax may be held personally liable for failure to do so. A penalty equal to 100 percent of the amount withheld from employee's paycheck, also may be imposed. The IRS calls this the Trust Fund Recovery penalty.

Interest is assessed on unpaid withholding tax (plus penalties). Interest accrues from the date the payment should have been made to the date the payment actually is made. The interest rate is adjusted to reflect market rates.

CONTRACTOR AND SUBCONTRACTOR CLEARANCE

A prime contractor, contractor or subcontractor who performs work on a project for the State of Minnesota or any of Minnesota's political or governmental subdivisions (e.g., counties, cities, school districts) must file a Withholding Affidavit for Contractors, Form IC134, with the

Department of Revenue certifying that the contractor has complied with Minnesota's withholding tax laws in order to receive final payment for the work.

A **contractor** is a person who is awarded a contract to perform work and who performed the work personally or through his or her employees. A **prime contractor** is a contractor who is awarded a contract to perform work but who subcontracts all or part of the work to other contractors. A **subcontractor** is hired by a prime contractor to perform all or part of the work on a contract. A **subcontractor** files Form IC134 when the subcontractor completes its part of the project. A **prime contractor** or **contractor** files Form IC134 when the entire project is completed.

Go to the Minnesota Department of Revenue's website and click submit contractor affidavit on the e-services menu to submit a withholding contractor affidavit for approval.

MINNESOTA INCOME TAX WITHHOLDING ON PAYMENTS TO INDEPENDENT CONTRACTORS IN THE CONSTRUCTION TRADES

A construction contractor (payer) who makes payments to an individual construction contractor (payee) carrying on a trade or business as a sole proprietorship must deduct and withhold 2 percent (.02) of the payment(s) to that individual construction contractor as Minnesota income tax withholding. Payments are subject to 2 percent withholding only if the work was performed in Minnesota and the total payments during the calendar year exceed \$600. All of the payments (including the first \$600) are subject to income tax withholding. A single member Limited Liability Company (LLC) is not a sole proprietor for the purpose of the law. A Minnesota tax ID number is required to withhold Minnesota tax.

Contact the Minnesota Department of Revenue or view their website for additional information and Withholding Tax Fact Sheet, #18.