



“What do I get each month?”

“What do I pay each month?”

In Example 1, the taxpayer is self-employed and must pay both parts of the Social Security and Medicare taxes (for both employee and employer). For people who are not self-employed, the two taxes are shared equally by employee and employer.

EXAMPLE 2 Calculating a Total Compensation Package

You own a business in Massachusetts, which has a flat income tax of 5.3%. You hire a new employee for \$60,000 a year. In addition to this salary, you pay a 5% matching contribution to a 401(k) retirement plan, \$940 a month for the employee’s health insurance, 1.25% for workers’ compensation insurance, and \$1000 each year for a holiday bonus.

- a. What is the *total compensation package* you are paying for this employee?
- b. How much does the employee receive each year as “take-home pay”?

SOLUTION

a. Total compensation package:

\$60,000.00	Salary	
\$ 1,000.00	* Holiday bonus	
\$ 3,050.00	* 401(k) matching	5% of \$61,000
\$11,280.00	* Health insurance	12 months at \$940
\$ 3,782.00	** Social Security matching	6.2% of \$61,000
\$ 884.50	** Medicare matching	1.45% of \$61,000
\$ 762.50	** Workers’ compensation	1.25% of \$61,000
\$80,759.00		

*Optional employee benefits

**Mandated employee benefits

The total compensation package for this employee is \$80,759 per year.

- b. **Take-home pay:** Assume the employee is single, does not have any other taxable income, and claims the standard deduction. The employee must pay income tax on the \$1000 holiday bonus but (currently) not on the 401(k) match or the health insurance.

401(k) employee portion:	\$ 3,050.00	5% of \$61,000
Social Security:	\$ 3,782.00	6.2% of \$61,000
Medicare:	\$ 884.50	1.45% of \$61,000
Federal income tax:	\$ 8,331.25	Taxable income of \$48,600
State income tax:	\$ 2,838.15	5.3% of \$53,550
Total:	\$18,885.90	

The employee’s take-home pay is $61,000 - 18,885.90 = \$42,114.10$, which is slightly more than half of the total compensation package.

Study Tip

As you can see, payroll deductions are complex and require a clear understanding of tax codes. Many small businesses hire a payroll company to prepare the paychecks and keep track of tax codes and deductions. In the calculations at the right, it was assumed that the employee had to pay Social Security and Medicare taxes on the 401(k) contributions but did not have to pay income tax on the 401(k) contributions, standard deductions, and exemptions.

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Refer to Example 2. Assume the holiday bonus is paid in 12 monthly installments.

- c. How much does the employer pay each month?
- d. How much does the employee receive each month as take-home pay?
- e. How can the difference in these two amounts affect a person’s perspective as an employee or as an employer?