

IRS Issues Final Supplemental FIT Withholding Regulations

The IRS has released final federal income tax (FIT) withholding regulations on supplemental wage payments in excess of \$1,000,000.

Background

Recall that, effective beginning in 2005, the American Jobs Creation Act (AJCA) of 2004 required employers to withhold federal income taxes at the highest withholding rate in the withholding tables on any supplemental pay in excess of \$1,000,000. Employers had questions and reservations about the new requirements, including concerns about the potential administrative burden. The IRS issued proposed regulations in January of 2005 that addressed many of these concerns. After taking and considering additional comments, the IRS has now responded to many previously unaddressed concerns and questions from employers and payroll industry associations.

Effective

The final regulations were released in the federal register (71 FR 42049-01) on July 25, 2006, and are effective January 1, 2007. The IRS had released proposed regulations on January 5, 2005 (REG-152945-04) and indicated that employers and withholding agents could rely on them until the final regulations were released. There was no indication that the final regulations could be applied prior to the effective date.

Expanded Withholding Tax Calculation Options

The final regulations give employers and withholding agents the following federal supplemental withholding tax calculation options:

Supplemental wage payments where no portion pushes employee over \$1,000,000 for the year

- Apply the aggregate procedure by adding the supplemental wage payment and the most recently paid regular wages in the same year and refer to the employee's Form W-4 to calculate the related federal income tax (FIT) on the total using the regular withholding tables and method, or;
- Apply an optional flat rate of 25 percent to calculate the FIT withholding as long as the employee has had income tax withheld from regular wages during the current or previous year and the supplemental wages are paid separately or identified separately in the employer's payroll records.

Supplemental wage payments where the entire payment exceeds \$1,000,000 for the year

- Apply a mandatory flat rate of 35 percent to calculate the FIT withholding on the entire payment.

Supplemental wage payments where a portion causes the employee to exceed \$1,000,000 for the year

- Apply a mandatory flat rate of 35 percent to calculate the FIT withholding on the entire payment, or;
- Apply a mandatory flat rate of 35 percent to the portion of the payment that causes the employee's year-to-date supplemental wages to exceed \$1,000,000 and, if the optional flat rate of 25 percent can be applied, apply the optional flat rate to the portion of the payment that does not cause the employee's supplemental earnings to exceed \$1,000,000, or;
- Apply a mandatory flat rate of 35 percent to the portion of the payment that causes the employee's supplemental wages for the year to exceed \$1,000,000 and apply the aggregate procedure to the other portion of the payment.

Supplemental earnings in a previous year are not counted towards the \$1,000,000 threshold. An employee's year-to-date regular wages are irrelevant in determining whether the \$1,000,000 supplemental wage threshold has been met.

Supplemental Earnings Defined

The IRS defined supplemental earnings as any earnings which are not regular earnings. The final regulations provide examples of how various forms of compensation should be classified:

Regular	Supplemental	Supplemental, at employer's discretion	Neither Regular Nor Supplemental
<ul style="list-style-type: none">• Wages paid at the regular hourly, daily, or similar periodic rate (not an	<ul style="list-style-type: none">• Commissions• Bonuses• Income recognized on the exercise of nonstatutory stock options• Wages paid as non-cash fringe	<ul style="list-style-type: none">• Tips• Overtime• Items reportable in Box 1 on Form W-2 that are not subject to FIT	<ul style="list-style-type: none">• Income from disqualifying dispositions of stock acquired pursuant to the

Regular	Supplemental	Supplemental, at employer's discretion	Neither Regular Nor Supplemental
overtime rate) <ul style="list-style-type: none"> • Pay attributable to a predetermined fixed amount, such as an employee's regular salary 	benefits <ul style="list-style-type: none"> • Payments of nonqualified deferred compensation to retirees • Nonqualified deferred compensation included in wages under rules of 409A • Back pay • Third-party sick pay paid by a person designated (or acting) as an agent of the employer • Reimbursements required to be included as wages (e.g. exceeds amount substantiated or not under an accountable plan) 	withholding	exercise of statutory stock options as described in Internal Revenue Code section 421(b) <ul style="list-style-type: none"> • Fringe benefits not subject to income tax withholding

The IRS eliminated the requirement that a payment could qualify as supplemental only if regular wages had been paid to the employee. Therefore, under the final regulations, commissions paid to an employee are considered to be supplemental wages even if they are the only type of pay the employee receives.

The final regulations allow employers to treat tips or overtime as supplemental earnings at their discretion. The employer's choice may vary among employees.

Supplemental Withholding Rates Tied to the Regular Withholding Tables

The so called "flat" supplemental withholding rates are linked to the regular withholding tax rates in effect. The optional supplemental flat rate, which applies to supplemental payments that are less than \$1,000,000, is linked to the third rate in the regular, graduated withholding tables. The third rate is currently 25 percent. The mandatory supplemental rate, which applies to supplemental wage payments that are greater than \$1,000,000, is the highest rate in the regular, graduated withholding tables. The highest rate is currently 35 percent.

Therefore, absent any change in federal legislation, the 25 percent rate will increase to 28 percent and the 35 percent rate will increase to 39.6%, effective January 1, 2011 when the tax cuts included in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) expire.

Consideration of Pretax Salary Reductions

The final regulations indicate that salary reductions must be allocated against the gross out of which they are actually deducted. Supplemental wages are taxable wages after consideration for (net of) salary reductions.

Form W-4 Is Not Applicable

When the optional or mandatory flat rates are applied, the employee's marital status and number of exemptions claimed are not used in the supplemental withholding tax calculation. Furthermore, any additional amount of withholding the employee has requested on Form W-4 is disregarded and the mandatory flat rate applies even if the employee has claimed that they are exempt from withholding.

Employee's Personal Income Tax Circumstances Disregarded

The final regulations indicate that the mandatory flat rate applies even if employees are legitimately eligible for a foreign tax credit or will have deductions when they file their tax returns which will work to lower their actual tax liability. The IRS asserted that it could not promulgate rules that would require employers to ascertain and assess an employee's personal tax situation in order to calculate the supplemental withholding tax.

Limited Payroll Agent Relief under New De Minimis Rule

Generally, payments made by a third party on behalf of the employer are considered made by the employer. However, in recognition of the potential administrative burden of having employers and unrelated agents continuously exchange year-to-date supplemental earnings information in order to make the correct withholding tax calculation, the IRS has indicated that unrelated payroll agents of the employer may assume that an employee is not subject to withholding at the mandatory 35 percent rate until the total payments made by the third party payer reaches \$100,000. The IRS refers to this as a de minimis exception.

After the \$100,000 threshold is reached, the employer and any agents must consider all of the supplemental earnings paid by any other agents (or other companies under common control) to the same employee when determining whether an employee has annual supplemental earnings in excess of \$1,000,000.

Caution: Under an anti-abuse rule, the de minimis exception is not permitted in any scheme where five or more companies make supplemental payments to individual employees of less than \$100,000 to thwart the intent of the mandatory 35 percent withholding requirement.

Multiple Companies under Common Control Treated As One

An employer with multiple companies under common control must consider supplemental earnings from all companies under its control.

IRS Payroll Guidance

Official information on taxing supplemental payments, which includes the supplemental withholding tax calculation requirements, is available in IRS Publication 15 Circular E. This document, which has not yet been revised to reflect the final regulations, is posted on the IRS' Forms and Publications Web page at: <http://www.irs.gov/formspubs/index.html>.

Click on *Forms and Publications by Number*. When the linked Web page opens, scroll down to *Pub. 15 Circular E, Employer's Tax Guide* in the list box. Follow the IRS' instructions on the web page to access the document.