ASAP™ A Littler Mendelson **Time Sensitive** Newsletter

in this issue:

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The IRS issues guidance on methods for calculating taxes on such supplemental wages as commission payments, vacation/sick pay cash outs, hiring bonuses and severance as follow up to its 2006 regulations. Some guidance, intuitive and others not so, warrants making sure payroll coding processes are reviewed to reflect these interpretations.

Employment Taxes

A Littler Mendelson Newsletter specifically for the Employment Taxes

IRS Provides Guidance on Proper Income Tax Withholding for Nine Common Supplemental Wage Payment Scenarios

By GJ Stillson MacDonnell and William Hays Weissman

In Revenue Ruling 2008-29, the IRS has provided specific guidance on the proper amount of federal income tax an employer must withhold in nine different situations under the supplemental wage regulations[1] that became effective January 1, 2007. Typically, states with income taxes default to following federal regulation principles for distinguishing between regular and supplemental wages. In addition to federal income tax withholdings, states also look for proper withholding on supplemental wages for state income tax purposes.

The Revenue Ruling addresses the following nine scenarios:

1. Commissions paid at fixed intervals with no regular wages paid to the employee;
2. Commissions paid at fixed intervals in addition to regular wages paid at different intervals;
3. Draws paid in connection with commissions;
4. Commissions paid to the employee only when the accumulated commission credit of the employee reaches a specific numerical threshold;
5. A signing bonus paid prior to the commencement of employment;
6. Severance pay paid after the termination of employment;
7. Lump sum payments of accumulated annual leave paid at termination of employment;
8. Annual cash-out payments of vacation and sick leave; and
9. Sick pay paid at a different rate than regular pay.

For each of the situations discussed, the IRS assumes that there is no constructive receipt or constructive payment of wages before the actual payment of wages, that no amounts are required to be included in income under section 409A before the actual payment of wages, and that all payments are made on or after January 1, 2007. In addition, except for Situation 5, none of the below is paid more than $1,000,000 of supplemental wages during any calendar year.

This most recent IRS guidance renders obsolete the guidance under Revenue Ruling 67-131, 1967-1 C.B. 291 and Revenue Ruling 66-294, 1966-2 C.B. 459.

Regular Wages

Whether an employer is paying "regular wages" or "supplemental wages" has an impact on the amount of income taxes that should be withheld. *Regular* wages means wages paid by an employer for a payroll period either at a regular hourly rate or in a predetermined fixed amount. The amount that is to be withheld in the case of regular wages is based on the tax table for the pay period (*e.g.*, bi-weekly) and the number of exemptions claimed on the employee's IRS Form W-4.

Supplemental Wages

Supplemental wages are all wages that are not regular wages. Stated differently, supplemental wages are wages that vary from payroll period to payroll period based on factors other than the amount of time worked. Examples of supplemental wages are overtime pay, bonuses, back pay, commissions, wages paid under reimbursement or other expense allowance arrangements, nonqualified deferred compensation, noncash fringe benefits, sick pay paid by a third party as an agent of the employer, amounts includible in gross income under IRC section 409A, income recognized on the exercise of a nonstatutory stock option and imputed income for health coverage for a nondependent.

If the amount of supplemental wages paid in any calendar year exceeds $1 million in the aggregate, withholding is at a mandatory 35% rate on the amount over $1 million, and optional for the payment that causes the total of all supplemental wages in the year to cross the $1 million threshold. If supplemental wages are less than $1 million, the employer may generally choose to use either:

- the optional (25%) flat rate; or
- the aggregate method.

The optional 25% flat rate method may not be used, however, unless income tax has been withheld from the employee's regular wages during the calendar year of the payment of the supplemental wages or the preceding calendar year, and the supplemental wages are separately stated from regular wages (in addition to being less than $1 million).

If all the requirements for the optional 25% flat rate method are not met, then the aggregate method must be used. To calculate the aggregate method, supplemental wages are added to regular wages for the most recent payroll period this year as if they were a single payment. The tax is then determined on the single payment based on the tax tables for the appropriate payroll period and using the employee's IRS Form W-4. The tax already withheld from the regular wages is then subtracted, and the remaining tax is subtracted from the supplemental wages. The IRS has advised that when there are no regular wages and supplemental wages must be paid using the aggregate method, the daily/miscellaneous table should be used when there are no other regular wages paid in the same year. This is common, for example, when back pay is paid to a former employee in settlement of litigation.

Situations 1 and 2: Sales Commissions with and without Regular Salary

In Situation 1, an employee receives only commissions on a monthly basis. Because there are no regular wages from which income taxes are withheld, the employer must use the aggregate method of withholding, and cannot use the 25% flat rate method.

In Situation 2, an employee receives a salary on the first of each month, from which income tax is withheld, and commissions based on sales on a weekly basis. Here, in contrast to Situation 1, because regular wages were paid from which income taxes were withheld, the employer can chose to use either the optional 25% flat rate withholding or the aggregate procedure.

Situation 3: Draws Against Commissions

In Situation 3, the employee works as a commissioned salesperson that receives a $5,000 draw on a semimonthly basis. The employee is paid his commissions with the second draw of each month. If the amount of commissions credited is less than the total amount of draws ($10,000) for the month, the draw is reduced by that amount in the next month. The employee is obligated to repay any draws received in excess of commissions earned if employment is terminated for any reason. The employee receives no other compensation.

Here, the draws represent payments of commissions that are supplemental wages and not salary because they are debited against commissions, and the employer reduces the amount of the draws if it exceeds commissions. Therefore, because the employer is only paying supplemental wages, it must use the aggregate method of withholding. In addition, because the payments are made on a semimonthly basis, the employer should use the semimonthly payroll tables.

Situation 4: Commissions with Unequal Payroll Periods

In Situation 4, the employee is compensated solely by commission. The employer pays the commissions whenever the employee's accumulated net commissions equal $1,000 or more. Under these facts, the first day of the calendar year accumulated earnings are paid is January 15.[2] The second day that accumulated earnings are paid is February 1.

Here, because only supplemental wages are paid, the aggregate method of withholding must be used. However, because the wages are not paid at regular intervals, the income tax withheld from the wages is based on the daily/miscellaneous table. For the first payment, the payroll period should be 15 days, the number of days between January 1 (or the first date of employment) and the first pay day. The withholding on the second wage payment is determined based on a miscellaneous payroll period of 17 days, from January 16 (the day after the last payment of wages) to February 1, the next day on which wages were paid.

Situation 5: Bonus Over $1 Million

In Situation 5, an employee receives a $2.1 million signing bonus five months before starting to perform services. Once the employee starts performing services he will receive regular wages of $75,000 per month. With respect to the amount of the signing bonus over $1 million the employer must use the mandatory 35% flat withholding method. For the amount of signing bonus under $1 million, the employer may use either the mandatory 35% flat withholding method, or the aggregate method. If the employer uses the aggregate method, it should use a monthly pay period, which is the scheduled payroll period for the regular wages.

Situation 6: Severance Pay

In Situation 6, an employee is involuntarily terminated. The employer has a severance pay plan for employees that states that if an employee is involuntarily terminated, the employee will receive weekly severance pay equal to his or her ending regular weekly pay. The severance pay will continue after termination for the number of weeks that is equal to the number of full years the employee performed services as an employee for the employer multiplied by 3. Under this plan, the employee will receive 51 weeks of severance starting on June 30 and continuing into the following year.

The IRS treats severance pay as supplemental wages because it is not a payment for services in the current payroll period but a payment made upon or after termination of employment for an employment relationship that has terminated, even though paid for a fixed 51 weeks. Thus, because the severance is treated as supplemental wages, the employer may chose to use either the optional 25% flat rate withholding or the aggregate method for all payments.

Situation 7: Payout of Accumulated Vacation Pay upon Termination

In Situation 7, an employee has accrued but unused annual leave that is paid out in a lump sum upon termination, either in the same check as final wages or in a separate check. The lump sum payment of accumulated annual leave is a supplemental wage payment, because it is not a payment at a regular rate for the current payroll period. Assuming that income tax was withheld from regular wages in the current or prior year, the employer may use either the optional 25% flat rate or the aggregate rate to withhold on the payment of the accrued annual leave.

Situation 8: Payment of a Lump Sum Vacation and Sick Leave Allowance Annually

An employer has a plan that pays its employees at the end of approximately each 12-month period a lump sum payment known as a vacation and sick leave allowance. An employee receives this payment whether or not he or she has been absent from work because of vacation or illness. However, when the employee is absent for vacation or illness, the employee receives no regular pay for the period of absence.

The annual payment of the vacation and sick leave allowance is a supplemental wage payment because it is not a payment at a regular rate for the current payroll period. The employer may use the aggregate method of withholding, or may use the optional 25% flat rate assuming that income tax was withheld from regular wages in the current or prior year.

Situation 9: Sick Pay Paid at Different Rate than Regular Pay

In Situation 9, an employer pays its employees at one rate when the employee is present and working and at another rate when the employee is absent because of sickness. The employer maintains payroll records that separately state the amount of wages paid for working days and the amount of wages paid for sick pay, but makes a single payment of wages to the employee for a payroll period that includes both payments. Because the sick pay is supplemental wages, given that it not paid at regular intervals (because employees are not sick at regular intervals), the employer may use the optional flat rate withholding method if income taxes have been withheld from the regular wages in the current or previous year, or may otherwise use the aggregate rate.

Advice for Employers

This Revenue Ruling is not an exhaustive list of all possible supplemental wage scenarios that may occur. Nonetheless, it provides guidance on common scenarios, and employers can review the results set forth in this Ruling to determine how to withhold in other particular situations. For example, an employer that pays commissions on an irregular basis in addition to regular wages can look at examples two and four for guidance on the allowable withholding options.

In light of the foregoing Ruling, employers should ensure that their payroll departments or third party payroll processors are properly coding payments that represent supplemental wages and are using the proper withholding method for those payments. When in doubt about the proper withholding method, employers should contact their tax professionals for advice.

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1 Treas. Reg. § 31.3402(g)-1.

2 The Revenue Ruling states January 14 is the first date of the payment of wages in the example portion, but uses January 15 for purposes of analysis. We, therefore, use the January 15 date.