

# MILLER & CHEVALIER

## EMPLOYEE BENEFITS ALERT



We partner with our clients in helping them navigate the vast array of laws and administrative agencies governing an employer's benefit and compensation practices.

On the planning side of our practice, we help clients find practical solutions in structuring employee benefit arrangements and executive compensation programs. Our comprehensive experience in the payroll tax and fringe benefit areas gives us a unique advantage in advising clients.

On the controversy side, our team has broad experience in handling tax controversy matters, and we pride ourselves on having one of the most dynamic ERISA litigation teams in the nation. We routinely help employers defend against individual and class action claims involving pension and health benefits plans as well as fiduciary litigation.

### IRS Releases Final Regulations on Flat-Rate Withholding on Supplemental Wages

Effective January 1, 2005, section 904 of the American Jobs Creation Act of 2004 (Pub. L. No. 108-357) provides that the supplemental wage withholding rate increases from the third-lowest tax rate for single filers (*e.g.*, 25% in 2006) to the maximum rate in effect (*e.g.*, 35% in 2006) once the employee's supplemental wages exceed \$1 million for the year. The final regulations (T.D. 9276) published today essentially adopt the amendments to the withholding procedures set forth in the proposed regulations, but specifically address many of the comments made during the vigorous debate following their January 2005 release seeking certainty about employers' withholding responsibilities.

#### *Classification of payments -- regular wages or supplemental wages?*

In response to employers' concerns about their ability to correctly classify particular wage payments, the Preamble states that, with the issuance of these final regulations, the IRS is confident that it has issued sufficient guidance to employers to classify any payment (either specifically or by analogy). The IRS demonstrated its confidence by rejecting suggestions that employers should be permitted to simply treat a wage payment as supplemental whenever it is unclear how the payment should be characterized under the regulatory definition.

As in the proposed regulations, the final regulations define "supplemental wages" as "all wages paid by an employer that are not regular wages" and "regular wages" as "amounts that are paid at a regular hourly, daily, or similar periodic rate . . . for the current payroll period or at a predetermined fixed determinable amount for the current payroll period." The final regulations offer the following additional guidance:

- The proposed regulations provided that a wage payment could qualify as a supplemental wage only if paid in addition to regular wages paid to the employee. The final regulations reject that

approach. Under the final regulations, amounts that fit within the regulatory description of "supplemental" are treated as supplemental without regard to whether the employer has paid the employee regular wages during either the calendar year or any prior year. As explained below, however, this classification does not empower employers to apply flat-rate withholding to supplemental wages less than \$1 million in the aggregate during the year unless there has been withholding from regular wages in the current or preceding year.

- The definition of "supplemental wages" is expanded to include "nonqualified deferred compensation includible in wages," "wages from imputed income for health coverage for a non-dependent," and "wage income recognized on the lapse of a restriction on restricted property transferred from an employer to an employee."
- Employers are permitted, at their option, to treat tips and overtime pay (which are included in the supplemental wage definition) as regular wages, without a requirement of uniformity among employees, but employers are not permitted to treat commissions, third-party sick pay paid by agents, bonuses, or taxable noncash fringe benefits as regular wages. (In the case of commissions, the final regulations specifically eliminate the proposed regulations' rule that commissions may be treated as regular wages if they are the only wages that the employee receives.)

#### *Post-termination payments.*

The Preamble rejects the suggestion that employers should be permitted to apply the supplemental wage withholding rate to *regular* wage payments made to a former employee in a post-termination year. In other words, the option to withhold using the flat rate applies only in situations where *supplemental* wages of less than \$1 million for the year are being paid *and* there has been withholding on regular wages during the current or

preceding year. (The ability to tack on to the preceding year was added by the final regulations.) Thus, in the case of any regular-wage payment following termination or any supplemental-wage payment of less than \$1 million paid later than the first calendar year following termination, the employer, for purposes of determining the correct withholding liability on the post-termination payment, must apply the last valid Form W-4 on file. In the event there is no valid Form W-4 on file, the employer must either request a new Form W-4 from the former employee or must treat the former employee as single claiming no withholding allowances.

*Procedures for withholding on supplemental wages in excess of \$1 million.*

The IRS held firm to its statutory interpretation that the mandatory supplemental withholding rate should be applied only to amounts in excess of \$1 million, even though employers had asked for permission to apply the mandatory rate when they anticipate that an employee's supplemental wages are approaching the threshold. The Preamble, however, asks for comments on whether the IRS should permit employers to withhold at the mandatory rate when the employee's total wages (both regular and supplemental) exceed \$1 million. Moreover, the regulations permit employers to apply mandatory withholding to the entire amount of any single supplemental wage payment that will result in the employee exceeding the \$1 million supplemental wage payment threshold, as opposed to the requirement in the proposed regulations that the mandatory withholding rate could only be turned on with respect to the portion of the payment meeting or exceeding the threshold.

In an apparent effort to address employers' concerns about their ability to know with specificity when to apply the mandatory withholding rate, a revenue procedure will be issued to provide employers with a number of options for determining when supplemental wages in excess of \$1 million have been paid.

"[I]n the interest of making the rules administrable for employers," the IRS accepted the suggestion that the employer should be permitted to treat amounts included in Box 1 of Form W-2, which are not subject to Federal income tax withholding, as supplemental wages. For example, income from the disqualifying disposition of a statutory option or imputed income under section 7872

would be reported in Box 1, but is not subject to Federal income tax withholding.

Salary reduction deferrals (e.g., 401(k), 403(b), etc.) must be properly allocated to the gross regular wages or supplemental wages from which they are deducted before the amount of supplemental wages is determined. The IRS rejected the suggestion that employers should be allowed to take into account the gross amount of supplemental wages subject to pretax reductions.

The regulations clarify that when applying the mandatory rate, not only must the employer ignore any claim of withholding allowances on the employee's Form W-4, but the employer must also ignore any requests for additional withholding on Line 6. In other words, employees are precluded from insisting that withholding greater than the mandatory withholding rate should be applied to the supplemental wage payment.

*Safe harbor for counting supplemental wages paid by third parties.*

In the case of payments made by third-party agents, the final regulations offer an optional *de minimis* safe harbor rule that permits the exclusion of less than \$100,000 in a third party's payments for the year from the overall calculation of supplemental wages. Once wage payments from an agent equal or exceed \$100,000, however, all payments made by the agent must be taken into account in the calculation of supplemental wages. In other words, this limited relief operates on a "cliff" basis. An anti-abuse rule trumps the safe harbor for payments made by agents when the employer creates an arrangement with five or more agents with the intent to defeat the mandatory flat-rate withholding with respect to an employee.

*Application of mandatory flat-rate withholding regardless of employee's personal income tax liability.*

The IRS vigorously rejected arguments that there should be an exception from mandatory withholding when the employee is eligible to take an offsetting income tax credit (such as the foreign tax credit) or an offsetting income tax deduction (such as alimony). The IRS rejected these suggestions on the grounds that they "are contrary to the statutory intent and would require the employer to assume a role in assessing employees' tax circumstances that employers cannot and should not be asked to perform."



*Effective date of regulations and absence of a good-faith relief provision.*

The final regulations are effective January 1, 2007 in order to “give employers time to implement any programming and coordination required . . .” Disappointingly, the regulations do not provide specific relief from the failure to withhold at the mandatory flat rate or related reporting failures if the employer or agent can demonstrate that it made reasonable, good faith efforts to comply with the new requirements, for the stated reason that such relief would be inconsistent with the mandatory withholding established by Congress.

***Click here for a copy of T.D. 9276 (71 Fed. Reg. 42049 (July 25, 2006)).***

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