



April 11, 2005

VIA ELECTRONIC AND HAND DELIVERY

Internal Revenue Service
CC:PA:RU (REG-157302-02)
Courier's Desk
1111 Constitution Avenue, NW
Washington, D.C. 20224

RE: Comments on Proposed Regulations For Supplemental Wage Withholding

Dear Sir or Madam:

I am writing on behalf of the member companies of the American Benefits Council (the "Council") to comment on the proposed regulations on the new supplemental wage withholding requirement enacted as part of the American Jobs Creation Act of 2004 (the "Jobs Act"). 70 Fed. Reg. 767 (Jan. 5, 2005) ("Proposed Regulations"). We appreciate the efforts of Treasury and the Internal Revenue Service to provide guidance within such a short period of time after the enactment of the Jobs Act. We also appreciate the helpful guidance included in the Proposed Regulations regarding the determination of "supplemental wages." Nevertheless, Council members have serious concerns regarding certain elements of the Proposed Regulations and the application of the new supplemental wage withholding requirement. Accordingly, we request that the Proposed Regulations be modified in certain respects and that Treasury and the Service provide both transition and ongoing administrative relief so that companies may implement the new rules. We also request a public hearing on these issues.

The Council is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans. Council members impacted by the new rules include many of our member companies and numerous payroll and benefit plan administrators.

Background

Section 904(b) of the Jobs Act generally requires that an "employer" withhold income taxes on supplemental wage payments at the maximum rate under section 1(i)(2) of the Internal Revenue Code of 1986 (the "Code") (35% for 2005) once total annual supplemental wage payments to an employee exceed \$1 million. The mandatory wage withholding requirement applies regardless of any other withholding rules, the withholding method employed by the employer, or the employee's election on IRS Form W-4. Section 904(b)(2) of the Jobs Act defines the term "employer" for these purposes to include all entities that are members of the employer's controlled group of corporations or commonly controlled trades or businesses that are treated as a single employer under subsections (a) and (b) of Code section 52. The new mandatory withholding requirement is effective with respect to payments made after December 31, 2004.

The Proposed Regulations expand on the provisions in the Jobs Act to also require that any supplemental wage payment made to an employee by a third party acting as an agent for the employer be considered as made by the employer. Under the Proposed Regulations, this requirement applies regardless of whether the third party has been designated as the employer's agent pursuant to Code section 3504. As a result, employers and their third party vendors are required to aggregate all supplemental wage payments made to an employee directly by the employer, any member of the employer's controlled group, and any third party vendor engaged by such entities, for purposes of determining when the application of mandatory withholding must commence.

Moreover, the Proposed Regulations provide that mandatory withholding at the maximum tax rate applies only to the excess of supplemental wages over \$1 million. As a result, the mandatory withholding rate could apply to only a portion of a supplemental wage payment. In the typical situation where a supplemental wage payment to an employee would cause the total supplemental wage payments to exceed the \$1 million threshold, the employer would be required to apply one withholding rate to the portion of the supplemental wage payment that, when added to the employee's total year-to-date supplemental wages, is less than \$1 million, and a different withholding rate to the remaining portion of the supplemental wage payment.¹

¹ We are aware of only one situation where different withholding rules may apply to portions of a single payment and it has proven to be highly problematic. We refer to the rules for retirement plan distributions where the amount of a "minimum required distribution" for the year is not eligible for rollover but payments in excess of the minimum are rollover-eligible. Treas. Reg. §1.402(c)-2, Q&A 7.

The Proposed Regulations are to be effective when they become final. Under the general withholding and reporting requirements in the Code, employers who fail to withhold and timely deposit the required amount could be liable for the shortfall and subject to related penalties and interest.

Concerns

As a result of the new withholding requirement, employers are confronted with a host of practical problems never before faced in the withholding area. Although the Proposed Regulations were designed to impact only employees making over \$1 million, in order to ensure compliance, every employer must identify, track, and withhold the proper amount of withholding with respect to all wage payments to all employees.

Identification

The new rules would for the first time require that employers designate the type of compensation being paid as either "regular" or "supplemental." Previously, employers had the option of combining regular and supplemental wage payments and treating them as a single wage payment for the regular payroll period. As a result, many employers did not identify whether a particular payment was comprised of regular wages, supplemental wages or a combination of both. In contrast, the new rules will require employers to distinguish between regular and supplemental wage payments and track the amount of supplemental wage payments made to an employee to determine when the \$1 million threshold has been reached, thereby triggering the maximum mandatory withholding rate.

Even though the Proposed Regulations provide helpful clarifications regarding the determination of supplemental wages, substantial uncertainties remain. For example, in the year following retirement, a retiree may receive a payment from a nonqualified deferred compensation plan and, later in that year, exercise a nonqualified stock option and receive a second payment. If the retiree has not received any "regular wages" prior to the time the nonqualified deferred compensation payment is made, will only the latter payment be treated as supplemental wages? Or, will neither payment be treated as supplemental wages?

In addition, it is not clear whether and to what extent the following types of amounts will be treated as supplemental wages for purposes of calculating the \$1 million threshold:

- Imputed income amounts (e.g., for domestic partner benefit coverage);
- Taxable non-cash fringe benefit amounts. Although they are listed as supplemental wages in the proposed regulations, it is unclear if the special valuation, withholding, and accounting rules will apply for this purpose – e.g., should non-cash fringe benefits be treated as paid on December 31 (or

later under the special accounting rule) for purposes of the \$1 million threshold?;

- Non-cash equity awards (e.g., restricted stock awards and the spread on nonqualified stock options, which may vest or be exercised during employment or post-retirement); and
- The portion of the supplemental wage payment (e.g., a bonus) that is deferred under (1) a qualified retirement plan pursuant to a salary deferral agreement, or (2) a nonqualified deferred compensation plan (i.e., confirmation that the portion deferred is not counted towards the \$1 million threshold because it is not currently taxable).

Tracking

In addition to identifying supplemental wage payments and distinguishing them from regular wage payments, employers will be required to track year-to-date supplemental wage payments that typically are made from multiple sources. It is not uncommon for employers to have multiple internal payroll systems (e.g., for specific types of compensation; for separate business units; as a result of corporate transactions). Employers do not currently have internal payroll systems that are able to coordinate and track payments from these various sources. Therefore, new administrative systems will have to be developed and implemented.

Moreover, employers previously have not been required to coordinate payroll systems between entities within the same controlled group. Employers often have decentralized payroll systems, and the vendor engaged to perform services on behalf of one member of the controlled group is not necessarily the same vendor who performs services on behalf of another. Coordination between companies in the same controlled group will make compliance with the new rules even more problematic.

The administrative difficulties facing employers have been exacerbated by the requirement in the Proposed Regulations that supplemental payments made by a third-party agent count toward the \$1 million threshold. Certain types of compensation are typically paid by third parties outside of the employer's basic payroll system (e.g., stock compensation; disability pay). In order to comply with the new rules, administrative systems will need to be developed to track these third-party payments and then provide "real-time" communications between employers and their agents. There currently are no administrative systems that are able to accomplish these tasks, and the development of such systems will be very difficult and will take significant time and financial resources to create.

Payment

In addition to identifying and tracking supplemental wage payments, employers and their record keepers also will be required, from a systems perspective, to separately code each type of compensation paid to employees. Payroll systems are typically programmed to use a single withholding code to indicate the applicable withholding rate for the payment. Now these codes must be either manually overridden or programs redesigned to accommodate multiple withholding codes, based on the various types of wage payments (25%, W-4 withholding, or 35%). These system changes will take time to design, test, and bring "online."

Negative Accounting Treatment

Because of the uncertainty and complex administrative issues that arise under the Proposed Regulations, it is very likely that withholding errors will occur. In the case of equity-based compensation, the consequences of failing to comply with the new mandatory withholding requirement can be severe. Statement of Financial Accounting Standards No. 123(R) ("SFAS 123") provides generally that if an amount in excess of the minimum statutory requirement is withheld from an equity award (or may be withheld at the employee's discretion) the entire award is classified and accounted for as a liability. The fair market value of such an award is then remeasured at the end of each reporting period until settlement (*i.e.*, variable accounting applies). For example, if an employer or third-party agent mistakenly applies the mandatory 35% withholding rate on the spread upon exercise of a nonqualified stock option, the entire award would be subject to variable accounting treatment.

Immediate Effective Date

Compounding all of the above problems is the fact that the new law already applies. The lack of any meaningful lead time to cope with all of these new compliance tasks makes it imperative that flexible, reasonable approaches be permitted.

Recommendations

Based on all of the foregoing concerns, we recommend that the final regulation delay the effective date for compliance with the 35% mandatory withholding rate at least until 180 days after the effective date of the final regulations, and provide permanent relief from the mandatory withholding requirement and related reporting and withholding penalties and interest if the employer (or third-party payer) makes reasonable, good faith efforts to comply with the new requirements. For example, if the employer develops initial procedures designed to identify, track, and process payments subject to the 35% withholding rate, it should be treated as meeting the reasonable, good faith standard. Such treatment would be consistent with the administrative relief provided elsewhere in the employment tax arena. See e.g., Treas. Reg. §31.3121(v)(2)-(1)(e)(5) (rule of

administrative convenience); Notice 94-96, 1994-2 C.B. 564 (reasonable good faith standard for application of FICA tax to nonqualified deferred compensation).

We also recommend that the final regulation provide a series of safe harbors that employers and other payers, in their discretion, may rely upon in complying with the new mandatory withholding rules. We submit that safe harbors along these lines are essential to alleviate severe administrative problems and help reduce the substantial costs that employers and service providers will incur to comply with the new rules. Possible safe harbors include--

- The mandatory 35% withholding rate should apply only after all payments of wages -- both supplemental and regular -- exceed \$1 million. Such treatment would be consistent with legislative history regarding the mandatory withholding requirement that suggests that the higher withholding rate be used to more closely approximate the applicable tax rate. See National Employee Savings and Trust Guarantee Act, S. Rept. 108-266, p. 105.
- A flat 35% withholding rate should apply (1) with respect to all supplemental wage payments paid to an employee whose total compensation for the preceding year (based upon the employee's Form W-2 for that year) exceeded the \$1 million threshold, and (2) in the case of other employees who receive a single payment in the current year that exceeds \$1 million. Such a prior year approach is consistent with how highly compensated employees are generally determined for qualified plan and other employee benefit purposes. This approach also is consistent with the statutory language, which sets forth a minimum (but not a maximum) withholding rate – i.e., "not [] less than 28%" – for supplemental wages of \$1 million or less. To prevent any perceived abuses, a consistency rule could also be added that would require the employer to use this safe harbor for all of its employees.
- Employers should not be required to count supplemental wage payments made by third-party agents (e.g., brokers, third-party sick pay agents) for purposes of applying the \$1 million threshold, at least with respect to those agents who do not perform the employer's general payroll functions. The Jobs Act does not require that such payments be treated as paid by the employer. Instead, a third-party agent, as with a Code section 3401(d)(1) payer, should be subject to its own \$1 million threshold, with no controlled group aggregation or aggregation with other vendors of the employer, taking into account only payments it makes (and permitting the treatment of all such special payments (other than general payroll payments) as supplemental wages). For example, the third-party agent could apply either W-4 withholding or the flat 25% withholding rate until its payments to an employee reach \$1 million, then use the 35% rate (or elect to use another safe harbor approach) once such payments exceed \$1 million. Regardless, the new

rules should confirm that payments from a Code section 3401(d)(1) employer are not aggregated with a common-law employer for purposes of the supplemental withholding requirements.

- In addition, to avoid having the mandatory withholding rate apply only to the portion of a supplemental wage payment that exceeds \$1 million, the final regulation should permit employers to apply the mandatory rate only to payments made after an employee has reached the \$1 million threshold.

*

*

*

We thank you in advance for your consideration of the foregoing comments and recommendations. Please contact me at (202) 289-6700 if you have any questions or need any additional information.

Sincerely yours,

Lynn Dudley
Vice president and Senior Counsel