

July 27, 2006

MEMORANDUM TO CLIENTS

RE: Final IRS Regulations on Supplemental Wage Withholding

The IRS recently finalized a new set of rules for supplemental wage withholding – the historically optional provision that allows employers to use a flat rate for income tax withholding on certain wage payments. 71 Fed. Reg. 42049 (July 25, 2006). The regulations take into account the changes made by the American Jobs Creation Act of 2004 ("Jobs Act") and clarify the definition of "supplemental wages."

Prior to the Jobs Act, employers could treat "supplemental wages" as either regular wages (e.g., subject to withholding tables) or apply flat 25% income tax withholding (based on the third lowest rate of tax applicable under section 1(c) of the Code). The Jobs Act made supplemental withholding mandatory for supplemental wages that exceed \$1 million, and increased the rate to 35%, the maximum individual tax rate, generally effective starting in 2005.

Proposed regulations released in January 2005 raised numerous administrative and other problems. Unfortunately, the final regulations largely follow the provisions of the proposed regulations, and do not adopt much of the practical relief that commentators had requested. Employers should carefully review their wage withholding procedures and be ready to fully comply with these regulations for payments made on and after January 1, 2007 (the effective date of the regulations). In the interim, it appears that reasonable efforts to comply with the proposed rules should be acceptable.

A brief summary of the final rules is set forth below highlighting major issues clarified in the final regulations.

A. General Rules

Supplemental wages paid to an employee by an "employer" – which includes all employers within the "controlled" group and third-party agents – are subject to the following income tax withholding rules:

- Supplemental Wages Exceed \$1 Million: Mandatory 35% withholding on amounts over \$1 million.
- Supplemental Wages Do Not Exceed \$1 Million: Either (1) W-4 wage withholding (aggregate approach) or (2) flat 25% withholding, at employer's election. However, the flat withholding is only available if:

(1) the employer has withheld income tax from regular wages paid the employee during the same year as the payment of supplemental wages or during the preceding calendar year, and

- (2) the supplemental wages are either: (i) not paid concurrently with regular wages, or (ii) separately stated on the payroll records of the employer.

B. Definition of "Supplemental Wages"

Supplemental wages are all payments that are not regular wages. Therefore, they are amounts that are not paid for a payroll period either at a regular hourly rate or in a predetermined fixed amount. Supplemental wages include commissions, tips and overtime pay, bonuses, back pay, wages under a taxable reimbursement arrangement, income from the exercise of nonstatutory stock options, taxable noncash fringe benefits, third party sick pay, payments under nonqualified deferred compensation ("NQDC") plans, wages from imputed income for health coverage for a non-dependent, and wage income recognized on the lapse of a restriction on restricted property.

The final regulations –

- Post-Termination Payments: Eliminate the rule that a payment can qualify as supplemental wages only if regular wages have been paid to the employee – therefore, if the payments meet the definition of supplemental wages (generally, all "wage" payments other than regular wage payments) they will be supplemental wages, regardless of whether the employee has received any regular wages in his or her working career with the employer. For example, NQDC payments made after termination of employment are supplemental wages; to the extent they do not exceed the \$1,000,000 threshold, the 25% flat rate may be used if regular wages (and withholding) were paid in the current or prior year.
- Tips and Overtime Pay: Permit employers to treat tips and/or overtime pay as regular wages; such treatment is not required to be applied uniformly to all employees.
- Noncash Fringes: Clarify that noncash fringe benefits continue to be subject to the special rules set forth in Announcement 85-113; if such amounts are not wages for income tax purposes, then they are not included in regular or supplemental wages.
- Disqualifying Dispositions: Clarify that income from a disqualifying disposition of stock acquired through statutory stock options is not supplemental wages.
- Taxable Wages with No Withholding: Provide that amounts reported in box 1 of W-2 that are not subject to income tax withholding can be treated as supplemental wages, for administrative ease.
- Gross vs. Net Payments: Prohibit taking into account pretax deductions that are attributable to supplemental wages because these amounts are not subject to income tax withholding. For example, if an employee elected to defer 10% of a \$1,000,000 bonus, only \$900,000 would be counted as supplemental wages.
- Split Payment: Permit treating the entire payment that results in the employee exceeding the \$1,000,000 threshold as subject to 35% withholding, on an employee-by-employee basis. However, the regulations prohibit treating the portion of a payment that results in the employee exceeding the \$1,000,000 threshold as not subject to the 35% rate.

- Domestic Relations Order: Reject a special exemption for payments subject to a domestic relations order.
- Working Abroad: Reject a special exemption for U.S residents or citizens who work overseas and are subject to a foreign tax credit.

C. Payments By Agents

The final regulations add a limited exception for payments made by third-party agents. Specifically, if the total wage payments to an employee are less than \$100,000, the agent can disregard the employer's wage payments (i.e., the agent can avoid 35% withholding), and the employer can disregard the agent's payments (i.e., it is not required to track the agents payments for the \$1,000,000 threshold). However, once the agent's total payments reach \$100,000, the agent(s) and the employer must count each other's supplemental payments for all payments made after the \$100,000 threshold is met. There is also an "anti-abuse" provision if 5 or more agents are used and the principal effect of the arrangement is to reduce applicable mandatory withholding – in that case, this de minimis exception does not apply.

D. Additional Relief

The regulations contain a placeholder for alternative methods to satisfy the mandatory flat rate withholding procedures. From the preamble, it is clear that, despite the numerous comments to simplify the process, the Service is still struggling with how to permit mandatory flat rate withholding on wages other than supplemental wages. It expressly asks for comments on whether it should permit employers to withhold at the mandatory flat rate on any amount of total wages (both regular and supplemental) that exceeds \$1,000,000.