

## in this issue:

SEPTEMBER 2006

On July 25, 2006, the IRS released final regulations addressing the issue of supplemental wages. The new regulations are effective for payments made beginning January 1, 2007. Employers should specifically understand the changes that will occur that may require modifications to current payroll systems.

Littler Mendelson is the largest law firm in the United States devoted exclusively to representing management in employment and labor law matters.

## Employment Taxes

A Littler Mendelson Newsletter  
specifically for the Employment Taxes

### IRS Issues Final Regulations on Supplemental Wage Payments

By GJ Stillson MacDonnell and William Hays Weissman

#### Introduction

On July 25, 2006, the IRS released final regulations addressing the issue of supplemental wages.<sup>1</sup> The new regulations are effective for payments made beginning January 1, 2007. Employers should specifically understand the changes that will occur that may require modifications to current payroll systems.

#### Regular and Supplemental Wages Defined

Similar to the proposed regulations issued in 2005, the final regulations define regular and supplemental wages. "Regular wages" means wages paid by an employer for a payroll period either at a regular hourly rate or in a predetermined fixed amount. 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.<sup>2</sup>

The final regulations list the following types of payments as supplemental wages:

- Reported tips
- 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 §409A
- Income recognized on the exercise of a nonstatutory stock option
- Imputed income for health coverage for a non-dependent
- Income recognized on the lapse of a restriction on restricted property transferred from an employer to an employee.<sup>3</sup>

#### New Rules Under the Final Regulations

The final regulations contain some new rules that differ from current law that employers should understand. These rules include:

- Under the new regulations a wage payment may be treated as a supplemental wage payment even if no regular wages are paid in the current or prior year.
- This is particularly important for former employees that are still

<sup>1</sup> 71 FR. 42049, July 25, 2006.

<sup>2</sup> Treas. Reg. § 31.3402(g)-1(a)(1)(i).

<sup>3</sup> *Id.*

receiving payments, such as non-qualified deferred compensation. In such a case the payments would be treated as supplemental wages.

- This rule is also important when an employer settles claims made by a former employee for back wages, because such payments must be treated as supplemental wages and may be subject to flat rate withholding rather than subject to withholding in accordance with the former employee's W-4. In cases where there is flat rate withholding, this will result in potentially greater withholding than if calculated using the employee's W-4.
- The employer has the option to treat tips and/or overtime pay as regular wages by an employer even if they would otherwise qualify as supplemental wages. Importantly, this treatment is not required to be consistent for all employees.
- Commissions, third-party sick pay paid by agents of the employer, or taxable fringe benefits must always be treated as supplemental wages.
- If a supplemental wage payment will make an employee's wages exceed the \$1 million threshold, the employer may treat the entire amount of the payment that results in the employee receiving total supplemental wages of more than \$1 million as subject to mandatory flat rate withholding rather than merely the portion that exceeds \$1 million.
  - Further, as noted, amounts paid by commonly controlled entities are all counted toward the \$1 million threshold.
  - There is a *de minimis* exception of \$100,000 for payments made by unrelated third party agents. This rule was enacted because payments

made by third parties are treated as made by the employer, but the IRS recognized that it might be very burdensome for employers and unrelated third parties to exchange payroll information in order to determine whether the \$1 million threshold is met. Thus, it created an optional exception up to \$100,000 for payments from unrelated third party payroll agents.

## Withholding on Supplemental Wages

The final regulations continue to allow for the two methods of withholding for supplemental wages under \$1 million. Under the first method, if supplemental wages are lumped and paid with regular wages, then federal income tax should be withheld as if the total were a single payment for a regular payroll period.<sup>4</sup>

Under the second method, if supplemental wages are paid separately (or combined in a single payment with each wage separately specified), the federal income tax withholding method depends partly on whether income tax is withheld from the employee's regular wages. If income tax is withheld from the employee's regular wages, then the supplemental wages can be withheld at either (1) a flat 25% rate; or (2) as if the total was a single payment by subtracting the tax already withheld from the regular wages and then withholding the remaining tax from the supplemental wages. However, if income tax was not withheld from the employee's regular wages, then the latter single payment method must be used.<sup>5</sup>

However, if supplemental wages paid to any one employee during the year exceed \$1,000,000, then withholding must be done using a flat rate that equals the maximum allowed tax rate (currently 35%) without regard to the employee's W-4.<sup>6</sup> To

determine whether wages exceed \$1 million, an employer with multiple companies under common control are treated as a single employer. Thus, for example, if employee X earns \$400,000 in supplemental wages from Company A, \$500,000 from Company B, and \$300,000 from Company C, and companies A, B and C are part of a commonly controlled group, then the threshold for mandatory flat rate withholding for employee X has been satisfied.

## Suggestions for Implementing the Final Regulations

Employer should review their payroll systems to ensure that they will be prepared to implement the final regulations on January 1, 2007. Among the steps employers should take are:

- Ensure that payroll systems are updated to identify all forms of supplemental wages.
- To the extent the regulations allow for discretion, employer should review those choices and determine the best choice. For example, employers should determine whether to treat tips and overtime pay as either supplemental or regular pay, and if so, for which classes of employees. While employers are not required to apply such treatment consistently for all such payments and employees, they should consider the pros and cons from a business and employee relations perspective of treating employees differently.
- Make sure employees understand which forms of compensation will be treated as regular wages which forms of compensation will be treated as supplemental wages.
- Employers might also want to remind employees that it is improper to claim exempt from tax unless they will owe no tax and owed no tax in the prior year, and that it is

<sup>4</sup> *Id.* at §§ 31.3402(g)-1(a)(5)-(7).

<sup>5</sup> *Id.*

<sup>6</sup> *Id.* at § 31.3402(g)-1(a).

improper to execute a new W-4 to significantly increase the number of claimed exemptions unless they actually qualify for them. Employers want to prevent to the extent possible employees changing their W-4s to circumvent required withholding. (For more information on this topic, see GJ Stillson MacDonnell and William Hays Weissman, *An Employer's Guide for Dealing with "Unusual" Tax Withholding Requests*, March 2006 ASAP.)

- Check to determine if employees are receiving supplemental wages from more than one entity in the corporate group, such that the amounts received can be aggregated to determine if they exceed the \$1 million threshold. Also decided whether to apply the *de minimis* exception for unrelated third party payroll agents.
- Remember that when settling claims for back wages such wages are treated as supplemental wages.
- Contact your counsel with any particular questions or problems.

---

*GJ Stillson MacDonnell is a shareholder and chair of Littler's Employment Taxes Practice Group and William Hays Weissman is an associate in Littler's Employment Taxes Practice Group. If you would like further information, please contact your Littler attorney at 1.888.Littler, info@littler.com, Ms. MacDonnell at gjmacdonnell@littler.com or Mr. Weissman at wwweissman@littler.com.*

---