NEW TAX REGULATIONS REQUIRE MANDATORY WITHHOLDING ON SUPPLEMENTAL WAGES GREATER THAN $1 MILLION

The American Jobs Creation Act of 2004 (Jobs Act) altered the rules for income-tax withholding on supplemental wages. Effective January 1, 2005, the Jobs Act requires that if an employee receives supplemental wages in excess of $1 million from an employer in a calendar year, the excess of the supplemental wages over $1 million is subject to mandatory withholding at the highest income-tax rate.

Under the rules applicable before the Jobs Act, employers could choose to apply flat-rate withholding at a rate generally lower than the highest income tax rate.

The following example illustrates mandatory withholding on supplemental wages in excess of $1 million.

Employer pays employee Bob a salary of $200,000 in 2007. The employer then decides it wants to grant Bob a $1.5 million bonus to be paid in 2007. In 2007, the employer withholds income tax from Bob’s $200,000 salary and does not make any non-bonus supplemental wage payments to him during the year. In 2007, the highest rate of income tax is 35% and the rate for optional flat rate withholding is 25%.

In this example, the employer has the option to apply the optional flat rate withholding because: (i) the bonus is considered a supplemental wage payment, and (ii) the employer withheld on regular wage payments in 2007. The optional flat rate may be applied to the first $1 million paid, and Bob would be subject to 25% withholding in such an event. However, the supplemental wages above $1 million (i.e., the $500,000) would be subject to 35% mandatory withholding in 2007. The employer would not have the option to apply the 35% withholding rate for the $500,000 above the mandatory withholding threshold.

Pursuant to the Jobs Act, the IRS recently published final regulations on supplemental wage withholding that are effective for all wages paid on or after January 1, 2007. The final regulations provide guidance and examples concerning the proper classification of certain types of payments as regular or supplemental wages.

Additional Guidance and Examples

The final regulations provide that regular wages are amounts that are paid at a set hourly, daily, or similar periodic rate (and not an overtime rate) for the current payroll period or at a predetermined fixed determinable amount for the current payroll period; supplemental wages are all other wages. However, the final regulations add that compensation that does not constitute wages subject to federal income tax withholding is not included in regular or supplemental wages. For example, income from disqualifying dispositions of stock acquired through the exercise of incentive stock options is not wages subject to withholding, and is not included in determining regular or supplemental wages.

Abandoning a rule found in the 2005 proposed regulations, the final regulations provide that amounts that are supplemental wages are treated as supplemental wages without regard to whether an employer has paid an employee regular wages during either the current year or any prior year (in other words, there do not have to have been regular wages to classify a payment as supplemental wages). However, there must have been withholding from regular wages in the same year as the payment or preceding year for optional flat rate withholding to be available to an employer. Therefore, income tax must have been withheld from an employee’s regular wages since the beginning of the previous tax year in order for optional flat rate withholding on supplemental wages to apply.

As a result, supplemental withholding may be available to an employer if a former employee is entitled to post-termination severance pay only if: (i) the former employee received regular wages from the employer in the current or preceding calendar year, (ii) such wages were subject to withholding, and (iii) the post-termination severance payments must meet the definition of supplemental wages and not be regular wages. For example:

Employer pays employee Joe a salary of $550,000 in 2006 and withholds on those regular wages. The employer decides to terminate Joe’s employment with the company. The termination entitles Joe to $1.1 million in severance payments throughout 2007. In 2007, Joe does not receive any other supplemental wage payments (other than the severance payments). The highest rate of income tax is 35% and the rate for optional flat rate withholding is 25% in 2007.

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In this example, the employer has the option to apply the optional flat rate of withholding on the first $1 million paid in 2007 because: (i) the severance payments are considered supplemental wage payments, and (ii) Joe had no regular wages in 2006. However, the supplemental wages above $1 million (i.e., the $100,000) would be subject to 35% mandatory withholding. The employer would not have the option to apply the 35% withholding rate for the $100,000 above the mandatory withholding threshold.

Alternatively, if Joe did not have any amounts withheld from regular wages in 2006 and no amounts were withheld from regular wages in 2007 (e.g., Joe earned no regular wages in 2006 and in 2007), the employer would not have the option of applying the optional flat rate of withholding on the first $1 million in supplemental wage payments in 2007. Therefore, the first $1 million would be subject to the withholding allowances claimed by Joe on Form W-4, "Employee's Withholding Allowance Certificate," and the employer must apply the regular income tax withholding rules and not a flat percentage rate on the first $1 million. However, the employer must still apply the 35% rate for mandatory withholding in 2007 for the $100,000 above the mandatory withholding threshold.

**New Special Rules**

One area of concern prior to the final regulations involved the treatment of salary reduction deferrals by employees (such as deferrals of wages into 401(k) plans and the like). The final regulations provide that employers are not permitted to treat commissions, third-party sick pay paid by agents, bonuses, or taxable non-cash fringe benefits as regular wages. These special rules were adopted by the IRS to permit employers and the IRS to continue applying long-standing business practices and regulations.

An employer cannot take into account offsetting income tax credits or offsetting income tax deductions of employees when applying the mandatory supplemental wage withholding rules. As a result, the mandatory supplemental wage withholding rate applies regardless of an employee's personal income tax liability.

**Simplification for Employers**

The final regulations provide employers with alternatives that are intended to simplify compliance with the new mandatory supplemental wage withholding rules, especially separate tracking that may be required for employees who receive payments of supplemental wages over $1 million. For example, the regulations permit employers to:

- Determine whether an employee has received $1 million of supplemental wages during a calendar year by including in supplemental wages amounts includible in income, but not subject to withholding, that are reported as wages, tips, or other compensation on IRS Form W-2.

- Treat the entire amount of the payment that results in total supplemental wages exceeding $1 million as subject to mandatory flat-rate withholding.

The final regulations also provide a safe-harbor rule for certain payments by agents of an employer. If any agent of an employer makes total wage payments (including regular and supplemental wages) of less than $100,000 to an individual during any calendar year, an employer or other agent may disregard such payments in determining whether the individual has received $1 million of supplemental wages during the calendar year supplemental wages paid by the employer or any other agent of the employer. Additionally, the agent need not consider whether the individual has received other supplemental wages. However, employers will not be allowed to use this exception if the employer is making payments using five or more agents and a principal effect of using agents is to reduce the application of mandatory flat-rate withholding.

For more information on how the final Jobs Act regulations may affect your company, please contact David Thomas, Cisco Palago-Ricketts, or any other member of the firm's Employee Benefits & Compensation practice.

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