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Federal Tax Coordinator 2d

Chapter H-3590 Compensation—Part II

H-4530 Withholding on Supplemental Wage Payments.

H-4542 Mandatory (increased) flat-rate withholding for supplemental wages in excess of \$1 million.


Federal Tax Coordinator 2d


¶H-4542. Mandatory (increased) flat-rate withholding for supplemental wages in excess of \$1 million.

Employers may withhold on supplemental wage payments (e.g., bonuses, commissions, overtime pay, see ¶ H-4531) under the aggregation method (see ¶ H-4540) or, if tax has been withheld from regular wages, under the optional flat-rate method (see ¶ H-4541), see ¶ H-4539.

Notwithstanding the above rule,¹⁹ if a supplemental wage payment that any one employer (see ¶ H-4543)²⁰ makes to an employee, when added to all supplemental wage payments previously made by the employer to the employee during the calendar year, exceeds \$1 million, the rate used in determining the amount of withholding on the excess (including any excess which is a portion of a supplemental wage payment, see ¶ H-4542.1) is the maximum rate of tax in effect under Code Sec. 1 (see below) for tax years beginning in that calendar year.²¹ (For tax years 2003 through 2012, the "maximum rate of tax in effect under Code Sec. 1" is 35%, see Tables & Rates ¶ TBL-1001 and ¶ A-1102; for tax years after 2012, unless there's further action by Congress, reductions to the Code Sec. 1 rates sunset and those rates revert to pre-EGTRRA levels, i.e., if the rate reductions sunset, the maximum rate in effect under Code Sec. 1 is 39.6%, see ¶ A-1102.)


In other words, the use of the flat-rate method of withholding is mandatory—and at the highest tax rate in effect—for supplemental wage payments in excess of \$1 million received by an employee from an employer in a calendar year.²² Thus, once the supplemental wage payments that an employer pays to an employee during a calendar year exceed \$1 million, any additional supplemental wages paid to the employee in that year are subject to withholding at the highest income tax rate.²³

 **RIA observation:** Thus, the employer must use the flat-rate method to withhold on the supplemental wages in excess of \$1 million, and must withhold at an increased rate rather than at the rate prescribed under the optional flat-rate method (see ¶ H-4541). The aggregation method (see ¶ H-4540) can't be used.

 **RIA observation:** The increased mandatory flat rate withholding rate, and the bar on using the aggregation method, only come into play when the employee's cumulative supplemental wages from the employer exceed \$1 million during the year. The employer may use the "regular" lower (25% for 2003-2012) rate (if the optional flat-rate method is otherwise available,


see ¶ H-4541), or the aggregation method, to withhold on the first \$1 million of supplemental wages paid to the employee.


A supplemental wage payment that exceeds the \$1 million threshold is treated as consisting of two components—(1) \$1 million, and (2) the excess over \$1 million. Separate withholding calculations are made for each of the two components.²⁴


 **RIA observation:** A supplemental wage payment doesn't have to be more than \$1 million to trigger mandatory flat-rate withholding. The mandatory flat-rate method applies to:


... a supplemental wage payment in excess of \$1 million (see below), and

... a supplemental wage payment of \$1 million or less that brings the employee's total supplemental wages for the year over the \$1 million threshold (see ¶ H-4542.1).

 **RIA illustration 1:** Company plans to pay a \$1.5 million bonus to its President in 2011. Company has withheld income tax from the regular wages it paid President during the year. Company may use either the aggregation method or the optional flat rate-method to withhold on the first \$1 million. Company must use the flat-rate method, and the increased 35% rate, for the excess over \$1 million (\$500,000 [\$1.5 million – \$1 million]).

 **RIA observation:** If a particular supplemental wage payment is more than \$1 million, the employer can use the aggregation method or the optional flat-rate withholding method (assuming those methods are otherwise permitted) to withhold on the first \$1 million of the payment. The employer must use mandatory flat-rate withholding (i.e., withholding at the highest income tax rate under Code Sec. 1 in effect for the year) for the portion of the payment in excess of \$1 million.

 **RIA illustration 2:** Assume the facts in *RIA Illustration (1)*. Company elects to use the optional flat-rate method of withholding for the first \$1 million of the \$1.5 million bonus paid to President. Company must withhold a total of \$425,000 (\$250,000 [25% \$1 million] + \$175,000 [35% \$500,000]) from President's \$1.5 million bonus, for federal income tax purposes.


 **RIA illustration 3:** Assume that the \$1.5 million bonus in *RIA Illustration (2)* is paid in two 2011 payments: \$750,000 paid on June 15 and \$750,000 paid on Dec. 15. Company must withhold \$187,500 (25% \$750,000) from the June 15 payment and \$237,500 (\$62,500 [25% \$250,000] + \$175,000 [35% \$500,000]) from the Dec. 15 payment. The total withholding—\$425,000—is the same as if the bonus were paid in one payment, as in *RIA Illustration (2)*.

The amount of regular wages the employee receives from the employer is irrelevant in determining whether mandatory flat rate withholding applies to the employee's supplemental wages.²⁵


However, to apply mandatory flat-rate withholding on a consistent basis, payments of wages must be correctly identified as either regular wages or supplemental wages.²⁶

For rules for determining whether supplemental wages paid to an employee during the year exceed the \$1 million threshold, see ¶ H-4543.


The employer must use the highest marginal rate (35% for 2003-2012) on the supplemental wages in excess of \$1 million for the year, regardless of any other withholding rules (and regardless of the employee's Form W-4, see below).²⁸

 **RIA observation:** The employer must begin using the mandatory flat-rate withholding rate on the first supplemental wage payment that brings the employee's total supplemental wages for the year over the \$1 million threshold. That rate (35% for 2003-2012) *must* be used on the portion of the payment that brought the total over \$1 million, but the employer *may* use it for the entire payment (see ¶ H-4542.1).


The mandatory flat rate method applies without regard to whether income tax has been withheld from the employee's regular wages.²⁹

 **RIA observation:** The *optional* flat-rate method is available for supplemental wage payments only if income tax has been withheld from regular wages (see ¶ H-4541).

The mandatory flat rate method is applied without regard to the withholding method used by the employer.³⁰

 **RIA observation:** Thus, if the employee's supplemental wages are over \$1 million, the employer must use mandatory flat-rate withholding for the excess. It makes no difference which method the employer uses for the employee's regular wages, or for the first \$1 million of his supplemental wages.

The mandatory flat rate method is applied without allowance for the number of withholding allowances claimed by the employee on Form W-4, and without regard to whether the employee has requested additional withholding on Form W-4.³¹


 **RIA observation:** This means that tax is withheld from the employee's excess supplemental wages at the highest marginal tax rate under Code Sec. 1(35% for 2003-2012), even if the withholding on the employee's regular wages takes into account allowances for exemptions. This corresponds to the rules for the *optional* flat-rate method; the optional supplement wage withholding rate (25% for 2003-2012) that applies to the first \$1 million of supplemental wages also doesn't take the employee's exemptions or regular wage payments into account (see ¶ H-4541).

Further, the mandatory flat rate method is applied without regard to whether the employee has claimed exempt status (i.e., exemption from withholding, see ¶ H-4526) on Form W-4.³²

In other words, the mandatory flat-rate withholding rule overrides the withholding that would apply under the employee's elections on Form W-4.³³ That is, the employer must use the highest marginal rate under on the supplemental wages in excess of \$1 million regardless of the employee's Form W-4.³⁴

Because the mandatory flat-rate requirement applies only to the excess of supplemental wages over \$1 million received by an employee from an employer, it can apply to a full payment or only a portion of a payment. Thus, it can result in an employer having to treat two portions of a single supplemental wage payment under different withholding regimes.³⁵ For further discussion, see ¶ H-4542.1.

The purpose of the mandatory flat-rate withholding rule is to impose income tax withholding on a basis that is more consistent with income tax liability.³⁶ Because most employees who receive annual supplemental wage payments in excess of \$1 million will ultimately be taxed at the highest marginal rate under Code Sec. 1, it is appropriate to impose an increased withholding rate on those payments so that withholding more closely approximates the ultimate tax liability with respect to these payments.³⁷

 **RIA observation:** Although the increased mandatory flat withholding rate (35% for 2003-2012) for the “excess” supplemental wage payments means that the employee receives less than he would have if tax were withheld at the “regular” optional flat withholding rate (25% for 2003-2012), the increased withholding rate may enable the employee to avoid having to pay estimated tax (see ¶ S-5201 et seq.) or penalties for estimated tax underpayments (see ¶ S-5260).

IRS may provide by publication in the Internal Revenue Bulletin (IRB) for alternative withholding methods that will allow an employer to meet its responsibility for the required mandatory flat-rate withholding.³⁸

The increased rate of withholding for supplemental wage payments in excess of \$1 million applies only for purposes of wage withholding; other types of withholding (such as pension withholding and backup withholding) aren't affected.³⁹

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Sec. 904(b)(1), PL 108-357, 10/22/2004.

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Reg § 31.3402(g)-1(a)(2).

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Sec. 904(b)(1), PL 108-357, 10/22/2004; Reg § 31.3402(g)-1(a)(2).

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Preamble to TD 9276, 7/24/2006

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Conf Rept No. 108-755 (PL 108-357) p. 772.

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Reg § 31.3402(g)-1(a)(8), Ex 1(iii).

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Reg § 31.3402(g)-1(a)(8), Ex 3(iii).

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Preamble to TD 9276, 7/24/2006.

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Conf Rept No. 108-755 (PL 108-357) p. 772.

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Reg § 31.3402(g)-1(a)(2).

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Reg § 31.3402(g)-1(a)(2).

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Reg § 31.3402(g)-1(a)(2).

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Reg § 31.3402(g)-1(a)(2).

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Preamble to TD 9276, 7/24/2006.

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Conf Rept No. 108-755 (PL 108-357) p. 772.

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Preamble to TD 9276, 7/24/2006.

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Preamble to TD 9276, 7/24/2006.

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Conf Rept No. 108-755 (PL 108-357) p. 772.

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Reg § 31.3402(g)-1(a)(10).

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Conf Rept No. 108-755 (PL 108-357) p. 772.

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