

Rev. Rul. 2008–29

ISSUE

How does an employer determine the amount of income tax required to be withheld under section 3402 of the Internal Revenue Code with respect to certain supplemental wages the employer pays to an employee.

FACTS

In this revenue ruling nine different situations are described:

- (1) commissions paid at fixed intervals with no regular wages paid to the employee;
- (2) commissions paid at fixed intervals in addition to regular wages paid at different intervals;
- (3) draws paid in connection with commissions;
- (4) commissions paid to the employee only when the accumulated commission credit of the employee reaches a specific numerical threshold;
- (5) a signing bonus paid prior to the commencement of employment;
- (6) severance pay paid after the termination of employment;
- (7) lump sum payments of accumulated annual leave;
- (8) annual payments of vacation and sick leave; and
- (9) sick pay paid at a different rate than regular pay.

In these situations, it is assumed, for income tax and income tax withholding purposes, that there is no constructive receipt or constructive payment of wages before the actual payment of wages, that no amounts are required to be included in income under section 409A before the actual payment of wages, and that all payments are made on or after January 1, 2007. Except for Employee F in Situation 5, none of the employees below is paid more than \$1,000,000 of supplemental wages during any calendar year.

Situation 1. Employee A works as a salesperson for employer X. During A's career as an employee with X, X has paid A only commissions as compensation for services. X pays the commissions credited to A on a monthly basis.

Situation 2. Employee B works as a salesperson for employer Y. Y pays B a monthly salary of \$10,000, which it pays on the first business day of the month. In addition to the salary, Y pays B a commission equal to 5 percent of sales. Y pays the amount of accumulated commissions to B each Monday unless the Monday is a federal holiday, in which case the amount is paid on the next business day. Y withholds income tax from the monthly salary paid to B.

Situation 3. Employee C works as a salesperson for employer Z. Under C's employment arrangement, Z pays a \$5,000 draw to C on a semimonthly basis. Together with the second \$5,000 draw payment for a month, Z pays C the amount of commissions credited to him less the total amount of draws (\$10,000) that Z pays C during that month. If C's draws exceed the amount of commissions earned by C during that month, Z reduces the amount of the draws paid to C during the next month. If C terminates employment with Z, he is obligated to repay any draws received in excess of commissions earned. C receives no wage payments other than the semimonthly draw payments and the monthly commission payments.

Situation 4. Employee D has worked as a salesperson for employer M for a number of years, and has been compensated solely by commission. M pays D the commissions credited to D whenever her accumulated net commissions equal \$1,000 or more. On January 13, D has \$1,350 in accumulated commissions. This is the first day of the year the amount of commissions credited to her has equaled or exceeded \$1,000, and M pays the full accumulated amount (\$1,350) to D on January 14. This payment is the first payment of wages to D for the calendar year. D has \$2,125 in accumulated commissions credited to her account on January 31, which is the next day in the calendar year that the amount of commissions credited to her has exceeded \$1,000. M pays the full amount of accumulated commissions (\$2,125) on February 1. This payment is the second payment of wages to D for the calendar year.

Situation 5. Under an employment contract entered into on May 1 of Year 1, Employee F is scheduled to begin performing services for employer P on October 1 of Year 1. F will receive regular wages of \$75,000 per month for his services as an employee of P, and will have a monthly payroll period. On June 1 of Year 1, P pays F \$2,100,000 as a bonus for signing the employment contract. F has received no wage payments in any year from P prior to the payment on June 1 of Year 1. F has received no wage payments from agents of P or any other person treated as the same employer as P under § 31.3402(g)–1(a)(3)(i) of the Employment Tax Regulations.

Situation 6. Employee G performs services for employer S, which has a severance pay plan for its employees. The plan provides that, generally, if an employee is involuntarily terminated, the employee will receive weekly severance pay equal to his or her ending regular weekly pay. The severance pay will continue after termination for the number of weeks that is equal to the number of full years the employee performed services as an employee for the employer multiplied by 3. G is involuntarily terminated by S on June 30 of Year 1, after G has performed services as an employee of S for 17 years. Thus, G will receive 51 weeks of severance pay, which will be paid weekly starting in July of Year 1 and continuing into Year 2.

Situation 7. In general, Civil Service employees of the Federal Government earn specified hours of annual leave each 80-hour biweekly pay period, depending on the length of the employee's service. Employees, under usual circumstances, are permitted to accumulate earned but unused annual leave from year to year, up to a specified maximum number of hours. When an employee leaves the service of the Federal Government, the employee receives his or her final payment of regular wages and, either in the same check or in a separate check, receives payment for any unused accumulated annual leave, computed at the employee's former regular pay rate. The terminating employee receives a report from the agency for which the employee works, or the agency's designated agent, specifying the amount of the payment of the accumulated annual leave. Federal agency T pays Employee H a lump sum payment for unused accumulated annual leave upon H's termination of employment.

Situation 8. Employer U maintains a plan that pays its employees at the end of approximately each 12-month period a lump sum payment known as a vacation and sick leave allowance. An employee receives this payment whether or not he or she has been absent from work because of vacation or illness. However, in the event of absenteeism because of vacation or illness, the employee receives no regular pay for the period of absence. U makes a lump sum payment under the plan to employee J.

Situation 9. Employer V pays its employees at one rate when the employee is present and working and at another rate when the employee is absent because of sickness. The employer maintains payroll records that separately state the amount of wages paid for working days and the amount of wages paid for sick pay. V makes a single payment of wages to employee K for a payroll period, and the payment includes an amount for working days and an amount for sick pay.

LAW AND ANALYSIS

Section 31.3402(g)–1(a) of the regulations, as amended by T.D. 9276, 2006–2 C.B. 423, provides rules for determining whether wages paid to an employee are regular wages or supplemental wages. The amendments to the regulations are effective with respect to wages paid on or after January 1, 2007. Whether wages are classified as regular wages or supplemental wages may have significance in determining the amount of income tax required to be withheld.

Section 31.3402(g)–1(a)(1)(i) of the regulations provides that supplemental wages are all wages paid by an employer that are not regular wages. Supplemental wages include wage payments made without regard to an employee's payroll period, but also may include payments made for a payroll period. The regulations provide many examples of supplemental wages including commissions, bonuses, nonqualified deferred compensation includible in wages, and back pay. The regulations also provide that amounts that are described as supplemental wages in the definition in the regulations are supplemental wages regardless of whether the employer has paid the employee any regular wages during either the calendar year of the payment or any prior calendar year.

Section 31.3402(g)–1(a)(1)(ii) of the regulations provides that, as distinguished from supplemental wages, regular wages are amounts that are paid at a regular 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.

Section 31.3402(g)–1(a)(2) of the regulations provides that if a supplemental wage payment, when added to all supplemental wage payments previously made by one employer (as defined under the regulations) to an employee during the calendar year, exceeds \$1,000,000, the rate used in determining the amount of withholding on the excess (including any excess which is a portion of a supplemental wage payment) shall be equal to the highest rate of tax applicable under section 1 of the Code for such taxable years beginning in such calendar year. This flat rate shall be applied without regard to whether income tax has been withheld from the employee's regular wages, without allowance for the number of withholding allowances claimed by the employee on Form W–4, "Employee's Withholding Allowance Certificate," without regard to whether the employee has claimed exempt status on Form W–4, without regard to whether the employee has requested additional withholding on Form W–4, and without regard to the withholding method used by the employer. Withholding under § 31.3402(g)–1(a)(2) is referred to as mandatory flat rate withholding.

If the supplemental wages paid to an employee by an employer (as defined in the regulations) during a calendar year do not exceed \$1,000,000, then the amount of income tax withholding is determined under the rules provided in § 31.3402(g)–1(a)(6) and (7). These paragraphs describe two procedures for withholding on supplemental wages: the aggregate procedure and optional flat rate withholding.

An employer applies the aggregate procedure described in § 31.3402(g)–1(a)(6) by using the withholding tables applicable to the payroll period with respect to which the employer is calculating the income tax withholding liability on the supplemental wages. The supplemental wages, if paid concurrently with wages for a payroll period, are aggregated with the wages paid for such payroll period. If not paid concurrently, the supplemental wages are aggregated with the wages paid or to be paid within the same calendar year for the last preceding payroll period or for the current payroll period, if any. The amount of tax to be withheld is determined as if the aggregate of the supplemental wages and the regular wages constituted a single wage payment for the regular payroll period.

The aggregate procedure can be used to determine the amount of income tax to be withheld with respect to any payment of supplemental wages, except to the extent that mandatory flat rate withholding applies. See § 31.3402(g)–1(a)(6) of the regulations. However, optional flat rate withholding may only be used under certain conditions.

Under § 31.3402(g)–1(a)(7)(i) of the regulations, an employer must meet the following conditions at the time of payment to use optional flat rate withholding with respect to a supplemental wage payment or portion of a payment:

- (A) The wage payment or portion of the payment is not subject to mandatory flat rate withholding under § 31.3402(g)–1(a)(2) of the regulations;
- (B) The supplemental wages are either not paid concurrently with regular wages or are separately stated on the payroll records of the employer; and
- (C) Income tax has been withheld from regular wages of the employee during the calendar year of the payment of the supplemental wages or the preceding calendar year.

In determining the amount of income tax withholding applicable under the aggregate procedure, it is necessary to determine the payroll period of the employee so that the correct withholding table can be applied. Withholding tables are updated each year and are found in Publication 15, (Circular E), Employer's Tax Guide.

Section 31.3401(b)–1(a) of the regulations provides that the term "payroll period" means the period of service for which a payment of wages is ordinarily made to an employee by his or her employer. It is immaterial that the wages are not always paid at regular intervals.

Section 31.3401(b)–1(b) of the regulations provides that for purposes of section 3402, an employee can have only one payroll period with respect to wages paid by any one employer. Thus, if an employee is paid a regular wage for a weekly payroll period and in addition thereto is paid supplemental wages (for example, bonuses) determined with respect to a different period, the payroll period is the weekly payroll period.

Section 31.3401(b)–1(d) of the regulations provides that the term “miscellaneous payroll period” means a payroll period other than a daily, weekly, biweekly, semimonthly, monthly, quarterly, semiannual, or annual payroll period.

Employers may elect to use either the percentage method of withholding or the wage bracket method of withholding in withholding on regular wages of an employee. In applying the aggregate procedure applicable to supplemental wages, the employer will ordinarily apply the method of withholding used with respect to regular wages if the employer pays regular wages to the employee. Section 31.3402(b)–1 of the regulations provides that the amount of tax to be deducted and withheld under the percentage method of withholding shall be determined under the applicable percentage method of withholding table contained in Publication 15, according to the instructions contained therein. Similarly, § 31.3402(c)–1(a)(1) of the regulations provides that the correct amount of withholding under the wage bracket method shall be determined under the applicable wage bracket withholding table contained in Publication 15 issued for use with respect to the period in which such wages are paid.

Section 3402(c)(3) and § 31.3402(c)–1(c)(3) of the regulations provide, with respect to wage bracket withholding, that if wages are paid to an employee without regard to any particular period, as, for example, commissions paid to a salesperson upon consummation of a sale, the amount of tax to be deducted and withheld shall be determined in the same manner as in the case of a miscellaneous payroll period containing a number of days (including Saturdays, Sundays, and holidays) equal to the number of days (including Saturdays, Sundays, and holidays) which have elapsed beginning with the latest of the following days:

- (i) The first day after the last payment of wages to such employee by such employer in the calendar year, or
- (ii) The date on which such individual’s employment with such employer began in the calendar year, or
- (iii) January 1 of such calendar year, and ending with (and including) the date on which such wages are paid.

Situation 1. Section 31.3402(g)–1(a)(1)(i) of the regulations specifically includes commissions as an example of supplemental wages. Amounts included as supplemental wages under the definition in the regulations are supplemental wages regardless of whether the employer has paid the employee any regular wages during either the calendar year of the payment or any prior calendar year. Because the commission payments are supplemental wages, X has paid A only supplemental wages and no regular wages. An employer determines income tax withholding on a payment of supplemental wages under either the aggregate procedure or optional flat rate withholding. X may not use the optional flat rate method with respect to the wages paid to A because one of the three requirements set forth in § 31.3402(g)–1(a)(7)(i) has not been met. X has not withheld income tax from regular wages paid to A during the calendar year or the preceding calendar year. Therefore, X must use the aggregate procedure to determine the amount of income tax withholding on the commissions paid to A.

The payroll period of any particular employee is the period of service for which a payment of wages is ordinarily made to an employee by the employer. See § 31.3401(b)–1(a). A receives no regular wages; therefore, the payroll period cannot be determined with respect to regular wage payments made by X but is determined by the period of service for which the payments of supplemental wages are ordinarily paid by X to A. Because X makes payments of the commissions to A on a monthly basis, A has a monthly payroll period. Therefore, X determines withholding on the commissions by using the applicable table for a monthly payroll period found in Publication 15.

Situation 2. Y is paying B both regular wages (the salary) and supplemental wages (the commissions). Because the regular wages are paid on a monthly basis, B has a monthly payroll period. The frequency of payment of the supplemental wages has no effect on the determination of B’s payroll period because B receives periodic regular wage payments during the calendar year.

Y may use either the aggregate procedure or optional flat rate withholding to determine income tax withholding on the commissions paid to B. Under the facts here, Y did not pay the supplemental wages concurrently with the wages for the payroll period. Therefore, if Y uses the aggregate procedure, Y may include, in the calculation of the aggregate of regular wages and supplemental wages, the regular wage payments for either the current or the last preceding payroll period. In calculating the aggregate wages, the employer would also include any other supplemental wage payments made for such payroll period. Thus, for example, in determining the correct withholding on the fourth commission payment during a month under the aggregate procedure, Y needs to aggregate regular wages paid for the payroll period plus the three prior commission payments for the payroll period (and any other supplemental wage payments paid for that payroll period) and then apply the applicable monthly payroll table in Publication 15. Because Y has withheld income tax from regular wages paid to B, Y may also use optional flat rate withholding to determine the amount of withholding on the supplemental wage payments to B.

Situation 3. Under this wage structure, the draws represent payments of commissions that are supplemental wages. The draws are debited against commissions, and the employer reduces the amount of the draws if they exceed commissions. Thus, the payment of the draw is a payment of commissions and not a payment of salary, and constitutes supplemental wages not regular wages. Therefore, Z is paying only supplemental wages to C, and, as in situation 1, the employer must use the aggregate procedure in determining the amount of withholding on the payments of wages to the employee. Because Z ordinarily pays C her supplemental wages on a semimonthly basis, C has a semimonthly payroll period. Thus, Z should use the applicable semimonthly withholding table in Publication 15 in determining withholding on payments to C.

Situation 4. Under the facts of this situation, D is receiving only supplemental wages, and thus M must use the aggregate procedure in determining income tax withholding required under section 3402. However, the wages are not paid at regular intervals. Because the wages are not paid based on a period of service, but on some other basis (i.e., the date the amount of unpaid commissions credited to the employee equals or exceeds \$1,000), the income tax withheld from the wages paid to D is based on the rules applicable to wages paid without regard to any period provided in § 31.3402(c)-1(c)(3) or Publication 15. Under these rules, the income tax to be withheld is determined based on the applicable table for a miscellaneous payroll period. The first payment to the employee is treated as a payment for a miscellaneous payroll period of 15 days, and the employer determines the income tax withholding based on that period. The 15 days is derived from a beginning date of January 1, which is the latest of (a) the first day after the last payment of wages to such employee by such employer in the calendar year, (b) the date on which the employee began employment with such employer in the calendar year, and (c) January 1 of the calendar year, and an ending date of January 15, the date on which the wages were paid. Similarly, the withholding on the second wage payment is determined based on a miscellaneous payroll period of 17 days, from January 16 (the day after the last payment of wages) to February 1, the date on which the wages were paid.

Situation 5. The bonus payment on June 1 of Year 1 is supplemental wages. See Rev. Rul. 2004-109, 2004-2 C.B. 958, and § 31.3402(g)-1(a)(1). To the extent the bonus exceeds \$1,000,000, P is required to apply mandatory flat rate withholding under § 31.3402(g)-1(a)(2) because the supplemental wages paid to F by P exceed \$1,000,000 for the calendar year. Thus, P is required to apply mandatory flat rate withholding with respect to \$1,100,000 of the bonus.

With respect to the first \$1,000,000 portion of the signing bonus, P has the choice of either applying the aggregate procedure or treating the amount as subject to mandatory flat rate withholding. See § 31.3402(g)-1(a)(4)(iv) of the regulations, which provides that, in the case of a supplemental wage payment that, when added to all supplemental wage payments previously made by the employer to the employee in the calendar year, results in the employee having received in excess of \$1,000,000 supplemental wages for the calendar year, the employer may subject the entire amount of such supplemental wage payment to mandatory flat rate withholding. If P uses the aggregate procedure, the payroll period to be applied with respect to determining the amount of income tax to be withheld on the first \$1,000,000 portion of the bonus is the monthly payroll period, because the regular wage payments to be paid to F during the calendar year are scheduled to be paid on a monthly basis. P may not use optional flat rate withholding to determine income tax withholding on F's signing bonus because at the time the bonus is paid P has not withheld income tax from regular wages paid during

year 1 or the preceding year.

Situation 6. Severance pay is supplemental wages because it is not a payment for services in the current payroll period but a payment made upon or after termination of employment for an employment relationship that has terminated. Thus, although the payments in this situation are for a fixed determinable amount for 51 weeks, they are not fixed payments for the current payroll period and thus are not regular wages.

Because the severance pay is supplemental wages, the usual rules for determining income tax withholding with respect to supplemental wages apply. S can use the aggregate procedure to determine withholding on the payments. Alternatively, if S has withheld income tax on regular wages paid to G in Year 1, S can use optional flat rate withholding to determine the withholding with respect to the supplemental wage payments in Year 1 and Year 2.

Situation 7. The lump sum payment of accumulated annual leave is a supplemental wage payment, because it is not a payment at a regular rate for the current payroll period. T can use the aggregate procedure in determining income tax withholding with respect to the amount of the accumulated annual leave payment. T separately states the amount of the supplemental wages on its payroll records. Thus, if T has withheld income tax from regular wages paid to H during the calendar year or the preceding calendar year, T can use optional flat rate withholding to determine the withholding with respect to the supplemental wage payment.

Situation 8. The annual payment of the vacation and sick leave allowance is a supplemental wage payment, because it is not a payment at a regular rate for the current payroll period. U can use the aggregate procedure to determine the income tax withholding with respect to the leave allowance payment. The supplemental wages are not paid concurrently with regular wages, and thus U meets one of the requirements for use of optional flat rate withholding, that the supplemental wage payment must be either not paid concurrently with regular wages or separately stated on the payroll records of the employer. If U has withheld income tax from regular wages paid to J during the calendar year or the preceding calendar year, U can use optional flat rate withholding to determine the withholding on the leave allowance payment.

Situation 9. The portion of the wage payment for sick days is supplemental wages, because the sick pay is paid at a different rate than the regular wages paid the employee. V can use the aggregate procedure to determine withholding with respect to the sick pay. V separately states the amount of the sick pay on its payroll records. Thus, if V has withheld income tax from regular wages paid to K during the calendar year or the preceding calendar year, V can use optional flat rate withholding to determine the withholding on the sick pay.

HOLDINGS

Situation 1. X must use the aggregate procedure described in § 31.3402(g)–1(a)(6) in determining the amount of income tax withholding on the payments of commissions to A. Because the supplemental wages are ordinarily paid for a monthly period of service, X should use the applicable withholding table for a monthly payroll period found in Publication 15 in applying the aggregate procedure.

Situation 2. Y is permitted to use either optional flat rate withholding or the aggregate procedure. If Y is applying the aggregate procedure, Y must aggregate all wages paid to B for the monthly payroll period, including all payments of supplemental wages for that payroll period.

Situation 3. The payments of the draws are supplemental wages. Therefore, Z is paying only supplemental wages to C, and, as in Situation 1, Z must use the aggregate procedure in determining the amount of withholding on the wages paid to C.

Situation 4. M is required to use the aggregate procedure in determining the amount of income tax to be withheld. Furthermore, because D is paid supplemental wages without regard to any particular period of service, income tax withholding on the payments of the supplemental wages is determined under the rules applicable for wages paid without regard to any period under § 31.3402(c)–1(c)(3), if the employer is using the wage bracket method, or under Publication 15, if the employer is using the percentage method of withholding.

Situation 5. The signing bonus is a supplemental wage payment. To the extent the signing bonus exceeds \$1,000,000, P is required to apply mandatory flat rate withholding under § 31.3402(g)–1(a)(2) because F will have received in excess of \$1,000,000 in supplemental wages from P during the calendar year. Thus, \$1,100,000 of the signing bonus is subject to mandatory flat rate withholding. In determining the payroll period applicable with respect to the payment of the signing bonus, P uses the payroll period for which regular wages will be paid the employee. With respect to the first \$1,000,000 of the bonus, P may either treat the amount as subject to mandatory flat rate withholding or withhold using the aggregate procedure based on a monthly payroll period.

Situation 6. The severance pay paid to G is supplemental wages. Therefore, S should withhold on the payments under the rules applicable in determining withholding on supplemental wages.

Situation 7. The lump sum annual leave payment is a supplemental wage payment. Therefore, T should withhold on the payment under the rules applicable in determining withholding on supplemental wages.

Situation 8. The lump sum annual payment for vacation and sick leave is a supplemental wage payment. Therefore, U should withhold on the payment under the rules applicable in determining withholding on supplemental wages.

Situation 9. The amount paid for sick pay is supplemental wages. Therefore, V should withhold on the payment under the rules applicable in determining withholding on supplemental wages.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 67–131, 1967–1 C.B. 291, and Rev. Rul. 66–294, 1966–2 C.B. 459, are obsolete. This revenue ruling and § 31.3402(g)–1(a) of the regulations, as amended by T.D. 9276, provide rules with respect to the types of payments described in Rev. Rul. 66–294 and Rev. Rul. 67–131.

DRAFTING INFORMATION

The principal author of this revenue ruling is Alfred G. Kelley of the Office of Associate Chief Counsel (Tax Exempt & Government Entities). For further information regarding this revenue ruling, contact Mr. Kelley at (202) 622–6040 (not a toll-free call).