



# Nonqualified Plan Distributions

## Mapping Out Your Tax Withholding Method

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*Employers and payroll providers frequently ask how to withhold federal income taxes on nonqualified plan distributions. With recent changes to federal tax regulations, deciding on an appropriate withholding method can be complicated.*

The following information addresses the newest guidelines and provides a road map for those questioning their tax withholding methods.

### Out with the old

Over the last half decade, numerous modifications were made to the laws that govern taxable income. The American Jobs Creation Act of 2004 (AJCA) changed the way employers withhold federal income tax on supplemental wages. In 2005, proposed regulations under Sections 3401 and 3402 of the Internal Revenue Code were issued. In July 2006, the U.S. Department of Treasury and the Internal Revenue Service released Treasury Decision 9276 (T. D. 9276), which amended the proposed regulations and implemented the AJCA withholding provisions, thereby affecting wages paid on or after January 1, 2007. Considering the abundance of recent modifications, it is not surprising that some confusion lingers in this altered tax environment.

### Regular vs. supplemental wages

Wages can be broken down into two categories: regular and supplemental. Regular wages are amounts paid at an hourly, daily or similar periodic rate for the current payroll period or in a predetermined fixed amount. Supplemental wages are generally all other forms of compensation that vary from payroll to payroll period, based on factors other than the amount of time worked. Current regulations specifically provide that distributions from nonqualified deferred compensation plans are supplemental wages.

The way wages are classified (regular or supplemental) plays a role in determining the amount of federal income tax required to be withheld. Section 31.3402(g) – 1(a), as amended by T. D. 9276, provides rules for determining the classification of wages.

### Supplemental wages of \$1,000,000 or less

The final regulations provide that if an employee has not received more than \$1 million of supplemental wages during the calendar year, there are 2 tax-withholding procedures available: (1) the aggregate procedure and (2) the optional flat rate withholding.

Under the aggregate procedure, employers calculate the amount of withholding due by aggregating the amount of supplemental wages with the regular wages paid for the current payroll period (or the most recent payroll period of the year), and treating the aggregate as if it were a single wage payment for the regular payroll period. The amount of tax to be withheld is determined through the same method the employer uses for regular wages. The employer calculates the withholding, taking into consideration the Form W-4 submitted by the employee.

The optional flat rate allows the employer to disregard the amount of regular wages paid to an employee, as well as the withholding allowances claimed by the employee on the W-4, and uses a flat percentage rate specified in the regulations when calculating the amount to withhold. Under 31.3402(g)-1(a)(7)(iii)

(F), the rate applied is a flat percentage under IRC Section 1(i)(2) in effect for the calendar year in which the supplemental wage is paid. For 2010, the flat rate under IRC Section 1(i)(2) is 25%.

The optional flat rate withholding is generally available only when 3 conditions are met:

1. The wage payment, or a portion of the payment, is not subject to mandatory flat rate withholding for supplemental wages in excess of \$1 million under Section 31.3402(g)-1(a)(2) of the regulations.
2. The supplemental wages are not paid concurrently with regular wages or are separately stated on the payroll records of the employer.
3. Income tax has been withheld from the employee's regular wages during the current or preceding calendar year of the payment of supplemental wages.

If the supplemental wage payment qualifies for the optional flat rate, the decision whether to use the optional flat rate rather than the aggregate procedure is made at the employer's discretion.

For example, if an executive is scheduled to retire in October 2010 and will receive a lump sum distribution from a nonqualified deferred compensation plan in April 2011, the employer may elect to withhold federal income taxes under the aggregate or optional flat rate methods. In this case, an employer may choose the optional flat rate withholding (currently 25%) or withhold based on the Form W-4 obtained from the former executive.

Consider yet another example in which an executive retires in March 2010 and is to receive a series of monthly payments from a nonqualified deferred compensation plan beginning in May of that same year. The nonqualified deferred compensation payments qualify for the optional flat rate withholding method since conditions 1, 2 and 3 above are satisfied. The employer may choose to apply either the aggregate or the optional flat rate withholding method for the nonqualified deferred compensation plan payments made during 2010 and 2011. When the nonqualified deferred compensation plan payments begin in 2012, the employer must use the aggregate withholding method because the payments no longer meet the third condition of the optional flat rate method (no income tax has been withheld from regular wages in 2011 or 2012). To avoid changing withholding methods, employers will often opt for the aggregate withholding method for all nonqualified deferred compensation payments.

## *Deciding on a proper tax withholding method does not have to be an overwhelming process.*

### **Supplemental wages in excess of \$1,000,000**

If the sum of payments from a nonqualified deferred compensation plan and all other supplemental wage payments paid to an employee during the calendar year exceeds \$1 million, employers are required to withhold at a flat rate. This is the highest income tax rate under IRC Section 1 in effect for the calendar year in which the supplemental wage payment is made. The current mandatory flat rate in 2010 for supplemental wages exceeding \$1 million is 35%; this will not adjust until income tax rates change.

The flat rate withholding on supplemental wages in excess of \$1 million is applied without regard to whether there has been withholding from the employee's regular wages or withholding allowances on the employee's Form W-4.

### **Breaking it down**

Despite the various changes to tax law, choosing the correct withholding procedure can be easily broken down into the following steps:

- Determine if the wages are regular or supplemental.
- If supplemental wages are involved, an employer must determine if the supplemental wages fall into the category of \$1 million or less, or exceed \$1 million for a calendar year.
- If the supplemental wages are \$1 million or less, the employer must determine if they meet the 3 conditions for the optional flat rate method withholding.
- If the 3 conditions are met, the employer may elect to use either the aggregate or the optional flat rate withholding method.
- If supplemental wages are in excess of \$1 million, an employer is required to withhold income tax at the mandatory flat rate of 35% for 2010.

Deciding on a proper tax withholding method does not have to be an overwhelming process. Even with the recent "construction" to tax law, there are resources available that can help you avoid roadblocks and map out the detours that will get you to an appropriate withholding method. Become familiar with the latest federal regulations so you can make the best tax withholding decisions for your employees.