

## Part I

### Section 3401(h).—Differential Wage Payments to Active Duty Members of the Uniformed Services

(Also §§ 3121(a), 3306(b))

Rev. Rul. 2009-11

#### ISSUES

1. Are differential wage payments made by employers to individuals while on active duty in the uniformed services of the United States for more than 30 days "wages" for purposes of taxation under the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and the Collection of Income Tax at Source on Wages (income tax withholding)?
2. How do employers calculate the amount of income taxes required to be withheld on differential wage payments?
3. What information return reporting requirements apply to differential wage payments?

## FACTS

M, an employer, has employees who are called or voluntarily enlist for active military service in the United States uniformed services (as defined in chapter 43 of title 38, United States Code) for periods exceeding 30 days. M continues making payments to the individuals in an amount equal to the difference between the compensation they receive for their military service and the wages the employees would have received from M if the employees were performing services for M. The payments supplement compensation received by the employees from the Federal government for their military service.

## LAW AND ANALYSIS

### Income Tax Withholding, FICA and FUTA Treatment

Section 3402(a), relating to income tax withholding, generally requires every employer making a payment of wages to deduct and withhold upon those wages a tax determined in accordance with prescribed tables or computational procedures.

Sections 3101 and 3111 impose taxes under the Federal Insurance Contributions Act ("FICA") on employees and employers for wages paid with respect to employment.

Section 3301 imposes tax under the Federal Unemployment Tax Act ("FUTA") on employers on wages paid with respect to employment.

Section 3401(a) defines "wages" for income tax withholding purposes as all remuneration for services performed by an employee for his employer, subject to certain exceptions. Sections 3121(a) and 3306(b) contain similar, but not identical, definitions of wages for FICA and FUTA purposes.

Revenue Ruling 69-136, 1969-1 C.B. 252, addresses the tax treatment of payments made by civilian employers to their employees who are called to or enlist in active military service for an extended time period. The payments are made by the civilian employers during the period of active military service in amounts equal to the difference between the compensation paid by the military and the wages that would have been paid if the individuals were performing services for the civilian employer. The ruling holds that the payments are not wages subject to the taxes imposed by FICA or FUTA or to income tax withholding.

Revenue Ruling 68-238, 1968-1 C.B. 420, addresses the tax treatment of payments made by civilian employers to their employees who are temporarily absent from work while serving in a State National Guard. The payments are equivalent to the difference between the employees' normal wages and the amounts received from the State for their services in the National Guard. The ruling holds that these payments are wages and are subject to FICA and FUTA taxes as well as income tax withholding.

Section 3401(h) was added to the Code by section 105(a) of the Heroes Earnings Assistance and Relief Tax Act of 2008, Pub. L. No. 110-245, 122 Stat. 1624, 1628-630. New subsection 3401(h) provides that, for purposes of income tax withholding, any differential wage payment is to be treated as a payment of wages by the employer to the employee. The term "differential wage payment" means any payment which (A) is made by an employer to an individual with respect to any period during which the individual is performing service in the uniformed services (as defined in chapter 43 of title 38, United States Code) while on active duty for a period of more than

30 days, and (B) represents all or a portion of the wages the individual would have received from the employer if the individual were performing service for the employer. Section 3401(h) applies to differential wage payments paid after December 31, 2008. The enactment of section 3401(h) modifies the holding in Revenue Ruling 69-136 that differential wage payments are not subject to income tax withholding.

The payments made by M to the employees while they are in military service with the United States uniformed services constitute “differential wage payments” under section 3401(h) as these payments represent all or a portion of the wages the individuals would have received if still performing services for M and are made while the individuals are actively serving in the United States uniformed services for a period of duty scheduled to exceed 30 days. These payments are therefore treated as wages for income tax withholding purposes, and M must withhold income taxes on the differential wage payments.

However, because the individuals are scheduled to be on active military duty for an extended period of time, rather than being temporarily absent, the differential wage payments are not wages for purposes of FICA and FUTA taxes. Section 3401(h) does not address the FICA and FUTA treatment of differential wage payments and does not alter the holding in Revenue Ruling 69-136 that differential wage payments do not constitute wages subject to FICA or FUTA taxes. Therefore M is not required to withhold or pay FICA or FUTA tax, with respect to the differential wage payments.

### Supplemental Wage Withholding

Differential wage payments are supplemental wages because they are not a payment for services for the nonmilitary employer in the current payroll period. As a supplemental wage, if the amount of the differential pay, when added to all other supplemental wages paid by the same employer to the employee during the calendar year does not exceed \$1,000,000, then the amount of the income tax withholding is determined under the rules provided in Regulations § 31.3402(g)-1(a)(6) and (7). The two alternative procedures for calculating the amount of income taxes required to be withheld from the differential wage payments are the aggregate procedure and optional flat rate withholding.

Under the aggregate procedure, M adds the differential wage payment to the employee's regular wages, if any, for the payroll period and treats the aggregate of the two as if it constituted a single wage payment for the payroll period. The withholding method used by M with respect to regular wages is then used to calculate the withholding on this single wage payment and M takes into consideration the Form W-4, Employee's Withholding Allowance Certificate, submitted by the employee.

Alternatively, M may determine the income tax withholding on the differential wage payment using optional flat rate withholding, if certain requirements are satisfied. Optional flat rate withholding may be used provided that (1) the differential wage payment is either not paid concurrently with regular wages or is separately stated on the payroll records of the employer, and (2) income tax has been withheld from the regular wages paid to the employee during the calendar year of the differential wage payment

or the preceding calendar year. The rate used for optional flat rate withholding is provided in § 31.3402(g)-1(a)(7)(iii)(F) of the Regulations. For 2009, the rate for optional flat rate withholding is scheduled to be 25 percent, but this rate could change if income tax rates change. The determination of the amount of tax to be withheld under optional flat rate withholding is made without reference to any payment of regular wages, 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.

If the differential wage payment, when added to all supplemental wage payments previously made by M to the employee during the calendar year, exceeds \$1,000,000, § 31.3402(g)-1(a)(2) of the Regulations provides that the rate used in determining the amount of withholding on the excess shall be equal to the highest rate of tax applicable under section 1 of the Code. Under current law, the highest rate of tax applicable under section 1 is 35 percent.

#### Information Return Reporting

Section 6051(a) provides that any person required to deduct and withhold from employees the tax under § 3402, must furnish each employee with a written statement showing the amount of wages paid and amounts withheld for income tax purposes. Section 31.6051-1(a) states that employers must use Form W-2 to fulfill this requirement. Because differential payments are treated as wages subject to income tax withholding, M must report the payments on each employee's Form W-2.

## HOLDINGS

1. Differential wage payments made to an individual while on active duty in the United States uniformed services for more than 30 days are subject to income tax withholding, but are not subject to FICA or FUTA taxes.
2. Employers may use either the aggregate method or optional flat rate withholding to calculate the amount of income tax required to be withheld on differential wage payments which do not exceed \$1,000,000 when added to all other supplemental wages paid by the same employer to the individual during the calendar year.
3. The amounts of the differential wage payments must be reported by the employer on the employee's Form W-2.

## EFFECT ON OTHER REVENUE RULINGS

Revenue Ruling 69-136, 1969-1 C.B. 252 is modified and superseded.

## PROSPECTIVE APPLICATION

This revenue ruling is effective for differential wage payments made after December 31, 2008 (the effective date of § 3401(h) under the Heroes Earnings Assistance and Relief Tax Act of 2008).

## DRAFTING INFORMATION

The principal author of this revenue ruling is Joseph Perera of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt & Government Entities). For

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