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OFFICE OF THE CHIEF COUNSEL

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The Honorable Robert P. Casey, Jr.
United States Senate
Washington, DC 20510

Attention:

Dear Senator Casey:

This letter responds to your inquiry dated August 14, 2012, on behalf of your constituent, . wants the IRS to revise the 25 percent withholding rate on payments made for the benefit of members of the Armed Forces to pay off student loans.

The affected members of the Armed Forces were commissioned with military enlistments including student loan payoff contracts. The contracts provide that the Defense Department will pay part of the original principal of the student loan on each enlistment anniversary. explained the problems military personnel encounter because of the 25 percent withholding rate, including: (1) withholding of income tax in excess of the ultimate income tax liability, (2) underpayment of the principal on the student loan, and (3) additional interest on the loan. He requested that we modify our regulations to permit a 15 percent withholding rate on these payments because he believes the soldiers' income is generally in the 15 percent marginal income tax bracket.

Employers must deduct and withhold income tax from employees' wages (section 3402(a) of the Internal Revenue Code (the Code)). The two types of wages include regular and supplemental wages. The Defense Department's annual payment of the student loan principal is considered supplemental wages and not regular wages. For payments of supplemental wages that do not exceed \$1,000,000 from an employer to an employee in a calendar year, the employer can generally use either the optional 25

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percent flat withholding rate or the aggregate procedure to determine the amount of withholding required.

Your constituent noted that the current Employment Tax Regulations provide for an optional flat withholding rate at 25 percent for supplemental wages paid in 2012. The 25 percent rate in the regulations is the lowest rate the statute allows. Section 904(a) of Public Law 108-357, the American Jobs Creation Act of 2004, provides for the following if an employer uses optional flat rate withholding:

[T]he rate to be used in determining the amount to be ... deducted and withheld shall not be less than 28 percent (or the corresponding rate in effect under section 1(i)(2) of the ..Code ...for taxable years beginning in the calendar year in which the payment is made [25 percent for payments in 2012]).

There is no statutory exception permitting a lower optional flat rate on supplemental wage payments to be set by the IRS. Under current law, the rate is scheduled to increase to 28 percent on January 1, 2013.

Under the aggregate procedure, the employer adds the supplemental wage payments to the employee's regular wages for the current or preceding payroll period and then determines the amount that would be withheld on the total of the regular wages and supplemental wages for the payroll period. The employer applies the graduated withholding tables applicable for that type of payroll period and filing status to determine the withholding on the total regular and supplemental wages. Then the employer subtracts the amount withheld on the regular wages, and the remaining amount is the amount of withholding on the supplemental wages.

For employees receiving a large supplemental wage payment, the aggregate procedure generally will result in withholding on supplemental wages at a rate higher than the employee's withholding rate on regular wages. For example, if an employer pays \$8,000 of supplemental wages in a lump sum to an employee with a semi-monthly payroll period, the withholding determined under the aggregate procedure on the supplemental wages would likely exceed the withholding calculated under the 25 percent rate. Apparently, for that reason, the Defense Department has elected to use the optional flat rate to withhold on these student loan payments.

If employees have income tax withholding on supplemental wages in excess of their anticipated income tax liability for such wages, the employees should claim all the withholding allowances they are entitled to claim with respect to their regular wages. Additional allowances claimed reduce withholding on regular wages and would

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generally reduce the amount of any refund received after filing federal income tax returns.

In summary, Congress has provided that the optional flat withholding rate on supplemental wages paid in 2012 shall not be less than 25 percent. The regulations merely implement the express statutory language by providing for the lowest rate permissible under the statute. As with any one flat rate that is set in the middle of income tax brackets, the resultant withholding will not always correspond to the employee's income tax bracket. However, the statutory language indicates that the optional flat rate cannot be lowered to 15 percent on any supplemental wage payments. A change in the law would require Congressional action.

If you have any questions on this matter, please call either me or _____ of my staff at _____.

Sincerely,

Lynne Camillo
Branch Chief, Employment Tax Branch 2 (Exempt
Organizations/Employment Tax/Government
Entities)
(Tax Exempt & Government Entities)