Internal Revenue Service

Number: **200505004**
Release Date: 2/4/05
Index Number: 3402.06-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:TEGE:EOEG:ET2
PLR-123076-04
Date:
October 18, 2004

Legend:

Taxpayer =
Provision Z =

Dear :

This is in reply to your request for a ruling concerning the federal income tax withholding requirements with respect to payments of lump sum vacation allowances to certain employees of the Taxpayer.

According to the information submitted, the Taxpayer has entered into an agreement with a union that represents certain of its employees. This agreement provides for the accrual and payment of vacation pay. Under this agreement, certain employees accrue vacation pay credit according to the number of hours worked and the length of time spent working in the business. The vacation pay accrued from January 1 of one year through June 30 of the same year is paid in full as a lump sum payment to the employee by July 15 of that year. The vacation pay accrued from July 1 of one year through December 31 of the same year is paid in full as a lump sum payment to the employee by January 15 of the following year. The amount of the vacation payment is not reduced by the vacation time actually taken by an employee during that vacation pay accrual period. The employee receives no other wage payments for periods in which he or she takes time off.

The Union agreement also contains a provision describing the method the corporation is to use when withholding federal income taxes on vacation payments. Provision Z of the Union agreement states that taxes shall be withheld on the vacation payments "…on the basis of the number of weeks of vacation or portion of a week of vacation the accrued vacation pay represents." Under this method, the gross amount of

the vacation payment is divided by the number of weeks or portion of a week of vacation the accrued vacation pay represents, and the withholding on that amount is determined based on the withholding allowances and the appropriate table for a weekly payroll period. Once the weekly withholding amount is determined, it is multiplied by the number of weeks represented by the gross payment to arrive at the total withholding on the vacation payment. In essence, the proposed withholding method on the annual vacation lump sum payment treats the vacation payment as a collection of weekly vacation payments, or regular wage payments, for tax withholding purposes and results in lower overall federal income tax withholding than treating the payment as a wage payment for a single payroll period.

You have asked for four rulings with respect to the proper method for withholding federal income taxes on vacation payments made by the Taxpayer to certain of its employees. The requested rulings will be addressed in turn.

Ruling Request # 1:

Whether the method of withholding Federal income taxes detailed in Provision Z of the Union agreement is an allowable one.

Ruling Request # 2:

Whether the vacation payments made by the Company to its Union employees are considered “wages” for purposes of sections 3402(h)(1), (2), (3) and (4) of the Internal Revenue Code (“the Code”), and sections 31.3402(h)(1)-1, 31.3402(h)(2)-1, 31.3402(h)(3)-1 and 31.3402(h)(4)-1 of the Employment Tax Regulations (“the Regulations”).

Rulings # 1 & # 2:

Section 3401(a) of the Code defines wages as all remuneration for services performed by an employee for his employer, with certain specific exceptions which are not applicable here. The vacation payments are “wages” as that term is defined under section 3401(a) of the Code, and thus are “wages” for purposes of section 3402(h) of the Code and the accompanying regulations. However, the alternative methods of withholding authorized under section 3402(h) of the Code are only allowed when used as comprehensive methods for withholding on all of an employee’s wages. That is, an employer cannot apply the alternative methods authorized under section 3402(h) of the Code and the accompanying regulations to only a portion of an employee’s wages while applying another method to some other portion of the employee’s wages. Section 3402(h)(4) of the Code allows an employer to withhold on wages using any other method that will require the employer to deduct and withhold upon such wages substantially the same amount as would be required to be deducted and withheld by applying subsection (a) or (c) of that section. The maximum permissible deviations for determining whether the amounts deducted and withheld are substantially the same for purposes of section 3402(h)(4) of the Code are detailed in section 31.3402(h)(4)-1(a) of

the Regulations.

Section 31.3402(h)(4)-1(a) of the Regulations cautions that "[a]n employer should thoroughly test any method which he contemplates using to ascertain whether it meets the tolerances prescribed by [section 31.3402(h)(4)-1(a) of the Regulations]." According to our understanding the amounts withheld under the withholding method described in Provision Z of the Union agreement do not meet the maximum permissible deviation standards if compared to the methods for withholding on supplemental wages provided under section 31.3402(g)-1 of the Regulations or if compared to amounts calculated based on a payment for a single payroll period. The withholding method described under the Union agreement is not an allowable one. It is not one of the listed methods (Code section 3402(h)(1) through (3)), and would fail the maximum possible deviation test under section 3402(h)(4).

The Union agreement, in the same provision that details the proposed withholding method, states that the intent of that provision is "that taxes will be withheld at weekly rates rather than the higher rates for a lump sum payment of vacation pay." This is directly contrary to section 31.3402(h)(4)-1(a) of the Regulations, which prohibits an employer from using "any method, one of the principal purposes of which is to consistently produce amounts to be deducted and withheld which are less (though substantially the same) than the amount required to be deducted and withheld by applying section 3402(a)." The withholding method proposed by the Union agreement is not an allowable one under the Code and Regulations.

Requested Ruling # 3:

Whether the vacation pay payments made to the Company's Union employees are supplemental wage payments, and therefore subject to the supplemental wage withholding rules under section 31.3402(g)-1 of the Regulations.

Ruling # 3: The vacation pay payments made to the Company's Union employees are supplemental wage payments. These payments are subject to the withholding rules prescribed by section 31.3402(g)-1 of the Regulations. Section 31.3402(g)-1(c) of the Regulations provides that the amounts of so-called "vacation allowances" shall be subject to withholding as though they were regular wage payments made for the period covered by the vacation. If the vacation allowance is paid in addition to the regular wage payment for such period, the rules applicable with respect to supplemental wage payments shall apply to such vacation allowances.

In Rev.Rul. 66-294, 1966-2 C.B. 459, the Service considered whether certain payments were treated as supplemental wages for federal income tax withholding purposes. In Question 1, employees receive at the end of approximately each 12 months' 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.

The ruling concludes that the lump sum payment is a supplemental wage payment.

The payments in the instant case are similar to the supplemental wage payment described in question 1 of Rev.Rul. 66-294. An employee receives the lump sum vacation allowance payment from the Taxpayer regardless of whether the employee takes vacation. As in the ruling, in the event the employee takes vacation, the employee receives no regular pay for the period of absence. Because the vacation allowance here is paid under similar circumstances as the payments in question 1 of Rev.Rul. 66-294, the vacation allowance payments by the Taxpayer are supplemental wage payments for income tax withholding purposes.

Therefore, we conclude that the vacation allowance payment is a supplemental wage payment.

Requested Ruling # 4:

Guidance as to the appropriate withholding methods available to the Taxpayer for the vacation pay payments.

Ruling # 4:

Section 3402(a) of the Code provides that, except as otherwise provided in section 3402, every employer making payment of wages shall deduct and withhold upon such wages a tax determined in accordance with tables or computational procedures prescribed by the Secretary. Section 3402 specifically provides for the percentage method of withholding and the wage bracket method of withholding.

Section 31.3402(g)-1(a) of the regulations provides that an employee's remuneration may consist of wages paid for a payroll period and supplemental wages, such as bonuses, commissions, and overtime pay, paid for the same or a different period, or without regard to a particular period. When such supplemental wages are paid (whether or not at the same time as the regular wages), the amount of the tax required to be withheld under section 3402(a) (the percentage method) or under section 3402(c) (the wage bracket method) shall be determined in accordance with section 31.3402(g)-1(a) or (b). See also Rev.Rul. 82-200, 1982-2 C.B. 239. If supplemental wages are paid together with regular wages and the amount of each is not specifically indicated, the supplemental wages are aggregated with the regular wages and withholding is determined as if the total were a single payment for a regular payroll period.

If supplemental wages are separately paid from regular wages (or if the amount of the supplemental wages is specifically indicated in a payment combining regular and supplemental payments), two different methods of calculating the amount of income tax withholding on the supplemental wages can be used. See section 31.3402(g)-1(a) of the regulations. Under the first method, 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. The amount of tax is determined as if the aggregate of the supplemental wages and the regular wages constituted a single wage payment for the regular payroll period.

Under the second method of withholding on separate payments of supplemental wages provided in section 31.3402(g)-1(a) of the regulations, as amended by section 13273 of the Omnibus Budget Reconciliation Act of 1993 (Pub. L. No. 103-66) and section 101(c)(11) of the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. No. 107-16), the employer may determine the tax to be withheld from supplemental wages by using a flat percentage rate of 25 percent without allowance for exemption and without reference to any regular wages. This second method can only be used if tax has been withheld from the employee's regular wages.

If federal income tax has been withheld from the employee's regular wages, the Taxpayer can withhold federal income tax on the supplemental wage payment by using a flat 25 percent rate without allowance for exemption and without reference to any regular payment of wages.

If federal income tax has not been withheld from the regular wages of the employee, the vacation allowance payment is aggregated with the regular wages paid for the current payroll period or the last preceding payroll period. The amount of withholding tax is determined as if the aggregate of the supplemental wages and the regular wages constituted a single wage payment for the regular payroll period.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

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