



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

OFFICE OF  
CHIEF COUNSEL

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Reference:

Dear \_\_\_\_\_ :

This letter is in response to your inquiry dated February 9, 2005, on behalf of your constituent, \_\_\_\_\_. He asks why his disability income is subject to 25 percent income tax withholding even though he is in the lowest bracket of income taxation. He also requests suggestions of ways he can reduce amount of income tax withheld.

The facts of \_\_\_\_\_ case are not entirely clear from our file, but it appears that:

- He receives disability payments through health or accident insurance;
- His employer funded this health or accident insurance;
- A third party (the "Insurance Company") makes these payments to your constituent as an agent of the employer;
- The Insurance Company treats these payments as supplemental wages and withholds income tax on the payments using a flat rate of 25 percent.

If your constituent must include the payments he receives from the Insurance Company in gross income under section 105(a) of the Internal Revenue Code (the "Code") or section 1.105(a) of the Income Tax Regulations, and the Insurance Company is an agent of the employer as that term is defined in section 31.3401(a)-1(b)(8) of the Employment Tax Regulations (the "Regulations"), then those payments are supplemental wages. The agent is entitled to withhold on these payments as though tax had been withheld from the employee's regular wages, unless the agent is also an agent for purposes of withholding tax from the employee's regular wages. This means

that the law permits the Insurance Company to use the flat rate method of withholding. However, the Insurance Company also has the option of using the aggregate method of withholding, which would more closely approximate your constituent's actual tax liability for a given year. Apart from legislative action, your constituent's only recourse is to persuade the Insurance Company to use the aggregate method instead of the flat rate method. I hope the following general information on withholding requirements is helpful.

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 of the Treasury. Code section 3402 specifically provides for the percentage method of withholding and the wage bracket method of withholding.

Section 31.3401(a)-1(b)(8)(i)(a) of the Regulations provides that withholding is required on all amounts paid under accident or health plans if those amounts are includible in gross income under Code section 105(a) and Income Tax Regulations section 1.105(a) (relating to amounts attributable to employer contributions).

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.

Regulations section 31.3401(a)-1(b)(8)(i)(b)(1) provides that payments made under accident or health plans are considered made by the employer if a third party makes the payments as an agent of the employer. Under Regulations section 31.3401(a)-1(b)(8)(i)(b)(2), payments made by such agents are supplemental wages as defined in Regulations section 31.3402(g)-1.

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. An agent subject to Regulations section 31.3401(a)-1(b)(8) making payments of supplemental wages may deem tax to have been withheld from the employee's regular wages unless the agent is also an agent for purposes of withholding tax from the employee's regular wages. Consequently, the agent may determine the tax to be withheld from supplemental wages by using a flat percentage rate of 25 percent as provided in Regulations section 31.3402(g)-1.

If the supplemental wage payment is made separately from the regular wage payment and federal income tax has not been withheld from the regular wages of the employee, the supplemental wage 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.

Again, I hope this information is helpful. Please contact me or  
my staff at (202) 622-6040 if we can assist you further.

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Sincerely,

Lynne A. Camillo  
Chief, Employment Tax Branch 2  
Division Counsel/Associate Chief Counsel  
(Tax Exempt and Government Entities)