DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 31

[TD 9276]

RIN 1545–BD96

Flat Rate Supplemental Wage Withholding

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations amending the regulations that provide for determining the amount of income tax withholding on supplemental wages. These regulations apply to all employers and others making supplemental wage payments to employees. These regulations reflect changes in the law made by the American Jobs Creation Act of 2004.

DATES: *Effective Date:* January 1, 2007.

Applicability Date: These regulations are applicable to payments made on or after January 1, 2007.

FOR FURTHER INFORMATION CONTACT: A. G. Kelley, (202) 622–6040 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 31 under sections 3401 and 3402 of the Internal Revenue Code (Code). Section 904(b) of the American Jobs Creation Act of 2004 (Pub. L. 108–357, 118 Stat. 1418) (AJCA) provided for mandatory income tax withholding at the highest rate of income tax in effect under section 1 of the Code to the extent an employee's total supplemental wages paid by the employer exceed $1,000,000 during the calendar year. The AJCA also provided that the supplemental wages paid by other businesses under common control would be taken into account in determining whether the employer has paid $1,000,000 of supplemental wages to an employee in the calendar year. In addition, section 904(a) of the AJCA provided that the rate for purposes of optional flat rate withholding on other supplemental wages (*i.e.*, those supplemental wages not subject to mandatory flat rate withholding at the highest rate of income tax) would remain at 25 percent, but could change if income tax rates change.

Proposed regulations under sections 3401 and 3402 of the Code were published in the **Federal Register** on January 5, 2005 (70 FR 767, 2005–1 C.B. 484). Written and electronic comments responding to the notice of proposed rulemaking were received. A public hearing was held on June 9, 2005. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision.

Summary of Comments and Explanation of Provisions

The final regulations reflect a balancing of two concerns: (1) In accordance with section 3402(a), procedures for withholding should have the goal of approximating the income tax liability of the employee receiving the wages; and (2) procedures for income tax withholding should not place undue administrative burdens on employers.

Definitions of Regular Wages and Supplemental Wages

The final regulations have adopted the definitions of regular wages and supplemental wages provided in the proposed regulations with certain modifications discussed below. In response to comments on the proposed regulations, the final regulations also allow an employer to treat certain wage payments as regular wages or supplemental wages.

The final regulations, like the proposed regulations, provide that supplemental wages include any wages paid by an employer that are not regular wages. Regular wages are defined as amounts paid by an employer for a payroll period either at a regular hourly rate or in a predetermined fixed amount. Wages that vary from payroll period to payroll period based on factors other than the amount of time worked, such as commissions, tips, and bonuses, are supplemental wages.

The proposed regulations provided that a wage payment could qualify as a supplemental wage payment only if it was paid in addition to regular wages paid to the employee. Many commenters were concerned that the same type of compensation would be classified as regular or supplemental wages depending on whether the compensation was paid in addition to regular wages. Commenters also requested that payments of wages after the termination of employment be treated as supplemental wages if such payments would have been treated as supplemental wages prior to termination. Commenters suggested that characterizing the same type of compensation differently depending upon the circumstances upon which the payment was made unduly complicated payroll administration. Commenters also noted that the proposed regulations did not address the classification of wage payments if the employee received two or more types of payments that would normally be classified as supplemental wages, but received no regular wages.

In response to these comments, the final regulations eliminate the rule that a payment can qualify as supplemental wages only if regular wages have been paid to the employee. Under the final regulations, payments that satisfy the basic definition of supplemental wages (*i.e.*, all wage payments other than regular wage payments) will be supplemental wages regardless of whether the employee has received any regular wages in his or her working career with the employer. For example, if an employee's compensation from an employer consists of only income from the exercise of nonstatutory stock options and noncash fringe benefits, such wages will be supplemental wages for federal income tax withholding purposes. Similarly, if a retiree is receiving payments of nonqualified deferred compensation made by the employer or a rabbi trust, such payments will be supplemental wages regardless of whether the payments are made in addition to regular wage payments during either that calendar year or the employee's entire career with the employer.

Commenters requested more flexibility for employers in determining whether particular types of payments are supplemental wages, such as a facts and circumstances test, or a default determination that amounts are supplemental wages where there is uncertainty regarding the correct classification of wages as regular or supplemental wages. Although the final regulations do not adopt these specific suggestions, the final regulations nonetheless address these concerns in other ways. As described below, the final regulations provide more guidance, compared to the proposed regulations, regarding the proper classification of certain types of payments as regular or supplemental wages. Also, the final regulations provide employers with a number of options regarding the treatment of certain payments that will simplify compliance with the requirement that the employer separately track the payment of supplemental wages prior to reaching the threshold for mandatory flat rate withholding. These features of the final regulations help to minimize uncertainties about the classification of particular wage payments.

Commenters requested guidance on whether a number of specific types of payments were regular wages or supplemental wages, including shift differentials paid to employees on an

hourly basis, payments to retirees, sick pay, income from restricted stock awards, income from nonstatutory stock options exercised by former employees or retirees, amounts deferred under a retirement plan pursuant to a salary reduction agreement or a nonqualified deferred compensation plan, post-retirement or post-termination payments of wages that would have been treated as supplemental wages if paid prior to the termination of the employment relationship, and imputed income amounts for health insurance coverage for non-dependents. The final regulations have provided additional examples of supplemental wages and regular wages, including some of the items for which specific advice was requested. Other items that are not specifically included in the final regulations were considered to be either analogous to items covered or specifically covered by applicable rules.

A commenter requested that employers be permitted to treat tips, overtime pay, commissions, third-party sick pay, and taxable fringe benefits as either supplemental wages or regular wages. The commenter indicated that many employers have systems in place that treat such payments as regular wages and wanted to continue with such systems. In addition, the commenter noted that tips are considered to represent a basic part of the compensation of many employees and that a tip credit is permitted against the minimum wage for Fair Labor Standards Act (FLSA) purposes. Also, many employees receiving overtime pay earn such pay each payroll period.

In response to this comment, the final regulations permit employers to treat tips and/or overtime pay as regular wages. To provide employers with more flexibility, any such treatment is not required to be applied uniformly to all employees of the employer.

The final regulations do not allow an employer to treat commissions, third party sick pay paid by agents of the employer, or taxable fringe benefits as anything other than supplemental wages. Commissions may vary considerably from pay period to pay period, have the essential characteristics of supplemental wages, and have historically been characterized in the existing regulations as supplemental wages. A longstanding regulation treats sick pay paid by an agent of the employer as supplemental wages and the final regulations have not amended that regulation in providing a definition of supplemental wages. Also, noncash fringe benefits have been treated as supplemental wages since withholding requirements with respect to noncash fringe benefits were set forth in response to the fringe benefit laws enacted by the Deficit Reduction Act of 1984. See Announcement 85–113, (1985–31 I.R.B. 31). With respect to supplemental wage payments below the threshold for mandatory flat rate withholding, employers may use the aggregate procedure, as described below, in determining the amount of withholding to produce similar withholding amounts as if the payments were classified as regular wages.

Procedures for Withholding on Supplemental Wages

These regulations also interpret provisions of the AJCA relating to the taxation of supplemental wages.

Procedures for Withholding on Supplemental Wages of $1,000,000 or Less During a Calendar Year

The final regulations continue to provide that, if an employee has not received cumulatively more than $1,000,000 of supplemental wages during the calendar year, generally there are two procedures available to an employer in withholding on a payment of supplemental wages: (1) The aggregate procedure and (2) 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 for the most recent payroll period of the year of the payment, and treating the aggregate as if it were a single wage payment for the regular payroll period.

Optional flat rate withholding on supplemental wages (of $1,000,000 or less cumulatively) allows employers to disregard the amount of regular wages paid to an employee as well as the withholding allowances claimed by an employee on Form W–4, ''Employee's Withholding Allowance Certificate,'' and use a flat percentage rate specified in the regulations in calculating the amount of withholding. The final regulations, like existing regulations and revenue rulings, continue to provide that optional flat rate withholding on supplemental wages is generally available only if (1) the employer has withheld income tax from regular wages paid the employee, and (2) the supplemental wages are either (a) not paid concurrently with regular wages or (b) separately stated on the payroll records of the employer.

Commenters requested that employers be allowed to use optional flat rate withholding with respect to such payments to a former employee even if no other payments of wages were being made to the employee during that calendar year. Commenters believed that the requirement that income tax must have been withheld from the regular wages of the employee was unduly restrictive and noted that employers may have difficulty in obtaining Forms W–4 from individuals who were no longer employees.

However, eliminating the requirement that income tax must have been withheld from regular wages paid to the employee in order for optional flat rate withholding to be available to the employer would exacerbate the problem of overwithholding on wages paid to employees. Therefore, the final regulations have retained the rule that income tax must have been withheld from the regular wages of the employee in order for optional flat rate withholding to be available to employers. The final regulations clarify that the income tax withholding requirement will be satisfied if income tax has been withheld from regular wages paid during the same year as the payment of supplemental wages or during the preceding calendar year. The final regulations continue to provide that if the supplemental wage payment is paid under the conditions permitting the use of optional flat rate withholding, the decision whether to use optional flat rate withholding rather than the aggregate procedure is discretionary with the employer.

Procedures for Withholding on Supplemental Wages in Excess of $1,000,000 Paid to One Employee in One Calendar Year

The AJCA established different withholding rules for supplemental wages in excess of $1,000,000 received by an employee from an employer during a calendar year. The AJCA provided that, effective January 1, 2005, employers must withhold from supplemental wages in excess of $1,000,000 at the highest income tax rate under section 1 of the Code.

The final regulations provide that if the sum of a supplemental wage payment and all other supplemental wage payments paid by an employer to an employee during the calendar year exceeds $1,000,000, the withholding rate on the supplemental wages in excess of $1,000,000 shall be equal to the maximum rate of tax in effect under section 1 for taxable years beginning in such calendar year. The maximum rate of tax in effect for taxable years beginning in 2005 is 35 percent. Thus, the mandatory flat rate for supplemental wages in excess of $1 million in a given taxable year is 35 percent and will

remain at 35 percent until income tax rates change.[1]

Comments on Method for Withholding on Wages over $1,000,000

Many commenters expressed concern that the mandatory flat rate withholding requirements would force them to identify whether every wage payment was a regular wage or a supplemental wage and to track all supplemental wages paid to determine whether mandatory flat rate withholding applied. Under prior law, treating any wage payment as a supplemental wage was optional for employers, and many employers withheld on supplemental wages under the aggregate procedure and thus were not required to identify whether payments were regular wages or supplemental wages. Commenters were concerned about the cost and burden of implementing a system to track whether payments were regular wages or supplemental wages, especially if only a few employees would have wages subject to mandatory flat rate withholding. While the IRS and Treasury Department appreciate the potential burden created by the need to distinguish between regular and supplemental wages in order to comply with the requirements of section 904(b) of the AJCA, section 904(b) mandates flat rate withholding only for supplemental wages in excess of $1,000,000. The IRS and Treasury Department request additional comments on how any burden could be mitigated while taking into account the scope of section 904(b) and the rules provided in section 3402 of the Code which describe the circumstances under which employees provide withholding exemption certificates, and employers must follow them in implementing withholding. For example, the IRS and Treasury Department are interested in views on whether it should permit employers to withhold at the mandatory flat rate on any amount of total wages (both regular and supplemental) that exceeds $1,000,000.

Special Rules for Determining Applicability of Mandatory Flat Rate Withholding

A commenter also requested that an employer be permitted to treat any supplemental wage payment as subject to mandatory flat rate withholding whenever it is anticipated the employee's supplemental wages for the year are approaching the $1,000,000 threshold. To address these concerns, the final regulations and the revenue procedure provide employers with a number of options in determining whether supplemental wages in excess of $1,000,000 have been paid to an employee during the calendar year.

One commenter suggested that guidance was needed as to the calculation of the amount of noncash fringe benefits to be included in supplemental wages for purposes of determining whether the $1,000,000 threshold for mandatory flat rate withholding has been reached. With respect to the determination of the amount of supplemental wages for purposes of the mandatory flat rate withholding, the regulations are not intended to require different calculations of the amount of wages than would normally apply in determining the amount of wages subject to withholding. Thus, currently applicable procedures for the calculation of noncash fringe benefits of an employee (see Announcement 85–113, which provides employers with special accounting rules that they may use to determine the amount of noncash fringe benefits that are wages subject to income tax withholding) will continue to apply in determining the amount of supplemental wages for purposes of the mandatory flat rate withholding. If the noncash fringe benefit amounts are not wages subject to income tax withholding, then they are not included in regular wages or supplemental wages.

A commenter suggested that specific guidance was needed concerning whether disqualifying dispositions of shares of stock acquired pursuant to the exercise of statutory stock options are taken into account as supplemental wages for purposes of determining whether the $1,000,000 threshold has been reached. Such income is not wages subject to federal income tax withholding. The final regulations specifically provide that income from disqualifying dispositions of shares of stock acquired pursuant to the exercise of statutory stock options is not included in supplemental wages.

A commenter also requested that, for purposes of determining whether an employee has received $1,000,000 of supplemental wages, an employer should be allowed to treat amounts included in Box 1 of Form W–2, ''Wage and Tax Statement'' as ''wages, tips, other compensation'' as supplemental wages. Items reportable in Box 1 of Form W–2 include items that are not subject to income tax withholding. Nevertheless, in the interest of making the rules administrable for employers, the regulations provide that employers can treat such amounts as supplemental wages.

A commenter requested that, in determining whether the employee has received $1,000,000 of supplemental wages, employers should be allowed to take into account the gross amount of a supplemental wage payment including any pretax deductions that are attributable to such supplemental wages. However, pretax deductions, including salary reduction deferrals, are not includible in gross income for the taxable year and are not wages subject to income tax withholding. Therefore, the IRS and Treasury Department have not adopted this proposal.

Mandatory flat rate withholding applies only to the excess of supplemental wages over $1,000,000 received by an employee from an employer, taking into consideration all payments of supplemental wages made by an employer to an employee. Therefore, the new mandatory flat rate withholding on supplemental wages in excess of $1,000,000 can apply to all of a payment or only a portion of the payment.

The proposed regulations provided that if a particular supplemental wage payment results in an employee exceeding the $1,000,000 supplemental wage threshold, mandatory flat rate withholding will apply to the extent that the payment, together with other supplemental wage payments previously made to the employee during the year, is in excess of $1,000,000. Because this provision could result in an employer having to treat two portions of a single supplemental wage payment under different withholding regimes, commenters requested that employers be permitted to elect to treat the entire amount of the payment that results in supplemental wage payments to the employee exceeding $1,000,000 as subject to mandatory flat rate withholding. Commenters also requested that to avoid having the mandatory flat rate withholding apply only to the portion of a supplemental wage payment that exceeds $1,000,000, employers be allowed to apply the mandatory rate only to payments after the payment which causes the employee to have received $1,000,000 or more of supplemental wages.

The IRS and Treasury Department concluded this latter approach could not be reconciled with the statute. Section 904(b) of the AJCA provides that ''if the supplemental wage payment, when added to all such payments previously made by the employer to the employee during the calendar year, exceeds $1,000,000, the rate used with respect to such excess shall be equal to

[1] Under the sunset provision in section 901 of the Economic Growth and Tax Relief Reconciliation Act of 2001, the mandatory flat rate will change to 39.6 percent for taxable years beginning after December 31, 2010.

the maximum rate of tax * * *.'' Accordingly, the final regulations continue with the rule that, if a supplemental wage payment results in the total supplemental wage payments to the employee from the employer during the calendar year exceeding $1,000,000, the amount of that payment in excess of $1,000,000 (when added to the supplemental wage payments previously made in the calendar year) is subject to mandatory flat rate withholding. The final regulations, however, permit employers to treat the entire amount of the payment that results in the employee receiving total supplemental wages of more than $1,000,000 as subject to mandatory flat rate withholding. This treatment can apply on an employee-by-employee basis.

A commenter requested that guidance be provided as to the calculation of supplemental wages for purposes of determining the applicability of mandatory flat rate withholding in a situation where salary reduction deferral amounts are deferred from either gross regular wage payments or gross supplemental wage payments to the employee. The commenters requested flexibility in allocating such deferrals. However, in order to apply mandatory flat rate withholding on a consistent basis, payments of wages must be correctly identified as either regular wages or supplemental wages. Therefore, the final regulations provide that, in determining the amount of supplemental wages paid, salary deferral amounts are allocated to the gross regular wage payments or to the gross supplemental wage payments from which they are actually deducted. For example, if an employee had a valid salary reduction agreement deferring 10 percent of all salary and bonuses, and the employee had received wage payments based on $1,500,000 of gross salary and $1,000,000 of gross bonuses prior to reduction for the deferrals (and no other wages), the employer would allocate $150,000 to the gross regular wage payment and $100,000 to the gross supplemental wage payment. Thus, for purposes of the mandatory flat rate withholding, the example employee has received $900,000 of supplemental wages.

Taking Into Account Payments by Agents of Employers in Determining Applicability of Mandatory Flat Rate Withholding

In determining whether the supplemental wages paid by an employer to an employee in a given taxable year exceed $1,000,000, the proposed regulations provided that an employer (the first employer) must consider wage payments made to the employee by any other person treated as a single employer with the first employer under section 52(a) or 52(b). Furthermore, if an employer enlists a third party to make a payment to an employee on the employer's behalf, the payment will be considered as made by the employer even though it may have been delivered to the employee by the third party.

Commenters expressed the view that employers should not be required to count supplemental wage payments made by third party agents in determining whether the $1,000,000 supplemental wage threshold has been met. Although the AJCA did not specifically address whether supplemental wage payments made by employers through agents must be considered in determining the applicability of mandatory flat rate withholding, requiring that such wages be taken into account is consistent with the purpose of the legislation to impose income tax withholding on a basis that is more consistent with income tax liability. Failure to consider payments made by agents of an employer would create an inconsistency in the application of mandatory flat rate withholding based on the type of payment systems that employers choose to put in place. Thus, the final regulations retain the rule of the proposed regulations requiring that payments made by agents of the employers must be considered in determining the applicability of mandatory flat rate withholding (with the exception of certain payments discussed below).

A commenter requested that common law employers be allowed to disregard payments made by agents if the payments would be unlikely to trigger the mandatory flat rate withholding. The commenter noted the administrative burden imposed if a third party agent were required to coordinate every payment with the employer to determine whether the employee has received $1,000,000 of supplemental wages. The commenter requested that agents be allowed to presume that mandatory flat rate withholding does not apply until year-to-date payments that they themselves make to a particular worker exceed $100,000. Also, the commenter requested that employers be allowed to presume that the mandatory flat rate withholding does not apply until year-to-date payments that the employer makes to a particular worker, without regard to payments made by a third party payer, exceed $500,000.

In order to provide relief with respect to payments made by agents, the final regulations provide a de minimis rule exception. An agent making total wage payments, including regular and supplemental wages, of less than $100,000 to an individual in any calendar year may disregard other supplemental wages from the common law employer or any other agent of the employer that would subject the employee to mandatory flat rate withholding. Similarly, an employer may disregard supplemental wage payments made by an agent to an employee in determining whether the employee has reached the $1,000,000 threshold if the agent has made total wage payments of less than $100,000 to the employee during the calendar year. If an agent does reach the $100,000 threshold of wages paid to a single employee in a calendar year, then the employer, in determining the applicability of mandatory flat rate withholding, must take into account all supplemental wages paid by the agent in determining whether mandatory flat rate withholding applies to a wage payment made after the agent reaches the $100,000 threshold. Similarly, with the payment that reaches the $100,000 threshold, the agent who has made $100,000 of wage payments to an employee during a calendar year, is required to take into account all wages paid by the employer and any other agent of the employer who has reached the $100,000 threshold in determining the applicability of mandatory flat rate withholding. This de minimis rule is subject to an anti-abuse rule, in that it does not apply to the employer in situations where the employer has created an arrangement or arrangements with five or more agents if a principal effect of the arrangement or arrangements is to reduce applicable mandatory flat rate withholding with respect to an employee. Application of the de minimis rule is optional. An employer may take into account all supplemental wages paid by agents, regardless of how small the payments are from any particular agent, in determining whether the employee has received $1,000,000 of supplemental wages during the calendar year. Similarly, an agent is not required to apply the de minimis rule.

Rates Applicable for Purposes of Optional Flat Rate Withholding

The final regulations change the optional flat rate withholding on supplemental wages to provide that the 20 percent rate applies only to supplemental wages paid prior to January 1, 1994. The rate of 28 percent

applies to supplemental wages paid after December 31, 1993, and on or before August 6, 2001. The Revenue Reconciliation Act of 1993, as amended by the Economic Growth and Tax Relief Reconciliation Act of 2001, provides that the supplemental withholding rate shall not be less than the third lowest rate of tax applicable under section 1(c) of the Code for wages paid after August 6, 2001, and before January 1, 2005. Consistent with this amendment, the regulations provide that the rate of 27.5 percent applies to supplemental wages paid after August 6, 2001, and on or before December 31, 2001, the rate of 27 percent applies to wages paid after December 31, 2001, and on or before May 27, 2003, and the rate of 25 percent applies to wages paid after May 27, 2003, and on or before December 31, 2004.

One commenter suggested that optional flat rate withholding for wages paid after December 31, 2002, and on or before May 27, 2003, should be 25 percent. The law in effect at the time as enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001 provided that the supplemental withholding rate ''shall not be less than the third lowest rate of tax applicable under section 1(c) of the Internal Revenue Code of 1986.'' The commenter stated that the optional flat rate withholding should be 25 percent because the Jobs and Growth Tax Relief Reconciliation Act of 2003 provided that the third lowest rate of tax under section 1(c) of the Code after December 31, 2002, would be 25 percent. However, this provision changing the third lowest rate of income tax rate to 25 percent was not enacted into law until May 28, 2003. Thus, at the time of payments of supplemental wages made after December 31, 2002, and prior to May 28, 2003, the third lowest rate of tax under section 1(c) was 27 percent. As noted in the preamble to the proposed regulations, the IRS and Treasury Department believe that the 27 percent rate for this period is consistent with the general principle that the employment taxation of wage payments is determined based on the rates in effect at the date the wages are paid. *United States* v. *Cleveland Indians Baseball Co.,* 532 U.S. 200 (2001). Therefore, the final regulations continue to provide that the optional flat rate withholding for wages paid after December 31, 2002, and prior to May 28, 2003, was 27 percent.

For 2006, the optional flat rate withholding for supplemental wages of $1,000,000 or less in a given taxable year is 25 percent. The optional flat rate withholding will remain at 25 percent until income tax rates change.[2]

Application of Mandatory Flat Rate Withholding Regardless of Employee's Personal Income Tax Liability

Commenters requested that the final regulations provide an exception from mandatory flat rate withholding when the employee receiving the supplemental wage amount will be eligible to take an offsetting income tax credit or an offsetting income tax deduction, but no exception from the definition of wages for income tax withholding purposes applies. Commenters noted that some foreign countries impose foreign income tax but not foreign income tax withholding on supplemental wage payments made to United States employees who are based in and working in those foreign countries. If an employer is not required by foreign law to withhold foreign income tax from a supplemental wage payment, the exception from wages provided by section 3401(a)(8)(A)(ii) of the Code does not apply. However, the payment may be subject to foreign income tax and the employee may be eligible for a foreign income tax credit that could offset any liability for United States income tax. The commenters requested that the regulations provide an exception for United States residents or citizens who are working overseas and receive supplemental wage payments that are subject to foreign income tax, but not foreign income tax withholding.

Another commenter noted that an employee may be required by the terms of a divorce decree to pay the entire amount of a bonus to a former spouse and may be eligible to take an alimony deduction with respect to the transfer to the former spouse. This commenter suggested that the IRS and Treasury Department create an administrative exception from mandatory flat rate withholding that would apply if the employee submits a Form W–4 establishing that the employee will be entitled to an offsetting income tax deduction with respect to the supplemental wage payment.

In enacting the requirement for mandatory flat rate withholding, Congress made clear its intent to override the withholding that would apply pursuant to the employee's elections on the Form W–4 with withholding at a specific statutorily prescribed rate. To provide exceptions for tax credits or deductions that an employee would expect to receive would require the employer to give the employee's Form W–4 or some other document from the employee precedence over the statutory mandate. Moreover, although the commenters are suggesting limiting the exceptions to circumstances in which specific credible claims for credits or deductions can be made, implementation of such proposals would require the employer to vet claims made by individual employees about their tax circumstances. The IRS and Treasury Department decline to adopt the suggestions made by the commenters because they are contrary to statutory intent and would require the employer to assume a role in assessing employees' tax circumstances that employers cannot and should not be asked to perform.

Effective Date of Regulations

Many commenters stated that making the changes to their payroll systems necessary to comply with mandatory flat rate withholding would take time and require testing. Of particular concern was the coordination of payments by agents. In response to these comments, the final regulations will be effective with respect to wages paid on or after January 1, 2007. This will give employers time to implement any programming and coordination required by the final regulations.

A commenter also asked for permanent relief from mandatory flat rate withholding and related reporting and withholding penalties and interest if the employer (or third party payer) makes reasonable, good faith efforts to comply with the new requirements. Because Congress established this withholding as mandatory, it would be inconsistent with the statute to provide permanent relief from liability for the mandatory flat rate withholding.

Special Analyses

It has been determined that these final regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply, and therefore,

[2] Under current law, section 1(i)(2) will not be applicable to taxable years beginning after December 31, 2010, pursuant to the sunset provisions contained in section 901 of the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. 107–16; 115 Stat. 150). See also section 107 of Public Law 108–27 (117 Stat. 755). Absent legislative action, the optional flat rate will change to 28 percent in 2011.

a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, the proposed regulations preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on the impact on small business.

Drafting Information

The principal author of these regulations is A. G. Kelley, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 31

Employment taxes, Income taxes, Penalties, Pensions, Railroad retirement, Reporting and recordkeeping requirements, Social security, Unemployment compensation.

Adoption of Amendments to the Regulations

■ Accordingly, 26 CFR part 31 is amended as follows:

PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT SOURCE

■ **Paragraph 1.** The authority citation to part 31 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 31.3402(n)–1 also issued under 26 U.S.C. 6001, 6011 and 6364. * * *

■ **Par. 2.** Section 31.3401(a)–1 is amended by revising paragraph (b)(8)(i)(*b*)(*2*) to read as follows:

§ 31.3401(a)–1 Wages.

* * * * *

(b) * * *

(8) * * *

(i) * * *

(*b*) * * *

(*2*) Payments made by agents subject to this paragraph are supplemental wages as defined in § 31.3402(g)–1, and are therefore subject to the rules regarding withholding tax on supplemental wages provided in § 31.3402(g)–1. For purposes of those rules, unless the agent is also an agent for purposes of withholding tax from the employee's regular wages, the agent may deem tax to have been withheld from regular wages paid to the employee during the calendar year.

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■ **Par. 3.** Section 31.3401(a)–4 is amended by revising paragraph (c) to read as follows:

§ 31.3401(a)–4 Reimbursements and other expense allowance amounts.

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(c) *Withholding rate.* Payments made under reimbursement or other expense allowance arrangements that are subject to income tax withholding are supplemental wages as defined in § 31.3402(g)–1. Accordingly, withholding on such supplemental wages is calculated under the rules provided with respect to supplemental wages in § 31.3402(g)–1.

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■ **Par. 4.** Section 31.3402(g)–1 is amended by:

■ 1. Revising paragraph (a).

■ 2. Adding a sentence at the beginning of paragraph (b)(1).

■ 3. Revising paragraph (b)(2).

The revisions and addition read as follows:

§ 31.3402(g)–1 Supplemental wage payments.

(a) *In general and withholding on supplemental wages in excess of $1,000,000*—(1) *Determination of supplemental wages and regular wages*—(i) *Supplemental wages.* An employee's remuneration may consist of regular wages and supplemental wages. Supplemental wages are all wages paid by an employer that are not regular wages. Supplemental wages include wage payments made without regard to an employee's payroll period, but also may include payments made for a payroll period. Examples of wage payments that are included in supplemental wages include reported tips (except as provided in paragraph (a)(1)(v) of this section), overtime pay (except as provided in paragraph (a)(1)(iv) of this section), bonuses, back pay, commissions, wages paid under reimbursement or other expense allowance arrangements, nonqualified deferred compensation includible in wages, wages paid as noncash fringe benefits, sick pay paid by a third party as an agent of the employer, amounts that are includible in gross income under section 409A, income recognized on the exercise of a nonstatutory stock option, wages from imputed income for health coverage for a non-dependent, and wage income recognized on the lapse of a restriction on restricted property transferred from an employer to an employee. Amounts that are described as supplemental wages in this definition are supplemental wages regardless of whether the employer has paid the employee any regular wages during either the calendar year of the payment or any prior calendar year. Thus, for example, if the only wages that an employer has ever paid an employee are payments of noncash fringe benefits and income recognized on the exercise of a nonstatutory stock option, such payments are classified as supplemental wages.

(ii) *Regular wages.* As distinguished from supplemental wages, regular wages are amounts that are paid at a regular hourly, daily, or similar periodic rate (and not an overtime rate) for the current payroll period or at a predetermined fixed determinable amount for the current payroll period. Thus, among other things, wages that vary from payroll period to payroll period (such as commissions, reported tips, bonuses, or overtime pay) are not regular wages, except that an employer may treat tips as regular wages under paragraph (a)(1)(v) of this section and an employer may treat overtime pay as regular wages under paragraph (a)(1)(iv) of this section.

(iii) *Amounts that are not wages subject to income tax withholding.* If an amount of remuneration is not wages subject to income tax withholding, it is neither regular wages nor supplemental wages. Thus, for example, income from the disqualifying dispositions of shares of stock acquired pursuant to the exercise of statutory stock options, as described in section 421(b), is not included in regular wages or supplemental wages.

(iv) *Optional treatment of overtime pay as regular wages.* Employers may treat overtime pay as regular wages rather than supplemental wages. For this purpose, *overtime pay* is defined as any pay required to be paid pursuant to federal (Fair Labor Standards Act), state, or local governmental laws at a rate higher than the normal wage rate of the employee because the employee has worked hours in excess of the number of hours deemed to constitute a normal work week or work day.

(v) *Optional treatment of tips as regular wages.* Employers may treat tips as regular wages rather than supplemental wages. For this purpose, tips are defined as including all tips which are reported to the employer pursuant to section 6053.

(vi) *Amount to be withheld.* The calculation of the amount of the income tax withholding with respect to supplemental wage payments is provided for under paragraph (a)(2) through (a)(7) of this section.

(2) *Mandatory flat rate withholding.* If a supplemental wage payment, when added to all supplemental wage payments previously made by one employer (as defined in paragraph (a)(3) of this section) to an employee during the calendar year, exceeds $1,000,000, the rate used in determining the amount

of withholding on the excess (including any excess which is a portion of a supplemental wage payment) shall be equal to the highest rate of tax applicable under section 1 for such taxable years beginning in such calendar year. This flat rate shall be applied without regard to whether income tax has been withheld from the employee's regular wages, without allowance for the number of withholding allowances claimed by the employee on Form W–4, ''Employee's Withholding Allowance Certificate,'' without regard to whether the employee has claimed exempt status on Form W–4, without regard to whether the employee has requested additional withholding on Form W–4, and without regard to the withholding method used by the employer. Withholding under this paragraph (a)(2) is mandatory flat rate withholding.

(3) *Certain persons treated as one employer*—(i) *Persons under common control.* For purposes of paragraph (a)(2) of this section, all persons treated as a single employer under subsection (a) or (b) of section 52 shall be treated as one employer.

(ii) *Agents.* For purposes of paragraph (a)(2) of this section, any payment made to an employee by a third party acting as an agent for the employer (regardless of whether such person shall have been designated as an agent pursuant to section 3504) shall be considered as made by the employer except as provided in paragraph (a)(4)(iii) of this section.

(4) *Treatment of certain items in determining applicability of mandatory flat rate withholding*—(i) *Optional treatment of compensation not subject to income tax withholding.* For purposes of paragraph (a)(2) of this section, employers may determine whether an employee has received $1,000,000 of supplemental wages during a calendar year by including in supplemental wages amounts includible in income but not subject to withholding that are reported as wages, tips, other compensation on Form W–2.

(ii) *Allocation of salary reduction deferrals.* In allocating salary reduction deferral amounts excludable from wages for purposes of determining whether the employer has paid $1,000,000 of supplemental wages under paragraph (a)(2) of this section, employers must allocate such salary reduction deferral amounts to the type of compensation (*i.e.*, gross amounts of regular wage payments or gross amounts of supplemental wage payments) actually being deferred.

(iii) *Optional de minimis exception for certain payments by agents.* For purposes of paragraph (a)(2) of this section, if an agent makes total wage payments (including regular wages and supplemental wages) of less than $100,000 to an individual during any calendar year, an employer or other agent may disregard such payments in determining whether the individual has received $1,000,000 of supplemental wages during the calendar year, and such agent need not consider whether the individual has received other supplemental wages in determining the amount of income tax to be withheld from the payments. An employer may not avail itself of this exception if the employer is making payments to the employee using five or more agents and a principal effect of such use of agents is to reduce the applicability of mandatory flat rate withholding to the employee. For purposes of paragraph (a)(2) of this section, if an agent makes total wage payments of $100,000 or more to an individual during any calendar year, the entire amount of supplemental wages paid by the agent during the calendar year to the employee must be taken into account (by other agents of the employer that make total wage payments to the employee of $100,000 or more, by the agent, and by the employer for which the agent is acting) in determining whether the employee has received $1,000,000 of supplemental wages.

(iv) *Treatment of supplemental wage payment exceeding $1,000,000 cumulative threshold.* In the case of a supplemental wage payment that, when added to all supplemental wage payments previously made by the employer to the employee in the calendar year, results in the employee having received in excess of $1,000,000 supplemental wages for the calendar year, the employer is required to impose withholding under paragraph (a)(2) of this section only on the portion of the payment that is in excess of $1,000,000 (taking into account all prior supplemental wage payments during the year). However, an employer may subject the entire amount of such supplemental wage payment to the withholding imposed by paragraph (a)(2) of this section.

(5) *Withholding on supplemental wages that are not subject to mandatory flat rate withholding.* To the extent that paragraph (a)(2) of this section does not apply to a supplemental wage payment (or a portion of a payment), the amount of the tax required to be withheld on the supplemental wages when paid shall be determined under the rules provided in paragraphs (a)(6) and (7) of this section.

(6) *Aggregate procedure for withholding on supplemental wages*—(i) *Applicability.* The employer is required to determine withholding upon supplemental wages under this paragraph (a)(6) if paragraph (a)(2) of this section does not apply to the payment or portion of the payment and if paragraph (a)(7) of this section may not be used with respect to the payment. In addition, employers have the option of using this paragraph (a)(6) to calculate withholding with respect to a supplemental wage payment, if paragraph (a)(2) of this section does not apply to the payment, but if paragraph (a)(7) of this section could be used with respect to the payment.

(ii) *Procedure.* Provided this procedure applies under paragraph (a)(6)(i) of this section, the supplemental wages, if paid concurrently with wages for a payroll period, are aggregated with the wages paid for such payroll period. If not paid concurrently, 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, if any. The amount of tax to be withheld is determined as if the aggregate of the supplemental wages and the regular wages constituted a single wage payment for the regular payroll period. The withholding method used by the employer with respect to regular wages would then be used to calculate the withholding on this single wage payment and the employer would take into consideration the Form W–4 submitted by the employee. This procedure is the aggregate procedure for withholding on supplemental wages.

(7) *Optional flat rate withholding on supplemental wages*—(i) *Applicability.* The employer may determine withholding upon supplemental wages under this paragraph (a)(7) if three conditions are met—

(A) Paragraph (a)(2) of this section does not apply to the payment or the portion of the payment;

(B) The supplemental wages are either not paid concurrently with regular wages or are separately stated on the payroll records of the employer; and

(C) Income tax has been withheld from regular wages of the employee during the calendar year of the payment or the preceding calendar year.

(ii) *Procedure.* The determination of the tax to be withheld under paragraph (a)(7)(iii) of this section 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. Withholding

under this procedure is optional flat rate withholding.

(iii) *Rate applicable for purposes of optional flat rate withholding.* Provided the conditions of paragraph (a)(7)(i) of this section have been met, the employer may determine the tax to be withheld—

(A) From supplemental wages paid after April 30, 1966, and prior to January 1, 1994, by using a flat percentage rate of 20 percent;

(B) From supplemental wages paid after December 31, 1993, and on or before August 6, 2001, by using a flat percentage rate of 28 percent;

(C) From supplemental wages paid after August 6, 2001, and on or before December 31, 2001, by using a flat percentage rate of 27.5 percent;

(D) From supplemental wages paid after December 31, 2001, and on or before May 27, 2003, by using a flat percentage rate of 27 percent;

(E) From supplemental wages paid after May 27, 2003, and on or before December 31, 2004, by using a flat percentage rate of 25 percent; and

(F) From supplemental wages paid after December 31, 2004, by using a flat percentage rate of 28 percent (or the corresponding rate in effect under section 1(i)(2) for taxable years beginning in the calendar year in which the payment is made).

(8) *Examples.* For purposes of these examples, it is assumed that the rate for purposes of mandatory flat rate withholding for 2007 is 35 percent, and the rate for purposes of optional flat rate withholding for 2007 is 25 percent. The following examples illustrate this paragraph (a):

Example 1. (i) Employee A is an employee of three entities (X, Y, and Z) that are treated as a single employer under section 52(a) or (b). In 2007, X pays regular wages to A on a monthly payroll period for services performed for X, Y, and Z. The regular wages are paid on the third business day of each month. Income tax is withheld from the regular wages of A during the year. A receives only the following supplemental wage payments during 2007 in addition to the regular wages paid by X—

(A) A bonus of $600,000 from X on March 15, 2007;

(B) A bonus of $2,300,000 from Y on November 15, 2007; and

(C) A bonus of $10,000 from Z on December 31, 2007.

(ii) In this *Example 1*, the $600,000 bonus from X is a supplemental wage payment. The withholding on the $600,000 payment from X could be determined under either paragraph (a)(6) or (7) of this section because income tax has been withheld from the regular wages of A. If X elects to use the aggregate procedure under paragraph (a)(6) of this section, the amount of withholding on the supplemental wages would be based on aggregating the supplemental wages and the regular wages paid by X either for the current or last payroll period and treating the total of the regular wages paid by X and the $600,000 supplemental wages as a single wage payment for a regular payroll period. The withholding method used by the employer with respect to regular wages would then be used to calculate the withholding on this single wage payment, and the employer would take into consideration the Form W–4 furnished by the employee.

(iii) In this *Example 1*, the $2,300,000 bonus from Y is a supplemental wage payment. To calculate the withholding on the $2,300,000 supplemental wage payment from Y, the $600,000 of supplemental wages X has already paid to A in 2007 must be taken into account because X and Y are treated as the same employer under section 52(a) or (b). Thus, the withholding on the first $400,000 of the payment (i.e., the cumulative supplemental wages not in excess of $1,000,000) is computed separately from the withholding on the remaining $1,900,000 of the payment (i.e., the amount of the cumulative supplemental wages in excess of $1,000,000). With respect to the first $400,000, the withholding could be computed under either paragraph (a)(6) or (a)(7) of this section, because income tax has been withheld from the regular wages of the employee. If Y elected to withhold income tax using paragraph (a)(7) of this section, Y would withhold on the $400,000 component at 25 percent (pursuant to paragraph (a)(7)(ii)(F) of this section), which would result in $100,000 tax withheld. The remaining $1,900,000 of the bonus would be subject to mandatory flat rate withholding at the maximum rate of tax in effect under section 1 for 2007 (35%) without regard to the Form W–4 submitted by A. The amount withheld from the $1,900,000 would be $665,000. The withholding on the first component and the withholding on the second component then would be added together to determine the total income tax withholding on the supplemental wage payment from Y. Alternatively, under paragraph (a)(4)(iv) of this section, Y could treat the entire $2,300,000 bonus payment as subject to mandatory flat rate withholding at the maximum rate of tax (35%), in which case the amount to be withheld would be 35 percent of $2,300,000, or $805,000.

(iv) The $10,000 bonus paid from Z is also a supplemental wage payment. To calculate the withholding on the $10,000 bonus, the $2,900,000 in cumulative supplemental wages already paid to A in 2007 by X and Y must be taken into account because X, Y, and Z are treated as a single employer. The entire $10,000 bonus would be subject to mandatory flat rate withholding at the maximum rate of tax in effect under section 1 for 2007. The income tax required to be withheld on this payment would be 35 percent of $10,000 or $3,500.

Example 2. Employees B and C work for employer M. Each employee receives a monthly salary of $3,000 in 2007. As a result of the withholding allowances claimed by B, there has been no income tax withholding on the regular wages M pays to B during either 2007 or 2006. In contrast, M has withheld income tax from regular wages M pays to C during 2007. Together with the monthly salary check paid in December 2007 to each employee, M includes a bonus of $2,000, which is the only supplemental wage payment each employee receives from M in 2007. The bonuses are separately stated on the payroll records of M. Because M has withheld no income tax from B's regular wages during either the calendar year of the $2,000 bonus or the preceding calendar year, M cannot use optional flat rate withholding provided under paragraph (a)(7) of this section to calculate the income tax withholding on B's $2,000 bonus. Consequently, M must use the aggregate procedure set forth in paragraph (a)(6) of this section to calculate the income tax withholding due on the $2,000 bonus to B. With respect to the bonus paid to C, M has the option of using either the aggregate procedure provided under paragraph (a)(6) of this section or the optional flat rate withholding provided under paragraph (a)(7) of this section to calculate the income tax withholding due.

Example 3. (i) Employee D works as an employee of Corporation R. Corporations R and T are treated as a single employer under section 52(a) or (b). R makes regular wage payments to Employee D of $200,000 on a monthly basis in 2007, and income tax is withheld from those wages. R pays D a bonus for his services as an employee equal to $3,000,000 on June 30, 2007. Unrelated company U pays D sick pay as an agent of the employer R and such sick pay is supplemental wages pursuant to § 31.3401(a)–1(b)(2). U pays D $50,000 of sick pay on October 31, 2007. Corporation T decides to award bonuses to all employees of R and T, and pays a bonus of $100,000 to D on December 31, 2007. D received no other payments from R, T, or U.

(ii) In chronological summary, D is paid the following wages other than the regular monthly wages paid by R:

(A) June 30, 2007—$3,000,000 (bonus from R);

(B) October 31, 2007—$50,000 (sick pay from U); and

(C) December 31, 2007—$100,000 (bonus from T).

(iii) In this *Example 3*, each payment of wages other than the regular monthly wage payments from R is considered to be supplemental wages for purposes of withholding under § 31.3402(g)–1(a)(2). The amount of regular wages from R is irrelevant in determining when mandatory flat rate withholding on supplemental wages must be applied.

(iv) Because income tax has been withheld on D's regular wages, income tax may be withheld on $1,000,000 of the $3,000,000 bonus paid on June 30, 2007, under either paragraph (a)(6) or (7) of this section. If R elects to use optional flat rate withholding provided under paragraph (a)(7)(ii)(F) of this section, withholding would be calculated at 25 percent of the $1,000,000 portion of the payment and would be $250,000.

(v) Income tax withheld on the following supplemental wage payments (or portion of a payment) as follows is required to be

calculated at the maximum rate in effect under section 1, or 35 percent in 2007—
(A) $2,000,000 of the $3,000,000 bonus paid by R on June 30, 2007; and
(B) all of the $100,000 bonus paid by T on December 31, 2007.

(vi) Pursuant to paragraph (a)(4)(iii) of this section, because the total wage payments made by U, an agent of the employer, to D are less than $100,000, U is permitted to determine the amount of income tax to be withheld without regard to other supplemental wage payments made to the employee. Income tax withholding on the $50,000 in sick pay may be determined under either paragraph (a)(6) or (7) of this section. If U elects to withhold income tax at the flat rate provided under paragraph (a)(7)(ii)(F) of this section, withholding on the $50,000 of sick pay would be calculated at 25 percent of the $50,000 payment and would be $12,500. Alternatively, U may choose to take account of the $3,000,000 in supplemental wages paid by the employer during 2007 prior to payment of the $50,000 sick pay, and withholding on the $50,000 of sick pay could be calculated applying the mandatory flat rate of 35 percent, resulting in withholding of $17,500 on the $50,000 payment.

Example 4. (i) Employer J has decided it wants to grant its employee B a $1,000,000 net bonus (after withholding) to be paid in 2007. Employer J has withheld income tax from the regular wages of the employee. Employer J has made no other supplemental wage payments to B during the year. The rate for mandatory flat rate withholding in effect in the year in which the payment is made is 35 percent, and the rate for optional flat rate withholding in effect is 25 percent.

(ii) This *Example 4* requires grossing up the supplemental wage payment to determine the gross wages necessary to result in a net payment of $1,000,000. If the employer elected to use optional flat rate withholding, the first $1,000,000 of the wages would be subject to 25 percent withholding. However, any wages above that, including amounts representing gross-up payments, would be subject to mandatory 35 percent withholding. The withholding applicable to the first $1,000,000 (i.e., $250,000) would thus be required to be grossed-up at a 35 percent rate to determine the gross wage amount in excess of $1,000,000. Thus, the wages in excess of $1,000,000 would be equal to $250,000 divided by .65 (computed by subtracting .35 from 1) or $384,615.38. Thus the total supplemental wage payment, taking into account income tax withholding only (and not Federal Insurance Contributions Act taxes), to B would be $1,384,615.38, and the total withholding with respect to the payment if Employer J elected optional flat rate withholding with respect to the first $1,000,000, would be $384,615.38.

(9) *Certain noncash payments to retail commission salesmen.* For provisions relating to the treatment of wages that are not subject to paragraph (a)(2) of this section and that are paid other than in cash to retail commission salesmen, see § 31.3402(j)–1.

(10) *Alternative methods.* The Secretary may provide by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter) for alternative withholding methods that will allow an employer to meet its responsibility for the mandatory flat rate withholding required by paragraph (a)(2) of this section.

(b) *Special rule where aggregate withholding exemption exceeds wages paid*—(1) *Procedure.* This rule does not apply to the extent that paragraph (a)(2) of this section applies to the supplemental wage payment. * * *

(2) *Applicability.* The rules prescribed in this paragraph (b) shall, at the election of the employer, be applied in lieu of the rules prescribed in paragraph (a) of this section except that this paragraph shall not be applicable in any case in which the payroll period of the employee is less than one week or to the extent that paragraph (a)(2) of this section applies to the supplemental wage payment.

* * * * *

■ **Par. 5.** Section 31.3402(j)–1 is amended by adding a new sentence at the beginning of paragraph (a)(2) to read as follows:

§ 31.3402(j)–1 Remuneration other than in cash for service performed by retail commission salesman.

(a) * * *

(2) Section 3402(j) and this section are not applicable with respect to wages paid to the employee that are subject to withholding under § 31.3402(g)–1(a)(2). * * *

* * * * *

■ **Par. 6.** Section 31.3402(n)–1 is revised and the authority citation at the end of the section is removed to read as follows:

§ 31.3402(n)–1 Employees incurring no income tax liability.

(a) *In general.* Notwithstanding any other provision of this subpart (except to the extent a payment of wages is subject to withholding under § 31.3402(g)–1(a)(2)), an employer shall not deduct and withhold any tax under chapter 24 upon a payment of wages made to an employee, if there is in effect with respect to the payment a withholding exemption certificate furnished to the employer by the employee which certifies that—

(1) The employee incurred no liability for income tax imposed under subtitle A of the Internal Revenue Code for his preceding taxable year; and

(2) The employee anticipates that he will incur no liability for income tax imposed under subtitle A for his current taxable year.

(b) *Mandatory flat rate withholding.* To the extent wages are subject to income tax withholding under § 31.3402(g)–1(a)(2), such wages are subject to such income tax withholding regardless of whether a withholding exemption certificate under section 3402(n) and the regulations thereunder has been furnished to the employer.

(c) *Rules about withholding exemption certificates.* For rules relating to invalid withholding exemption certificates, see § 31.3402(f)(2)–1(e), and for rules relating to disregarding certain withholding exemption certificates on which an employee claims a complete exemption from withholding, see § 31.3402(f)(2)–1T(g).

(d) *Examples.* The following examples illustrate this section:

Example 1. Employee A, an unmarried, calendar-year basis taxpayer, files his income tax return for 2005 on April 10, 2006. A has adjusted gross income of $5,000 and is not liable for any income tax. He had $180 of income tax withheld during 2005. A anticipates that his gross income for 2006 will be approximately the same amount, and that he will not incur income tax liability for that year. On April 20, 2006, A commences employment and furnishes his employer a withholding exemption certificate certifying that he incurred no liability for income tax imposed under subtitle A for 2005, and that he anticipates that he will incur no liability for income tax imposed under subtitle A for 2006. A's employer shall not deduct and withhold on payments of wages made to A on or after April 20, 2006. Under § 31.3402(f)(4)–2(c), unless A furnishes a new withholding exemption certificate certifying the statements described in paragraph (a) of this section to his employer, his employer is required to deduct and withhold upon payments of wages to A made after February 15, 2007.

Example 2. Assume the facts are the same as in *Example 1* except that A had been employed by his employer prior to April 20, 2006, and had furnished his employer a withholding exemption certificate prior to furnishing the withholding exemption certificate certifying the statements described in paragraph (a) of this section on April 20, 2006. Under section 3402(f)(3)(B)(i), his employer would be required to give effect to the new withholding exemption certificate no later than the beginning of the first payroll period ending (or the first payment of wages made without regard to a payroll period) on or after May 20, 2006. However, under section 3402(f)(3)(B)(ii), his employer could, if it chose, make the new withholding exemption certificate effective with respect to any payment of wages made on or after April 20, 2006, and before the effective date mandated by section 3402(f)(3)(B)(i). Under § 31.3402(f)(4)–2(c), unless A furnishes a new withholding exemption certificate certifying the statements described in § 31.3402(n)–1(a) to his employer, his employer is required to deduct and withhold upon payments of wages to A made after February 15, 2007.

Example 3. Assume the facts are the same as in *Example 1* except that for 2005 A has

taxable income of $8,000, income tax liability of $839, and income tax withheld of $1,195. Although A received a refund of $356 due to income tax withholding of $1,195, he may not certify on his withholding exemption certificate that he incurred no liability for income tax imposed by subtitle A for 2005.

Mark E. Matthews,

Deputy Commissioner for Services and Enforcement.

Approved: July 14, 2006.

Eric Solomon,

Acting Deputy Assistant Secretary of the Treasury (Tax Policy).

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NATIONAL ARCHIVES AND RECORDS ADMINISTRATION

36 CFR Parts 1253 and 1280

RIN 3095–AB52

[Docket NARA–06–0007]

Changes in NARA Research Room and Museum Hours

AGENCY: National Archives and Records Administration (NARA).

ACTION: Interim final rule; request for comment.

SUMMARY: NARA is revising its regulations with respect to research room and museum hours at its facilities in the Washington, DC, area. The operating costs for these facilities have been increasing every year, particularly for staffing, security services and utilities. In these times of fiscal restraint, NARA has determined reluctantly that it is necessary to curtail service during time frames when only a small percentage of our users are present to ensure that we are able to provide quality services to customers during the times of greatest public use while we are also conducting other mission-critical duties. This regulation will affect individuals who use our archival research rooms in the National Archives Building and National Archives at College Park facility, and individuals who visit the National Archives Experience and the Rotunda exhibits in the National Archives Building. This rule also makes minor edits to related provisions, which are discussed in the **SUPPLEMENTARY INFORMATION** section, and adds the archival research room at the National Personnel Records Center to our list of research facilities.

DATES: This interim final rule is effective October 2, 2006. Comments on this interim final rule must be received by September 8, 2006 at the address shown below. NARA intends to publish any changes to the rule resulting from this comment period before the October 2, 2006 effective date.

A public meeting on this interim final rule will be held on August 3, 2006 at 1 p.m. See the **ADDRESSES** paragraph for additional information.

ADDRESSES: NARA invites interested persons to submit comments on this interim final rule. Comments may be submitted by any of the following methods:

- Federal eRulemaking Portal: *http://www.regulations.gov.* Follow the instructions for submitting comments.
- Fax: Submit comments by facsimile transmission to 301–837–0319.
- Mail: Send comments to Regulations Comments Desk (NPOL), Room 4100, Policy and Planning Staff, National Archives and Records Administration, 8601 Adelphi Road, College Park, MD 20740–6001.
- Hand Delivery or Courier: Deliver comments to 8601 Adelphi Road, College Park, MD.

The public meeting will be held at the Jefferson Room in the National Archives Building, Washington, DC 20408, on August 3, 2006 at 1 p.m. Please enter through the Constitution Avenue Special Events entrance (Constitution Ave. NW., between 7th and 9th Streets, NW.). Reservations are not required but space may be limited.

FOR FURTHER INFORMATION CONTACT: Nancy Allard at 301–837–1477 or Jennifer Davis Heaps at 301–837–1801 or via fax number 301–837–0319.

SUPPLEMENTARY INFORMATION: A discussion of the changes we are making in this rule follows.

Research Room Hours in DC Area Facilities

Our research center and Central Research Room in the National Archives Building and the research rooms at the National Archives at College Park facility are currently open for research Monday through Friday from 8:45 a.m. to 5 p.m.; on Tuesday, Thursday and Friday evenings from 5 p.m. to 9 p.m.; and Saturdays from 8:45 a.m. to 4:45 p.m. This interim final rule would eliminate Saturday hours and change the research room hours to 9 a.m. to 5 p.m. on weekdays, more closely reflecting NARA official business hours in those facilities. The new research room hours are specified in §§ 1253.1(a) and 1253.2(b). We are also amending § 1253.8 since we no longer will have Saturday hours.

During the evening and Saturday hours we must provide staff to supervise the seven research rooms and assist researchers. We also require additional security guard presence and incur additional utility costs because the buildings are open to the public. We determined that carrying out the necessary reduction in hours by eliminating evening and Saturday hours would inconvenience the fewest researchers. Researchers who conduct research in original archival records in the evening or on Saturday currently must make a reference request in-person before 3:30 on weekdays to have the records identified and retrieved from the stack areas for their research use; no records are retrieved during those extended hours. NARA had 96,393 researcher visits in FY 2005 in our DC area research rooms. The following charts show that at both facilities, significantly fewer researchers used the research rooms during evening and Saturday hours in FY 2005:

2005 EVENING/SATURDAY RESEARCH ROOM USAGE AT THE NATIONAL ARCHIVES BUILDING

National Archives Building only	Number of researchers		Researchers as a percentage of total researchers during the quarter	
	Evening research room usage from 5:30 p.m. forward	Saturday research room usage	Evening research room usage from 5:30 p.m. forward (percent)	Saturday research room usage (percent)
Jan–Mar 2005	968	691	14	10
Apr–Jun 2005	1,061	653	12	8
July–Sep 2005	1,268	823	13	8
Oct–Dec 2005	966	594	15	9