

MARCH 2006

An Analysis of Recent Developments & Trends

LITTLER MENDELSON, P.C.
THE NATIONAL EMPLOYMENT & LABOR LAW FIRM

An Employer's Guide for Dealing with "Unusual" Tax Withholding Requests

by: GJ Stillson MacDonnell and William Hays Weissman

Summary: Employers must know how to address both regular and "unusual" changes and requests concerning exemptions and personal allowances reflected on employees' W-4 forms. This Insight provides background on the issues and guidance to employers dealing with "unusual" tax withholding requests.

Introduction

In the ordinary course of commencing employment a new employee will execute a W-4, Withholding Exemption Certificate, to inform his or her employer of the correct filing status and number of exemptions and personal allowances to use when calculating income tax withholding. This process occurs upon hire, and sometimes changes during the year. But what happens when employees make "unusual" requests of their employer relating to withholding? This Insight provides a brief guide for employers to help determine their payroll tax obligations.

Determining an Employee's Federal Income Tax Withholding

Usual Reasons Why W-4 Withholding Changes

Employees should execute a valid W-4 upon hire (and may, in some cases, also execute a separate state version of the W-4). The W-4 informs the employer of the employee's filing status (e.g., single, married, head of household), as well as the number of exemptions and personal allowances being claimed. Thus, the W-4 provides the employer with the necessary information to determine the proper amount of federal income tax to withhold based on the appropriate withholding table.

There is no clear standard or bright line test for determining when an employer should know that a W-4 is valid or invalid. The only standard is set forth in the Treasury Regulations: an employer should reject a W-4 if "the employee clearly

indicates [that the W-4 is] false by an oral statement or by a written statement" other than the W-4 itself.¹ However, a W-4 is invalid if the form contains an unauthorized alteration or addition.²

Once a valid W-4 has been executed, there are several reasons why the number of exemptions and personal allowances may change, including:

- Getting married or divorced;
- Adding a new dependent, such as the birth or adoption of a child;
- Purchasing a new house;
- Losing a job or starting a second job;
- Retiring;
- Increasing or decreasing income not subject to withholding, such as dividends, interest or capital gains; or
- Increasing or decreasing itemized deductions or credits, such as job expenses or education credits.³

Prudent employees will review their withholding allowances at least yearly to ensure that the amount of withholding approximates their tax liabilities, based on the claimed exemptions and personal allowances. Changes should be made as follows:

- Employees may execute a new W-4 at any time, but it need not become effective until the first payment of wages at least 30 days after the next status determination date (which are January 1, May 1, July 1 and September 1).⁴

¹ Treas. Reg. § 31.3402(f)(2)-1(e).

² *Id.*, at § 31.3402(f)(5)-1(b).

³ See IRS Publication 919, *How Do I Adjust My Tax Withholding?*

⁴ Treas. Reg. § 31.3402(f)(3)-1(b).

continued from cover

- An employer, however, may elect to make the W-4 effective at an earlier date.
- For example, if on March 25 an employee executes a W-4 changing his prior valid W-4, it would not be effective until the first pay period beginning after June 1, although the employer could make it effective sooner.
- Employees are required to submit a new W-4 within 10 days of any change that causes the number of exemptions stated on a W-4 to be more than the number of exemptions to which the employee is entitled (e.g., the employee gets divorced, which would reduce his or her exemptions by one).

Employer's Obligations With Respect to Accepting and Rejecting W-4s

Prior to 2005, in an effort to combat tax avoidance, the IRS required any W-4 listing more than ten personal allowances to be filed with the IRS. However, beginning in 2005, the IRS abandoned that practice in favor of a different process. The current requirements for accepting and rejecting W-4s are:

- An employer should not knowingly use an invalid Form W-4 to calculate withholding.
- The employer should tell the employee when a W-4 is invalid and ask for another one.
- If the employee does not provide a valid W-4, the employer should withhold taxes as if the employee were single and claiming no withholding allowances; or, if a prior Form W-4 is in effect with respect to the employee, the employer should continue to withhold in accordance with the prior valid W-4.⁵
- If an employee submits a W-4 that eliminates all withholding requirements

(claims "exempt"), the employee must verify (1) that he or she was entitled to a full refund of all income taxes withheld because he had no income tax liability for the prior year, and (2) that he or she expects a full refund during the current year because he or she expects to have no tax liability.⁶

- A W-4 claiming "exempt" from withholding is only good until February 15 of the calendar year following the year in which the withholding is to be eliminated. Thus, an employee must execute a new W-4 by February 15 of each calendar year if he or she wants to avoid having any income tax withholding.⁷
- If the employer receives a letter from the IRS, called a "lock-in" letter, the employer must disregard the W-4 and any W-4s subsequently executed by the employee and follow the IRS' withholding instructions, unless the new W-4 would withhold more than the IRS requires.

Some of the More Common "Unusual" Requests

Taxpayers may make "unusual" requests of their employers in an attempt to reduce or avoid taxes or amounts withheld. These may be the result of deliberate conduct or may be the result of inadvertence or improper advice. However, regardless of motive, employers should be wary of such requests to ensure that they are properly complying with their payroll tax obligations.⁸ Employers should be wary of the following requests:

- Employee executes a W-4 claiming he or she is exempt from taxes just before a large bonus or commission is due. Claiming exempt from taxes is highly unusual for most employees because they must be able to attest that they had no tax liability in the prior year and expect to have none in the current year. This is unlikely for most employees that earn reg-

ular wages or salaries above more than very minimal amounts.

- Employee executes a new W-4 claiming a very large number of personal allowances just prior to a large year-end bonus or commission. In this situation the W-4 is probably invalid, particularly if the employee has otherwise had regular withholdings during the rest of the year. However, it may be difficult for an employer to know the actual basis for the increase in personal allowances unless the employee informs his or her employer.
- Employee requests to be classified as a "statutory employee" on the W-2.⁹ Some employees that work at home or are salespeople may believe that they can be classified as a statutory employee because they fit within the statutory employee categories for FICA tax purposes. Taxpayers may believe that they are exempt from income tax withholding or may be seeking to claim business expenses as an independent contractor that they cannot otherwise claim as an employee.¹⁰
- Employee claims that bonuses or other forms of supplemental wages are not subject to withholding. Employees may believe that only regular wages are subject to withholding. To the contrary, supplemental wages may be subject to a flat withholding rate of 25 percent (or 35 percent for amounts over \$1 million).

What Employers Should Do When They Receive an Unusual Request

Employers may be concerned when they receive a newly executed W-4 from an employee claiming exempt from withholding or an unusually large number of personal allowances. When an employer receives such a request, it should take the following actions:

- Determine whether the employee has

5 *Id.*, at §§ 31.3402(f)(2)-1(e), 31.3402(f)(5)-1(b).

6 *Id.*, at § 31.3402(n)-1; see also Instructions to Form W-4.

7 Prop. Treas. Reg. § 31.3402(f)(4)-2(c).

8 There are a group of taxpayers commonly referred to as "tax protestors" who generally assert that they are not required to pay taxes. We are not addressing tax protestors here, but will do so in a later Insight.

9 "Statutory employees" are workers that qualify as independent contractors under the common law for income tax withholding purposes, but nonetheless are treated as employees for FICA and/or FUTA purposes. Statutory employees includes certain commissioned sales persons and certain persons that work at home. See IRC § 3121(d).

10 See Rev. Rul. 90-93, 1990-2 C.B. 33.

made any oral or written statement indicating that the W-4 is invalid, other than the W-4 itself. The IRS has informally indicated that it believes a W-4 is invalid on its face when there has been regular withholdings throughout the year and there is a sudden significant increase in the number of personal allowances.

- Check the employee's personnel file to make sure there is no "lock-in" letter from the IRS regarding the proper method of withholding for the employee.
- Confirm with the employee that the W-4 properly reflects his or her intent with respect to withholding (i.e., that the employee did not simply make an error in filling out the W-4).
- Advise the employee of the penalties for filing a false W-4, including a \$500 civil penalty and a \$1,000 fine and imprisonment for up to one year.¹¹
- Contact counsel with any questions or concerns.

There is no express requirement that employers confirm that the information on a W-4 that appears valid on its face is not incorrect or fraudulent. IRS guidance on the issue is somewhat contradictory, because the IRS has stated that employers need not verify W-4s, but at the same time expressed the opinion that an employer should know that a W-4 is invalid on its face when it represents a sudden dramatic departure from the employee's prior withholding. Employers are thus put in the somewhat awkward position of having to make judgment calls about the validity of W-4s.

Therefore, until the IRS provides further clarification and guidance on this issue, employers should be wary of unusual W-4 requests. Littler's Employment Taxes Practice Group can assist employers with

any questions about questionable W-4s or unusual employee requests.

GJ Stillson MacDonnell is a shareholder and chair of Littler's Employment Taxes Practice Group and William Hays Weissman is an associate in the Employment Taxes Practice Group in Littler Mendelson's San Francisco office. If you would like further information, please contact your Littler attorney at 1.888.Littler, info@littler.com, GJ Stillson MacDonnell at GJMacDonnell@littler.com, or Mr. Weissman at WWeissman@littler.com.

¹¹ IRC § 7205; see *United States v. Echols*, 677 F.2d 498 (5th Cir. 1982); *United States v. Smith*, 484 F.2d 8 (10th Cir. 1973) (taxpayer who claimed ten exemptions on withholding statement, but knew that he was only entitled to claim two, willfully supplied false information).