



# Gross-ups

Prior-year income tax withholding adjustments prohibited under latest IRS guidance

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# Gross-ups: Prior-year income tax withholding adjustments prohibited under latest guidance

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It is customary for employers under certain circumstances to pay income taxes on behalf of their employees (i.e., gross-up) rather than withhold it from their pay. Gross-up, for instance, is commonplace for holiday bonuses and recognition awards where the required income tax withholding is readily ascertainable.

Gross-up is also typical in instances where the employee's tax liability is not known until after the close of the year when a reconciliation can be performed against the employee's pro-forma income tax return. Relocation reimbursements and hypothetical tax paid to international assignees are examples that fall into this category.

How employers address cross-year gross-up reconciliations may need to change in light of recent IRS guidance that clearly prohibits prior-year adjustments to federal income tax withholding paid by employers on behalf of their employees.

## Past IRS guidance concerning prior-year income tax withholding adjustments

Some employers took the position that federal income tax withholding reported through a gross-up is not "withheld" from employees' pay. Accordingly, the error is administrative and corrections after the close of the year are allowed. This would seem to have been supported by IRS Reg. [§31.6414-1\(1\)](#) that states "an employer that has overpaid federal income tax withholding may file a claim for refund of the overpayment only if the amount was not actually withheld from the employee's wages."

In the past, readily available IRS guidance in Publication 15 and the Form 941-X instructions also did not appear to contradict the presumption that if income tax withholding is not actually withheld from wages, prior-year adjustments are allowed. Both publications stated that federal income tax withholding errors for prior years were allowed only if IRC §3509 applies and if the amounts shown on Form 941 did not agree with the amounts actually withheld. (*Instructions for Form 941-X, Adjusted Employer's QUARTERLY Federal Tax Return or Claim for Refund*, page 7, rev. April 2014; *Publication 15, Employer's Tax Guide*, page 33, rev. 2016.)

This past characterization of "administrative error" as previously contained in the Form 941-X instructions is consistent with IRS Reg. [§31.6413\(a\)-2\(c\)\(2\)](#) and Rev. Rul. 2009-39. (*Rev. Rul. 2009-39, 2009-52, I.R.B. 951.*)

In guidance not as readily available as the Form 941-X instructions, the IRS was more definitive concerning its intent that prior-year income tax adjustments are not allowed for gross-ups. In a 2014 IRS Chief Counsel Advice (*CCA 201414019*), the IRS Office of the Chief Counsel advised that a prior-year gross-up of income tax represents tax actually withheld even though the employer paid the tax on behalf of the employee through the gross-up. The CCA further stated that the employer could not claim a refund of any excess income tax withholding remitted in a prior calendar year as a result of the gross-up. Instead, the CCA advised that any income tax refund must be claimed by employees on their federal individual income tax returns.

In light of this 2014 CCA, the previous practice of adjusting prior-year income tax withholding on the Form W-2c was not without risk.



# Gross-ups: Prior-year income tax withholding adjustments prohibited under latest guidance

Continued

## Current IRS guidance specifically disallows prior-year income tax withholding adjustments on gross-ups

For the first time in 2017, the IRS Office of Chief Counsel elaborated on the definition of “administrative error” by specifically clarifying that it does not include prior-year adjustments to federal income tax withholding that is paid by employers on behalf of their employees. (CCA 201727008.)

The 2017 Form 941-X instructions were revised and expanded to include a more detailed explanation of allowable prior-year federal income tax adjustments. Rather than merely stating that an administrative error is one where the Form 941 does not agree with amounts actually withheld, it elaborates by saying:

*“... you can’t correct federal income tax actually withheld from an employee in a prior year if you discover that you didn’t withhold the right amount. For example, you can’t correct federal income tax withheld in a prior year because you used the wrong income tax withholding table in Pub. 15 or you didn’t treat a payment correctly as taxable or nontaxable.”*

This extended language alone does not eliminate the question of IRS intent; however, when taken together with the following added paragraph, the IRS leaves no doubt that it will now disallow refund requests for prior-year income tax withholding overpayments on gross-ups.

*“ Similarly, if you paid federal income tax in a prior year on behalf of your employee, rather than deducting it from the employee’s pay (which resulted in additional wages subject to tax), and in a subsequent year you determine that you incorrectly calculated the amount of tax, you can’t correct the federal income tax withholding.” (Form 941-X instructions, page 9.)*

## Case study: Correction of gross-up in subsequent year under latest guidelines

Employer X agrees to pay on behalf of Employee G any federal income tax, Social Security or Medicare tax owed in connection with taxable relocation reimbursements. The agreement stipulates that the federal income tax gross-up will take into account any loss in tax credits the added income will have on Employee G’s federal individual income return.

On September 6, 2017, Employer X reimburses taxable relocation expenses of \$10,000 incurred by Employee G. On that date, Employee G’s year-to-date Medicare wages were \$300,000 (exceeding the 2017 Social Security wage base of \$127,200). Employer X used an estimate of 33% for the federal income tax portion of the gross-up. In February 2018, Employee G submitted a pro-forma Form 1040 for 2017, showing the effective rate of federal income tax on the relocation reimbursement was only 28%.

As shown in the calculations to follow, use of a federal income tax rate of 28% rather than 33% also caused an overstatement of Medicare and Additional Medicare tax because of the pyramiding effect of the gross-up.

### Gross-up estimate 2017

Tax %	Tax	Tax type
33.00%	\$ 5,104.41	Federal income tax
	15,467.90	Federal wages
	\$0.00	Social Security tax
1.45%	224.28	Medicare tax
	15,467.90	Medicare wages
0.90%	139.21	Additional Medicare
<b>Total tax</b>	<b>\$ 5,467.90</b>	

### True-up and adjustments for 2018

Tax %	Tax	Tax type
28.00%	\$ 4,020.10	Federal income tax
	\$ 14,357.50	Federal wages
	\$ 0.00	Social Security tax
1.45%	\$ 208.18	Medicare tax
	\$ 14,357.50	Medicare wages
0.90%	\$ 129.22	Additional Medicare
<b>Total tax</b>	<b>\$ (4,357.50)</b>	

### Employer X’s 2017 tax overpayment

<b>\$5,467.90 - \$4,357.50 = \$1,110.40</b>	
Federal wages .....	\$1,110.40
Federal income tax .....	1,084.31
Medicare wages .....	1,110.40
Medicare tax .....	16.10
Additional Medicare .....	9.99

Employer X wishes to recover the overpayment of federal income, Medicare and Additional Medicare tax, representing a total tax overpayment of \$1,110.40.

## Step 1: Request employee repay the overpayment

In 2018, the year of the true-up, Employer X should request the employee repay the gross overpayment of \$1,110.40 less the Medicare tax of \$16.10, for a net of \$1,094.30. By leaving \$16.10 with the employee, Employer X has refunded the Medicare tax withholding as required.

Under the latest IRS guidance, if Employee G doesn't repay Employer X, there is no remedy for resolving the overpayment. Employer G must absorb the loss.

## Step 2: When repayment is received, issue a 2017 Form W-2c

Keep in mind that a wage repayment occurring in years subsequent to the overpayment are subject to the claim-of-right rule. Accordingly, no adjustment is allowed to the federal taxable wages reported in box 1 (or in the federal income tax withholding reported in box 2 or the Additional Medicare tax reported in box 6). It will be up to the employee to claim any federal income or Additional Medicare tax refund that may be owed according to the instructions for wage overpayments in IRS Publication 525. See the Form W-2c entries below. ([IRC §1341](#); [Publication 15](#).)

### 2017 Form W-2c

Box number, description	Previously reported	Correct amount
5 – Medicare wages	15,467.90	14,357.50
6 – Medicare tax withheld	224.28	208.18

## Step 3: File Form 941-X to claim refund of Medicare tax overpayment

For the 2017 third quarter, Employer X will file a Form 941-X reporting the reduction of Medicare wages of \$1,110.40 and claim a refund for the employer portion of the Medicare tax totaling \$32.20 ( $\$1,110.40 \times 2.9\%$ ).

### Ernst & Young LLP insights

Pursuant to a gross-down (i.e., overpayment of tax), the ability to adjust prior-year federal income tax reported on Forms W-2 enabled the employer to easily recover its own money by claiming a refund of the full federal tax overpayment from the IRS on Form 941-X.

Now that IRS guidance removes this option, the employer is forced to seek repayment of the tax overpayment from employees, and if that is achieved, prepare and file Forms W-2c under the complex claim-of-right rule. (See our example above.)

Correcting prior-year federal income tax underpayments is also not allowed under this most recent IRS guidance. In order to avoid the liability for any under-withheld federal income tax, employers will need to obtain [Form 4469](#) from affected employees. If federal income tax withholding shortfalls are paid on behalf of employees for the prior year, such payment is subject to gross-up and reported on the Form W-2/Form 941 in the year the employer pays the tax to the IRS. (See our example above.)



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