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**Payroll Letter 924**

To: Agency HR Specialists, Payroll Specialists, Budget Specialists, Benefits Specialists, Labor Relations Specialists, and Regulatory Requirements Specialists of All Departments, Institutions, Boards and Commissions

From: David Holbrook, HCM Administrator

Subject: Federal Tax Liability on Deferred comp and December conversion

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This aid was created to help explain to state of Ohio employees how federal taxes were determined for employees who received conversion payouts in December and requested an increase in their deferred compensation deduction for that same pay period in an effort to offset the additional tax liabilities resulting from the conversion payout.

For example, if an employee knew that he or she was to receive $450 by cashing in sick leave and personal leave, the employee would request to have an additional $450 withheld in deferred compensation. We have received questions from agencies and employees asking how federal taxes were taken out of the paycheck that included these two transactions. The following example explains how the system assesses taxes on these liabilities.

1) **Employee receives the following paycheck the first pay in December:**

| | |
|---|---|
| Regular Gross Earnings: | $2,600.00 (55.32% of total) |
| December Conversion Payouts: | $2,100.00 (44.68% of total) |
| **TOTAL:** | **$4,700.00** |

Because the tax liabilities associated with supplements such as the conversion payouts are different from the tax liabilities associated with regular gross earnings, the employee's earnings and payouts must be separated.

2) **Determine the amount of before-tax contributions.**
Deferred compensation contributions are not taxable income. Therefore, employees are not required to pay income taxes on these contributions unless and until they receive payments from the accounts. Let's assume that this employee's paycheck reports a before-tax amount of **$2,500.00**, which includes a deferred compensation amount of $2,300.00.

These before-tax contributions must be separated into the earnings vs. payout categories based on the percentages below:

| TOTAL: $2,500.00 | |
|---|---|
| 55.32% x $2,500.00 = **$1,383.00**<br>(Before-Tax Contributions<br>for Gross Earnings) | 44.68% x $2,500.00 = **$1,117.00**<br>(Before-Tax Contributions<br>for December Conversion Payouts) |

3) **Determine the employee's total taxable income.**
The employee's earnings and payouts minus their before-tax contributions equals the amount of taxable income on which the employee is assessed a tax. Because supplements like conversion payouts are assessed taxes at a rate different from regular gross earnings, the regular gross earnings and conversion payouts must be kept in separate categories.

| Regular Gross Earnings | | Conversion Payouts | |
|---|---|---|---|
| Regular Gross Earnings: | $2,600.00 | Conversion Payouts | $2,100.00 |
| Before-Tax Contributions: | -- $1,383.00 | Before-Tax Contributions: | -- $1,1117.00 |
| **TOTAL:** | **$1,217.00** | **TOTAL:** | **$983.00** |

These totals represent the amount of taxable income the employee has as a result of her or his regular earnings and payouts for this pay period. Because the payroll system annualizes taxes, these numbers must be multiplied by 26 (the number of pay periods in one year), below:

| Regular Gross Earnings | | December Conversion Payouts | |
|---|---|---|---|
| **Pay Period Total:** | $1,217.00 | **Pay Period Total:** | $983.00 |
| **Yearly Total:** | **$31,642.00** | **Yearly Total:** | **$25,558.00** |

After the yearly total is determined, it is necessary to take into account any federal tax exemptions the employee has claimed. These exemptions are applicable to regular gross earnings only and cannot be claimed against the conversion payouts. For purposes of this example, we will assume that this employee has three federal tax exemptions at the married rate. The dollar amounts associated with these exemptions are set forth in the IRS regulations, currently $3,400 per exemption and reduce the employee's total taxable income by $10,200.00 ($3,400 x 3). Therefore, the employee's total taxable income is as follows:

| Regular Gross Earnings | | December Conversion Payouts | |
|---|---|---|---|
| **Yearly Total:** | $31,642.00 | **Yearly Total:** | $25,558.00 |
| **Federal Tax Exemptions:** | -- $10,200.00 | **--** | -- |
| **Total Taxable Income:** | **$21,442.00** | **Total Taxable Income:** | **$25,558.00** |

4) **Determine the federal tax.**
Federal income taxes for regular gross earnings are calculated based on the IRS Circular E Table for Percentage Method of Annual Withholding. This amount is determined based on the amount of the employee's total taxable income. In this case, an employee with $21,442.00 in total taxable income will be assessed an annual tax of **$1,344.20.** (The tax table instructs employers to subtract $8,000.00 from $21,442.00 and multiply that amount by 10 percent based on withholding at a married rate). Because this is an annual tax, the total tax must be divided by 26 (the number of pay periods in one year) to determine the tax that should be assessed this pay period. When we divide $1,344.20 by 26, we get **$51.70**, which is the amount of federal tax assessed on the employee's regular gross earnings this pay period.

Federal income taxes for supplemental wage payments such as the conversion payout are assessed at a flat rate of 25 percent. In this case, an employee with $25,558.00 in total taxable income will be assessed an annual tax of **$6,389.50.** Since this is an annual tax, we must divide $6,389.50 by 26 (the number of pay periods in one year) to determine the tax that should be assessed this pay period. When we divide **$6,389.50** by 26, we get **$245.75** which is the amount of federal tax that is assessed on the employee's conversion payout this pay period.

When the federal taxes assessed on both the employee's regular gross earnings are added to the federal taxes assessed on the conversion payouts, we get a total federal tax assessment of **$297.45**, which is the amount of federal taxes that will appear on the employee's paycheck.

For more information, please contact the HCM Customer Support Unit at 1-800-409-1205.