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Taxation of Employer Payments to Reservists and National Guard Members

By LT Marc J. Soss, SC, USNR

Employers who, in support for our troops, have continued making payments to their deployed employees (Reservist or National Guard members) must be aware of the IRS's tax position and the lack of updated guidance on this matter. Employer payments of the employee's full civilian salary or supplemental amount (difference between civilian salary and military pay), are not excluded from the definition of "wages" by the Internal Revenue Code (the "Code"). This article addresses the confusion in this area, caused by the lack of updated guidance from the IRS; provides guidance to employers on how to classify the payments for payroll tax purposes; provides support for reporting those payments to the government and employees; and substantiates the position that should be followed for tax reporting purposes.

Tax Reporting Options

Form 1099-MISC Reporting: The employer is not required to withhold income tax on the employee's behalf or be subject to Federal Insurance Contributions Act taxes (FICA) or Federal Unemployment Tax Act taxes (FUTA). The income reported on Form 1099 must be included on the employee's federal and/or state income tax return and the employee will be responsible for all associated income taxes.

Form W-2 Reporting: The employer must file IRS Form W-2 to report payments (wages, tips, bonus, and other compensation) and withholdings (Social Security and Medicare taxes) on behalf of the employee. The employer payments are listed under Box 1 of the W-2 and will not automatically trigger payroll taxes.

Current Ruling Position of IRS

The current ruling position of the IRS, as set forth under Revenue Ruling 69-136, is that employer payments (the employee's full civilian salary or supplemental amount) are not "wages." The ruling concluded that the employer–employee relationship "was terminated" upon the employee's deployment and any employer payments made to a former employee while in military service, are not "wages" and not subject to Federal Income Tax Withholding (FITW), FICA, or FUTA.

USERRA

The Uniformed Services Employment and Reemployment Rights Act (USERRA) provides that "a person who is absent from a position of employment by reason of service in the uniformed services shall be (1) deemed to be on furlough or leave of absence while performing such service; and (2) entitled to such other rights and benefits not

determined by seniority as are generally provided by the employer of the person to employees having similar seniority, status, and pay who are on furlough or leave of absence under a contract, agreement, policy, practice, or plan in effect at the commencement of such service or established while such person performs such service." USERRA also requires retirement plan accruals as if the employee had not left and requires employers to re-employ those returning from active duty unless re-employment is impossible, unreasonable or would impose an undue hardship.

Case Law

The United States Supreme Court, in the case of *Alabama Power Co. v. Davis*, 431 U.S. 581 (1977), upheld an employee's entitlement to be rehired, after being called to and returning from military service, without loss of seniority and credit toward his pension for his period of military service. The Court concluded that pension payments are rewards for continuous employment with the same employer and that protecting veterans from the loss of such rewards, when the employment break results from his or her response to the country's military needs, is the purpose of the law. More importantly, the court also ruled that any person restored to a position "shall be considered as having been on furlough or leave of absence during his period of training and service in the armed forces, shall be so restored without loss of seniority, shall be entitled to participate in insurance or other benefits offered by the employer pursuant to established rules and practices relating to employees on furlough or leave of absence in effect with the employer at the time such person was inducted into such forces, and shall not be discharged from such position without cause within one year after such restoration."

Likewise, in *Accardi v. Pennsylvania R. Co.,* 383 U.S. 225 (1966), the Court addressed a claim for severance pay and ruled in favor of the employees based upon the fact that if they had remained on their jobs, they would have received severance pay credit for the years they spent in the military and failing to credit them with their military service time violated the requirement for reinstatement without the loss of seniority. It is important to recognize that both of these cases are directly at odds with the IRS conclusion in Revenue Ruling 69-136 that the "employment relationship was terminated."

Tax Law

Employer compensation payments generally constitute "wages" for federal payroll tax purposes (FITW, FICA and FUTA) unless specifically excluded from the definition of wages by the Code. Treasury Regulation Sect. 1.112-1(a)(4) provides that "compensation paid by other employers (whether private enterprises or governmental entities) to members of the Armed Forces cannot be excluded under section 112 [as combat pay] even if the payment is made to supplement the member's military compensation or is labeled by the employer as compensation for active service in the armed forces of the United States." In addition, the employment tax regulations deem an employment relationship for wage withholding purposes to exist even in situations where the employment relationship has been terminated if the post-employment

payment relates to past services [Treas. Reg. Sects. 31.3401(a)-1(a)(5), 31.3121(a)-1(i) and 31.3306(b)-1(i)].

Congressional Approach

Congress, under both the Jumpstart Our Business Strength Act and the Patriotic Employers of Guard and Reservists Act of 2004, proposed “an employer wage credit for an employer that continues to pay wages to an employee-Reservist who has been called to active duty” and to provide employers a tax credit for compensation paid while employees are performing service in the Ready Reserve or the National Guard. These characterizations of payments appear to contradict the IRS position that the employer–employee relationship was terminated when the employee left his/her civilian job to go on active duty.

Recommendation and Conclusion

Based on the 1969 Revenue Ruling that the IRS has not rescinded and continues to reference on its Web site, employers have a reason to not subject the payments (full civilian salary or supplemental amount) to payroll taxation. The IRS position is at odds with both the case law and statutory regime discussed. Tax and legal experts are of the opinion that the payments should be reported on Box 1 of the W-2 form, even though the payments are not being subjected to FITW and FICA tax withholding. In addition, some payroll tax experts recommend offering a voluntary withholding arrangement to those employees who are to receive these payments in order to avoid a year-end underpayment of income taxes. It is this author’s hope that the IRS will revisit this issue soon, understand the impact and confusion that is caused by the 1969 Revenue Ruling and favorably readdress its tax position on the issue. But always remember: The compensation is taxable income to you.

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