DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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The Honorable Dennis J. Kucinich
Member, U.S. House of Representatives
Parmatown Mall
7904 Day Drive
Parma, Ohio 44129

Attention:

Dear Congressman Kucinich:

I am responding to your inquiry dated August 31, 2007, on behalf of your constituent, . He wrote about the income tax treatment of a bonus he received from the United States Army in exchange for his agreement to a 10% reduction in his retirement benefits (a " career status bonus"). elected to receive a career status bonus of $30,000 before his service in a combat zone, but actually received it during his service in a combat zone.

The materials submitted indicate that believed, based on advice from other military personnel, that he would be able to exclude the career status bonus from compensation if it was actually paid while he was in the combat zone. The Army payroll office did not treat the payment as combat zone compensation and therefore excludable from his gross income. Instead, they included it in his gross income and it was subjected to income tax withholding at the rate of 25%. While we understand unhappiness with this result, the actions of the Army payroll office were correct and in accordance with the governing statute and regulations described below.

Combat Zone Compensation [Section 112(a) of the Internal Revenue Code]

A member of the military can exclude from his or her gross income compensation received for active service in the Armed Forces of the United States in a combat zone. In order to be excludable from gross income, the payments must represent compensation for active service in a combat zone. *See Waterman v. Commissioner*, *179 F.3d 123 (4th Cir. 1999)*. In the *Waterman* case, a military member who accepted

an early separation from service offer, which included a special separation payment, while serving in a combat zone, was not entitled to exclude the separation payment from his income because the payment did not fall within the definition of "compensation received for active service in a combat zone." Instead, the Court determined that the payment represented an inducement to leave military service and thus, it did not qualify as excludable combat zone compensation.

The Income Tax Regulations provide that the time and place of payment are irrelevant in determining whether the member can exclude the compensation. Rather, the time and place of entitlement to the compensation determine whether the compensation is excludible. Thus, the member can exclude the compensation whether or not he or she receives it outside a combat zone, or in a year different from when he or she rendered the service for which the compensation is paid, if the military member's entitlement to the compensation fully accrued in a month during which the member served in a combat zone. For this purpose, entitlement to compensation fully accrues when the member completes all actions required of him or her to receive the compensation. [Income Tax Regulations section 1.112-1(b)(4)]

Conversely, a military member cannot exclude the compensation if the member's entitlement to the compensation fully accrued during a month in which he or she did not serve in a combat zone, even if the member received the compensation while serving in a combat zone. The Regulations contain the following example to illustrate this point:

> In July, while serving outside a combat zone, an enlisted member voluntarily reenlisted. In February of the following year, the member, while performing services in a combat zone, received a bonus as a result of the July reenlistment. The reenlistment bonus cannot be excluded from income as combat zone compensation although received while serving in the combat zone, since the member completed the necessary action for entitlement to the reenlistment bonus in a month during which the member had neither served in the combat zone nor was hospitalized for wounds incurred while serving in a combat zone. [Regulations section 1.112-1(b)(5), Example 6].

Similarly, if a member completes the necessary action for entitlement to a career status bonus during a month in which he or she did not serve in a combat zone, he or she cannot exclude the bonus from income even if he or she actually received it while serving in a combat zone. The Department of Defense (DOD) Financial Management Regulations provide that, in order to be eligible for a career status bonus, a member must submit an election form (DD Form 2839) not later than the date the member attains 15 years of active military service, or 6 months after the Secretary of the Military Department concerned notifies the member that he or she is eligible to make an election for the bonus, whichever is later. Additionally, the DOD Financial Management Regulations provide that the career status bonus is considered to be excludable combat zone compensation if the effective date of the election falls within a month in which the member is serving in a combat zone. If a member signs the election prior to attaining fifteen years of active military service, the effective date of the election is the date when the member has attained fifteen years of service. If the member signs the election on or

after the date he or she attains fifteen years of active military service, the effective date of the election is the date that the member signs it.

Supplemental Wage Withholding

also asked why the career status bonus was subjected to income tax withholding at a rate of 25%. The Employment Tax Regulations distinguish between regular wages paid for a payroll period and supplemental wages for purposes of income tax withholding. Supplemental wages are wages paid in addition to regular wages for services an employee performs for the employer. Bonuses are supplemental wages. An employee's remuneration may consist of both regular wages paid for a payroll period and supplemental wages, such as bonuses, paid for the same or a different period, or without regard to a particular period. [Employment Tax Regulations section 31.3402(g)-1].

Generally, two procedures are available to an employer for withholding income taxes 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 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. [Employment Tax Regulations section 31.3402(g)-1(a)(6)].

Optional flat rate withholding on supplemental wages allows employers to disregard the amount of regular wages paid to an employee and the withholding allowances claimed by an employee on Form W-4, "Employee's Withholding Allowance Certificate," and use a flat percentage rate in calculating the amount of withholding. The flat percentage rate currently in effect for supplemental wages of $1,000,000 or less is 25%. [Employment Tax Regulations section 31.3402-1(a)(7)].

I hope this information is helpful. The general principles of law set forth in this letter are intended for informational purposes only and do not constitute a ruling. See Rev. Proc. 2007-1, section 2.04, 2007-1 I.R.B. 1 (Jan. 2, 2007). If you have any questions, please contact me at ( ) or of my office at ( ) .

Sincerely,

Nancy J. Marks
Division Counsel/ Associate Chief Counsel
(Tax Exempt & Government Entities)