

STATE CONTROLLER'S OFFICE
PERSONNEL/PAYROLL SERVICES DIVISION
P. O. BOX 942850
Sacramento, CA 94250-5878

DATE: November 29, 2007

PAYROLL LETTER # 07-020

TO: All Agencies/Campuses in the Uniform State Payroll System

FROM: Don Scheppmann, Chief
Personnel/Payroll Services DivisionRE: **MILITARY LEAVE PAYMENTS**

This payroll letter announces tax changes for employees who receive military leave payments (payment type 7). Military leave payments issued by the State Controller's Office (SCO) on or after January 1, 2008 will no longer be subject to Federal, California State, Social Security, Medicare, and State Disability Insurance (SDI) tax withholding by the SCO and will not be reported on Form W-2, Wage and Tax Statement. However, these payments are reportable income and will be reported on the Internal Revenue Service (IRS) Form 1099-MISC effective with the 2008 tax year.

IRS Revenue Ruling 69-136 provides that military leave payments are not classified as "wages" for services performed in "employment" for the employer. Since such payments made by the employer to the employee while the employee is on active duty are not classified as "wages," they are not subject to certain taxes as discussed above. Further, considering the definition of "wages" as set forth in Internal Revenue Code Section 3401, military leave payments (also known as "military differential payments) are also not subject to "Collection of Income Tax at Source on Wages," as stated in Revenue Ruling 69-136; therefore, no tax will be withheld by the SCO from such payments. These tax changes do not affect regular payments (payment type 0) made to employees on military leave for the first 30 calendar days of that leave.

TAX LIABILITY

Employees should be aware that military leave payments are considered income and are reported to the IRS. As such, the payments may be taxable, and employees should be encouraged to seek the services of a tax professional for assistance with the reporting of income, the filing of tax returns, and the payment of the applicable taxes. Employees working for the State of California and residing in other states may be subject to state tax withholding based on the laws of the state in which they reside. If you have an employee who resides in another state and receives military pay, please contact the SCO for instructions on requesting military leave payments. Contact information is provided below.

The IRS has released an IRS Newsroom Article entitled "Employers with Employees in a Combat Zone," which answers many questions regarding military leave payments. A copy of this IRS publication is attached.

PRE-TAX DEDUCTIONS

With respect to military leave payments made to an employee on or after January 1, 2008, pre-tax deductions such as the 401(k), 457, 403(b), and retirement buy-back deductions cannot be withheld from these payments. These deductions will automatically resume when the employee returns to active pay status. Employees enrolled to have pretax benefit deductions made to pay for benefits such as health, dental, and vision care will retain their benefits, but the benefit codes will be changed to reflect after-tax benefit deductions. No action by agencies, campuses, or employees is necessary to effect these changes.

EMPLOYEE NOTIFICATION

Departments and campuses will be responsible for informing employees currently on military leave regarding the above-referenced changes to current procedures that are scheduled to take place. Departments are encouraged to notify employees before their December 2007 military leave payments are issued. A sample notification letter is attached for your convenience.

MILITARY LEAVE WORK SHEET

The Department of Personnel Administration (DPA) and the California State University (CSU) Chancellor's Office will release a revised Military Leave Work Sheet along with completion instructions. Employees currently on military leave do not need to submit a new worksheet. The SCO will automatically compute the new adjusted net salary beginning with military leave payments issued on/after January 1, 2008.

The revised Military Leave Work Sheet is to be used beginning January 1, 2008, for employees who are newly eligible to receive military leave pay, who are deployed on a new military tour, or who wish to change their current Military Leave Work Sheet information.

REQUESTING PAYMENTS

The tax withholding, income reporting, and pre-tax deduction changes explained above do not affect the procedures for requesting military leave payments. Continue to submit a Form STD. 674, Payroll Adjustment Notice, and the revised Military Leave Work Sheet, to request payments or changes to the payments. Please refer to PPM Section G 500 and Payroll Letters # 98-009 and # 02-007 CSU ONLY for specific processing information. Revisions to the PPM will be forthcoming.

Please direct questions or concerns regarding this letter as follows:

Contact Information

| | | | |
|-------------------------|---|--|----------------|
| DPA | Civil Service Military Leave Policy | PSB@dpa.ca.gov | (916) 323-3343 |
| CSU Chancellor's Office | CSU Chancellor's Office Military Leave Policy | Pamela Chapin | (562) 951-4414 |
| SCO Payroll Liaison | Requesting Payments | Dana Lyles | (916) 323-3081 |
| SCO | Tax Withholding and Income Reporting Changes | Lorena Medina | (916) 324-5879 |

DS:LM:PMAB

Attachments

Employers with Employees in a Combat Zone

Military Differential Pay

Q-36: What is military differential pay?

A-36: Differential pay is defined as payments made voluntarily by an employer to represent the difference between the regular salary of an employee called to military active duty and the amount being paid by the military, if the regular salary was higher. For purposes of the following questions and answers, the term differential pay also includes military continuation pay, active duty differential payments required by state statutes or payments made by certain states or commonwealths that pay a stipend or a set dollar amount to their employees called to military active duty.

Q-37: If an employer pays military differential pay to an employee called to active duty, are these payments considered wages?

A-37: For federal tax purposes, the employment relationship between the employee and the company was terminated when the worker was called for active military service with the U.S. government or for active service with the state National Guard. Under the circumstances, the payments made by the company to the former employees while they are in military service with the U.S. government or active service with the state National Guard are not "wages" for services performed in "employment" for the companies. These payments, therefore, are not "wages" subject to the taxes imposed by the Federal Insurance Contributions Act and the Federal Unemployment Tax Act or to the Collection of Income Tax at Source on Wages.

- **Reference:** IRS Revenue Ruling 69-136

Q-38: What is the tax treatment of military differential pay?

A-38: Certain compensation received for active service in a combat zone by members of the Armed Forces of the United States is excludable from gross income. However, this exclusion applies only to compensation paid by the Armed Forces of the United States to members of the Armed Forces. Compensation paid by other employers (whether private enterprises or governmental entities) to members of the Armed Forces cannot be excluded as combat zone compensation even if the recipient is performing active military service in a combat zone at the time the payment is made. See [Military Pay Exclusion — Combat Zone Service](#) for more information on the taxability of combat zone compensation.

Q-39: If an employee is called to active duty and receives military differential pay, how are these payments reported by the employer to the employee?

A-39: Employers should report military differential pay on Form 1099-MISC, Box 3: Other Income. Do not use Form W-2 for these payments. Employers should not withhold FICA or income tax from these payments and the payments are not subject to FUTA taxes.

Q-40: How does a person who receives military differential pay report this on the federal income tax return?

A-40: The recipient reports the Form 1099-MISC amount on Line 21 of Form 1040 (Other Income) and lists the type as Military Differential Pay. No self-employment tax is due because the income from these payments is not derived from any trade or business conducted by the taxpayer for self-employment tax purposes.

Q-41: Since these payments are considered income but not "wages" subject to withholding, what should persons receiving these payments do to avoid owing large amounts of tax when they file their returns?

A-41: Since the employer is not required to withhold income tax, the recipient should prepare for the tax liability by making quarterly estimated tax payments.

One option is for the taxpayer to sign up for the Electronic Federal Tax Payment System (EFTPS), which enables the person to schedule payments directly from a bank account for up to a year in advance. This is a preferred method, since it is easiest for both the taxpayer and the government and ensures prompt and accurate crediting of payments to the taxpayer's account. Other options are to make credit card payments or send checks with Form 1040-ES vouchers. Get more information on [electronic payment methods](#) or see IRS Publication 505,

Tax Withholding and Estimated Tax ([PDF 402K](#)).

Social Security Taxes (FICA)

Q-42: Are there any benefit reductions due to FICA not being withheld by the employer?

A-42: Military personnel have FICA taken out of their military pay even when serving in a combat zone. Thus, they will get Social Security credit for their military earnings. However, Social Security retirement benefits are based on a worker's total earnings history. Since the military differential pay is not subject to FICA, the person's Social Security retirement benefits may be reduced.

Q-43: How does an employer correct the Form 941 (Quarterly Employment Tax Return) if FICA and income taxes have been erroneously withheld?

A-43: Generally, you can correct errors on Forms 941 for prior quarters by making an adjustment on your Form 941 for the quarter during which the error is discovered. The adjustment increases or decreases your tax liability for the quarter in which it is reported and is interest-free. You must provide background information and certifications supporting prior quarter adjustments. You do this by filing a Form 941C, Supporting Statement to Correct Information, with your current quarter. Do not file Form 941C separately. The IRS will not be able to process your adjustments on Form 941 without this supporting information.

If excess FICA was paid in a prior period, you can also recover the excess amount by filing a refund claim using Form 843. You must file Form 941C, or equivalent statement, with Form 843. See the separate instructions for Form 843.

Related Items:

- Form 843, Claim for Refund and Request for Abatement ([PDF 46K](#))
- Instructions for Form 843 ([PDF 26K](#))
- Form 941C, Supporting Statement To Correct Information ([PDF 85K](#))

Q-44: How does an employee recover FICA taxes that were erroneously withheld by the employer?

A-44: Employees are encouraged to contact their employers and request that they seek a refund of the erroneously withheld FICA on the employees' behalf. Because employers also pay a portion of FICA that is not withheld from payments to the employee, the employer will also be entitled to a refund. The employer may have other similarly situated employees who are entitled to refunds and the IRS can process a single refund claim filed by the employer more efficiently than it can process numerous refund claims filed by individual employees. If the employer refuses to seek a refund on the employee's behalf, the employee may file a refund claim using Form 843. Line 5 is where the employee explains the reason for the refund and efforts made to secure it. The employee's claim for refund must include a statement from the employer indicating whether the employer has reimbursed any of the erroneously withheld FICA to the employee or filed a refund claim for any of the erroneously withheld FICA.

Other Benefits

Q-45: What is the tax treatment of health care benefits and coverage while the employee is on active military duty?

A-45: Generally, the gross income of an employee does not include employer-provided coverage under an accident or health plan or employer contributions to such plans. This exclusion from gross income extends to employees who are on military leave. The value of employer-provided coverage, or employer contributions to accident or health plans, are not reported on the Form 1099-MISC given to the employee.

Q-46: Is the cost of group term life insurance included in gross income while the employee is on military pay?

A-46: The tax treatment of group term life insurance coverage provided to employees on military leave is the same as coverage provided to current employees. Generally, the cost of \$50,000 of group term life insurance coverage is not included in gross income while the employee is on military leave.

Q-47: If an employer pays an employee who is called to active duty his vacation pay is this pay subject to social security, Medicare and income taxes?

A-47: Yes, vacation pay that is earned or accrued prior to the worker being called for active duty or active service is subject to withholding as if it were a regular wage payment, even if paid to the worker after activation. When vacation pay is in addition to regular wages for the vacation period, treat it as a supplemental wage payment. If the vacation pay is for a time longer than your usual payroll period, spread it over the pay periods for which you pay it. Vacation pay that is earned or accrues after the employment relationship is terminated by activation is not a wage payment.

Q-48: If a co-worker wants to donate vacation time to an employee who is called to active duty to whom is such leave taxable?

A-48: The donated vacation time is taxable to the recipient of the vacation time. As a result, the employee on active duty receiving donated vacation pay is subject to withholding of social security, Medicare and income taxes as if it were a regular wage payment. When vacation pay is in addition to regular wages for the vacation period, treat it as a supplemental wage payment. If the vacation pay is for a time longer than your usual payroll period, spread it over the pay periods for which you pay it.

Q-49: An employee received an award from the employer and wishes to donate it to a co-worker who has been called to active duty. To whom is the award taxable?

A-49: The award is taxable to the recipient. The recipient's award is subject to withholding of social security, Medicare and income taxes as if it were a regular wage payment. When an award is in addition to regular wages, treat it as a supplemental wage payment.

- **Reference for questions 44-51:** Publication 15, Employer's Tax Guide ([PDF 344K](#))

For more details on tax issues related to military service, see Publication 3, Armed Forces' Tax Guide ([PDF 166K](#)).

SAMPLE LETTER

November XX, 2007

Re: Military Leave Payments

Dear Employee:

This letter concerns the application of tax withholding to military leave payments, also known as “military differential pay.” Effective January 1, 2008, Federal, California State, Social Security, Medicare, and State Disability (SDI) taxes will no longer be withheld from military leave payments pursuant to Federal and State law.

Furthermore, pursuant to Internal Revenue Service reporting instructions, military leave payments will not be included on the W-2, Wage and Tax Statement forms provided to employees. Nevertheless, military leave payments are considered income, and are therefore reportable to the Internal Revenue Service (IRS) and The State of California Franchise Tax Board (FTB). Beginning with the 2008 tax year, such payments will be reported on Form 1099-MISC.

If you receive military leave payments, you may wish to contact a tax consultant/advisor for assistance with the reporting of income, the filing of tax returns, and the payment of the applicable taxes. Also, if you work for the State of California and reside in another state, you may be subject to state tax withholding based on the other state’s tax laws. Please contact your personnel office for more information on this subject.

With respect to military leave payments made to an employee on or after January 1, 2008, pre-tax deductions such as the 401(k), 457, 403(b), and retirement buy-back deductions can no longer be withheld from such payments. The deductions will automatically resume upon each employee’s return to active pay status. Employees enrolled to have pretax benefit deductions made to pay for benefits such as health, dental, and vision care will retain their benefits, and premium amounts will not change, but the benefit codes will be changed to reflect after-tax benefit deductions. You, the employee, do not need to take any action in order for these changes to go into effect.

The recently released IRS Newsroom Article entitled “Employers with Employees in a Combat Zone” answers questions regarding military leave payments, and is enclosed for your convenience.

If you have any questions regarding military leave payments, please contact your Human Resources Office.

Sincerely,

(Placeholder for signature)

Enclosures