

IRS Finalizes Default Withholding Rules for Periodic Retirement and Annuity Payments

Key Points

- Under the final regulations, the IRS can change the default rate of withholding applied to monthly pension or annuity payments simply by issuing new forms, instructions, or other guidance, rather than by having to issue new regulations.
- Plan administrators and annuity providers should consider making changes to their systems and processes to allow frequent changes to the default withholding rate for pension or annuity payments.
- The IRS will likely issue guidance prior to year-end to announce the default withholding rate that will apply for periodic retirement and annuity payments in 2021.

Retirement plan administrators and annuity providers are generally required to withhold on taxable periodic retirement and annuity payments as if the payment were wages paid by an employer to the employee. Retirees and beneficiaries usually fill out a Form W-4P to elect no withholding on their monthly payments or to instruct the plan administrator or annuity provider which withholding rate to use. The federal tax rules provide guidance regarding which withholding rate to use when a Form W-4P or equivalent form is not received (i.e., the default rule).

On Oct. 1, 2020, the IRS published final Treasury Regulations updating the income tax withholding rules for certain periodic retirement and annuity payments made after Dec. 31, 2020¹. These Regulations provide more flexibility to the IRS in adjusting the default rule for withholding for 2021 and future years.

The final Treasury Regulations are a response to the amendment of the default income tax withholding rule made by the Tax Cuts and Jobs Act (TCJA) of 2017. Prior to TCJA, the federal tax rules provided that if a payee did not submit a withholding certificate (Form W-4P) or did not submit an effective withholding certificate, income tax withholding on the payee's periodic retirement or annuity payments must be done at the rate used for a taxpayer who is "married claiming three exemptions."

The TCJA eliminated this default rule and provided instead that the default withholding rate would be determined by rules prescribed by the Secretary of the Treasury. The final Treasury

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Regulations clarify that, going forward:

1. the default withholding rate on periodic payments where no withholding certificate is in effect will be determined by the IRS in forms, instructions, IRS publications, and other guidance, and
2. rules for determining the effective date of a payee's withholding election would be determined by the rules under Code Section 3402(f) and applicable forms, instructions, and other guidance issued by the IRS.

This approach allows the IRS to respond more quickly to law changes and other circumstances.

For periodic retirement and annuity payments made on or before Dec. 31, 2020, retirement administrators and annuity companies can rely on the default withholding rate published in IRS Notice 2020-3, which indicates the default withholding rate for periodic retirement and annuity payments made in 2020 would remain the rate applicable for an individual who is "married and claiming three exemptions."

The IRS is likely to publish additional guidance later this year to announce the default withholding rate for periodic retirement and annuity payments made during the 2021 tax year, where no effective Form W-4P or its equivalent is in place. Plan administrators and annuity providers should annually review IRS guidance for updates to the default rule. Plan administrators and annuity providers may want to consider updating their processes and systems to accommodate changes in withholding rates more easily since the new guidance signals the potential for frequent changes to rates.

¹ These final Treasury Regulations are an adoption, without modification, of the Proposed Treasury Regulations issued on May 27, 2020.

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