



Managing wage repayments

The employment tax impact of the claim of right doctrine



Building a better
working world

Contents

Current-year wage repayments.....	1
Wage repayments that cross tax years	2
Reporting wage repayments under the claim of right doctrine	4
The impact of the claim of right doctrine on employee wage repayments.....	5
Talk to your wage-hour advisor	6
Sample state provisions limiting an employer's deduction of wage advances or wage overpayments from employee's future wage payments	6



Managing wage repayments: the employment tax impact of the claim of right doctrine

By Debera Salam, CPP, Ernst & Young LLP and Kenneth Hausser, CPP, Ernst & Young LLP



Most employers will encounter circumstances where employees need to pay back wages.

The wage payback may be in connection to an employment contract (e.g., failure to meet a length-of-service requirement), a salary advance agreement or an error in calculating pay. Regardless of the reason for the wage repayment, payroll tax withholding and reporting requirements are complex when the payback crosses tax years.

Because of the tax implications of wage repayments for both employers and employees, it is important to take these requirements into account in the design of policies that include the requirement that employees repay taxable wages.

Current-year wage repayments

A key principle in wage and tax reporting is the requirement that compensation is subject to employment tax and withholding in the year received. As a consequence, and with limited exceptions, wages are subject to federal income tax (FIT), federal income tax withholding (FITW), Social Security/Medicare (FICA) and federal unemployment insurance (FUTA) at the time wages are made available to employees without substantial limitation. (*IRS Reg. §1.451-2(a).*)

This [doctrine of constructive receipt](#) applies without regard to whether the wages were earned at the time of payment. For instance, a wage advance or wage overpayment continues to be subject to employment tax and withholding in the year received despite any future obligation of repayment.

If the wage overpayment or advance occurs in the same year as the original payment, application of the constructive receipt doctrine is straightforward – wages for FIT, FITW, FICA and FUTA purposes are reduced and any related tax obligations are refunded. If the repayment is made through payroll deduction, it is deducted on a pretax basis.

Managing wage repayments: the employment tax impact of the claim of right doctrine

Continued



Example 1: Wage repayments in the current year (wage-offset method)

Employee Ryan's regular weekly wages are \$300. On December 3, 2021, Ryan was erroneously paid \$330. The \$30 overpayment was deducted from wages paid to him on December 10, 2021.

Wage repayment in the year of the advance/repayment (Pretax deduction)		
Pay calculation	12-3-2021 Wage payment	12-10-2021 Wage payment
Gross pay	\$300.00	\$300.00
Wage overpayment/repayment	\$30.00	-\$30.00
Net taxable gross	\$330.00	\$270.00
FIT at 12%	-39.60 (\$330 × 12%)	32.40 (\$270 × 12%)
Social Security at 6.2%	-20.46 (\$330 × 6.2%)	-16.74 (\$270 × 6.2%)
Medicare at 1.45%	-4.79 (\$330 × 1.45%)	-3.92 (\$270 × 1.45%)
Net pay	\$265.15	\$216.94

When the wage payment and repayment occur in the same year, the repayment is deducted from wages on a pre-tax basis.

Wage repayments that cross tax years

Often an employee's repayment of an advance or overpayment will cross tax years. For instance, some employment contracts may require the repayment of a sign-on bonus or relocation reimbursement if the employee resigns before the end of the multiyear contract period. The employer may also make an agreement with employees that wage advances and overpayments can be repaid over a period that reaches into subsequent years.

When wage repayments occur in subsequent years, [the claim of right doctrine](#) applies. Under this doctrine, when a repayment is made, the adjustment to wages applies in the year of the original payment. For instance, if a salary advance paid in 2021 is repaid in 2022, the adjustment to wages applies to 2021 and not to 2022. Further, under the claim of right doctrine, a taxpayer's right to a federal income tax credit for the wage repayment may be restricted based on the facts and circumstances.

When deducting a wage advance or overpayment from wages that is subject to the claim of right doctrine, it must be taken on an after-tax basis.

Example 2: Wage repayments made in years subsequent to the advance of overpayment

Assume the same facts as Example 1, except that the overpayment is deducted from wages paid to Ryan on January 7, 2022.

Wage repayment in the year of the advance/repayment (After-tax deduction)		
Pay calculation	12-3-2021 Wage payment	01-07-2022 Wage payment
Gross pay	\$300.00	\$300.00
Wage overpayment	\$30.00	
Net taxable gross	\$330.00	\$300.00
FIT at 12%	-39.60 (\$330 × 12%)	-36.00 (\$300 × 12%)
Social Security tax	-20.46 (\$330 × 6.2%)	-18.60 (\$300 × 6.2%)
Medicare at 1.45%	-4.79 (\$330 × 1.45%)	-4.35 (\$300 × 1.45%)
Wage overpayment (after tax)		\$-30.00
Net pay	\$265.15	\$211.05

When deducting a wage advance or overpayment from wages that is subject to the claim of right doctrine, it must be taken on an after-tax basis because it does not reduce the FITW and FICA owed on current-year wages.

Notice that in Example 1, the wage overpayment was deducted on a pretax basis, reducing FIT and FICA earnings and taxes. In Example 2, the wage overpayment was deducted on an after-tax basis, having no effect on Ryan's 2022 taxable earnings or the 2022 FIT and FICA withheld. The computation in Example 2 must be used if amounts reported as taxable income in a prior year are repaid in a subsequent year. (*IRC §1341; Rev. Rul. 79-311, 1979-2 CB 25.*)



Managing wage repayments: the employment tax impact of the claim of right doctrine

Continued

Reporting wage repayments under the claim of right doctrine

Under the claim of right doctrine, when an employee repays taxable earnings from a prior year, the following rules apply for reporting the repayment on Forms W-2 and Forms 941-X. ([SCA 1998-026](#); [Publication 15](#), pg. 37.)

► **Social Security and Medicare wages.** If a wage repayment occurs within three years from April 15 following the year of the initial payment, the employer files a Form W-2c, [Corrected Wage and Tax Statement](#) for the tax year in which the taxable amount was originally paid. The Form W-2c reflects a reduction in Social Security up to the wage limit in the year of the original wage payment (box 3), Medicare wages (box 5) and the related taxes (boxes 4 and 6) equal to the amount of taxable income/taxes repaid by the employee.

The Form W-2c is filed in the year the repayment is made.

The employer is required to refund any FICA tax relating to the repayment. Upon refunding the FICA overpayment, the employer must obtain from the affected employee a signed letter stating that the employee received a refund of the FICA tax overpayment from the employer and that the employee will not claim a credit for the overpayment from the IRS. (See [IRS Rev. Proc. 2017-28](#).)

The employer may obtain a credit for the employer and employee Social Security and Medicare tax overpayment by filing Form 941-X, [Adjusted Employer's QUARTERLY Federal Tax Return or Claim for Refund](#). The overpayment reflected on Form 941-X may be offset against future deposits due or refunded subject to the limitations explained in the Form 941-X instructions. (See [the Form 941 and Form 941-X reporting instructions](#).)

► **Federal taxable wages.** The repayment of an advance/wage overpayment is not reported in box 1 of the Form W-2c nor can an employer refund FITW. Instead, employees claim a FIT adjustment (if applicable) on their federal income tax return subject to the limitations under IRC §1341 and IRC §67.

Example 3: Jason's employer reported taxable FIT and FICA wages of \$9,600 on his 2021 Form W-2. In 2022, his employer discovered that he had received a wage overpayment of \$960 for the pay period ending November 12, 2021. The overpayment was deducted on an after-tax basis from wages paid to Jason on March 18, 2022. A Form W-2c for tax year 2021 is completed as shown below and filed in tax year 2022.

Jason's 2021 Form W-2c Claim of right doctrine rule illustrated			
Line number/description	(a) As previously reported	(b) Correct information	(c) Increase (decrease)
(1) Wages, tips and other compensation*	\$9,600.00	\$9,600.00	\$0
(3) Social Security wages	\$9,600.00	\$8,640.00	(\$ 960.00)
(4) Social Security tax withheld	\$ 595.20	\$ 535.68	(\$ 59.52)
(5) Medicare wages and tips	\$9,600.00	\$8,640.00	(\$ 960.00)
(6) Medicare tax withheld	\$ 139.20	\$ 125.28	(\$ 13.92)

* A reduction is not shown in box 1 wages under the claim of right doctrine. Instead, employees claim a refund for FIT on their personal tax returns. Note that state and local wages may also need to be reduced; however, this is not always the case. Be certain to check state and local law to determine if there is conformity with the federal claim of right doctrine.

When the wage repayment is made in a subsequent tax year, it is not reflected in box 1 of Form W-2c.

The impact of the claim of right doctrine on employee wage repayments

According to Publication 525, *Taxable and Nontaxable Income*, whether a taxpayer can claim a credit for federal income tax for a wage repayment depends on the amount of the repayment and whether the employee believed they had an unrestricted right to the amount when it was paid.

- ▶ **Repayment of \$3,000 or less.** Through tax year 2017, if the amount repaid was \$3,000 or less, taxpayers may deduct it from income in the year they repaid it. When determining whether the amount repaid was more or less than \$3,000, taxpayers consider the total amount being repaid on the federal income tax return. Each instance of repayment isn't considered separately.

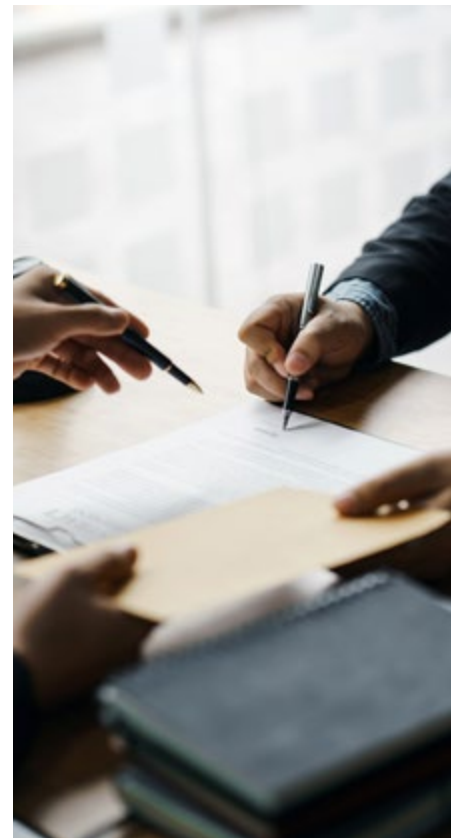
Under the Tax Cuts and Jobs Act and for tax years beginning after 2017, taxpayers can no longer claim any miscellaneous itemized deductions; therefore, if the amount repaid was \$3,000 or less, the taxpayer is not able to deduct it from his/her income in the year the wages were repaid.

- ▶ **Repayment over \$3,000.** If the amount repaid is more than \$3,000, taxpayers may deduct the repayment. However, they can choose instead to take a tax credit for the year of repayment if they included the income under a claim of right (meaning that at the time taxpayers included the amount in income, it appeared that they had an unrestricted right to it). If they qualify for this choice, they may figure their federal income tax under both methods and compare the results and use the method (deduction or credit) that results in less tax. (*Rev. Rul. 67-48, 1967-1 CB 50.*)

Particularly starting in 2018, wage repayments that cross tax years can have an adverse impact on employees' federal, state and local income tax liabilities. For this reason, when the wage overpayment is the fault of the employer, some businesses offer reimbursement for tax consequences and filing fees. Keep in mind that such reimbursements are taxable to employees in the year paid.

Don't forget this step

A Form 941-X also must be completed reflecting the reduction in FICA wages. The FICA adjustments are reported as corrections to wages in the tax year and quarter(s) in which the salary overpayment occurred. (See the Forms 941 and 941-X reporting instructions for more information.) It is also important to take into account corrections that may be necessary to state and local tax returns (e.g., state unemployment insurance).



Managing wage repayments: the employment tax impact of the claim of right doctrine

Continued

Talk to your wage-hour advisor about other wage repayment considerations

It is important that before employers choose to deduct employee wage advances or overpayments from future pay checks that they discuss with their wage-hour advisors state and local wage-hour laws that place restrictions on these wage deductions. Many states, for instance, require that employees provide written authorization for wage deductions, and your wage-hour advisors can assist you with developing appropriate templates for this purpose.

More important than obtaining a properly constructed payroll deduction authorization form, many states place other limitations on wage deductions for advances and overpayments. For instance, some states prohibit deductions that put the employee's pay below minimum wage, limit the deduction to a percentage of earnings or disposable pay or disallow the deduction after a period of time from discovering the wage payment error. Below is a sample of these provisions as of May 21, 2022.

Sample provisions limiting an employer's deduction of wage advances or wage overpayments from employee's future wage payments*

State	Limitations on repayment of wage advances/overpayments	Reference
Arizona	Employee written authorization required for wage deductions. Recoupment of wages not allowed if there is a reasonable good faith dispute about the wage repayment amount.	ARS §23-352. Withholding of wages
California	Employee written authorization required for wage deductions. There have also been adverse rulings involving an employer's deduction from current wages for past salary advances that were in error.	California Department of Industrial Relations website
Connecticut	Employee wage deductions for wage repayments must be approved in writing by the employee on a form approved by the Commissioner.	Connecticut General Statutes, Title 31, § 31-71e
Delaware	In the case of a cash advance, the employer and the employee must sign a written agreement specifying the amount of the advance or the value of the goods or services, the repayment schedule and the method of repayment. A cash advance repayment agreement may not cause a wage deduction of more than 15% of the employee's gross wages for the payroll period. If the amount is still owed at termination, an amount exceeding 15% can be deducted from final pay but only if included in the original repayment agreement.	Delaware Secretary of Labor, rules and regulations governing deductions from wages
Illinois	The employee and employer must agree, in writing, to the cash advance repayment. A cash advance repayment agreement may not cause a wage deduction of more than 15% of the employee's gross wages for the payroll period. If the amount is still owed at termination, an amount exceeding 15% can be deducted from final pay but only if included in the original repayment agreement. The employee and employer must agree to wage deductions from future wages for wage overpayments. If the employee does not agree, the employer must obtain consent for the wage deduction from the Illinois Department of Labor.	Illinois Department of Labor website

State	Limitations on repayment of wage advances/overpayments	Reference
Indiana	<p>In the case of wage overpayments, employers must give two weeks' notice before a repayment of overpaid wages can be deducted from the employee's wages. The wage deduction for the overpayment cannot exceed 25% of the employee's disposable earnings for a week or the amount by which the employee's disposable earnings for the week exceed 30 times the federal minimum wage.</p> <p>In the case of a wage advance, the employee must give written consent to a wage deduction for repayment. The agreement must be revocable at any time by the employee upon written notice and agreed to in writing by the employer. A copy of the deduction agreement must be delivered to the employer within 10 days of its execution.</p>	Indiana Department of Labor website
Kansas	Signed written agreement between employer and employee is required for the wage deduction of advances of overpayments and the deduction cannot reduce the employees below the federal or Kansas minimum wage, whichever is applicable.	K.S.A. §44-319
Louisiana	Generally, employers are not allowed to require employees to sign agreements to forfeit wages in the event they resign or are discharged before the contract is completed. Limited exceptions apply to the deduction of preemployment medical exams or drug tests.	LRS §RS 23:634
Maine	An employer who has overcompensated an employee through employer error may not withhold more than 5% (10% prior to October 18, 2021) of the net amount of any subsequent pay without the employee's written permission, except that if the employee voluntarily terminates employment, the employer may deduct the full amount of overcompensation from any wages due. Effective October 18, 2021, an employer that has overcompensated an employee through employer error may not recover more than the amount of overcompensation paid to that employee in the three years preceding the date of discovery of the overcompensation.	26 MRSA §635
Michigan	The employer must follow a seven-step process to determine if a deduction for the overpayment of wages without the specific of the employee.	Michigan Department of Labor and Economic Opportunity, Information Sheet for Overpayment Deductions
Missouri	Deductions for the employer's benefit cannot cause the employee's wage to fall below the state's minimum wage.	Missouri Department of Labor website
New Hampshire	A wage deduction for prior wage overpayments is allowed only if: (1) the recovery is agreed to in writing, (2) the deduction for the overpayment begins one pay period following the date the parties execute the written agreement and (3) the written agreements specifies: (a) the date the recovery of the overpayment will begin and end; (b) the amount to be deducted, which is agreed to by the employer and the employee but which, in no event, can be more than 20% of the employee's gross pay in any pay period; and (c) a specific agreement regarding whether the employer is allowed to deduct any amount outstanding from final wages at the termination of employment.	N Rev Stat §275:48
New Mexico	Deductions for the employer's benefit may not cause the employee's wages to fall below the minimum wage.	New Mexico Department of Workforce Solutions, Frequently Asked Questions about Wage and Hour Rights

State	Limitations on repayment of wage advances/overpayments	Reference
New York	The state imposes several limitations on the employer's ability to deduct wage overpayments from employees' future wages.	N.Y. Comp Codes §195-5.1
North Carolina	An overpayment of wages to an employee as a result of a miscalculation or other bona fide error, advances of wages to an employee or to a third party at the employee's request, and the principal amount of loans made by an employer to an employee are considered prepayment of wages and may be withheld or deducted from an employee's wages. Deductions for interest and other charges related to loans by an employer to an employee require the employee's written authorization.	North Carolina General Statutes §95-25.8
North Dakota	A wage deduction for wage advances is specifically allowed; otherwise, employee authorization is required.	North Dakota Department of Labor and Human Rights, ND Minimum Wage & Work Conditions Summary; N.D.C.C. § 34-14-04.1
Ohio	Deductions for the employer's benefit may not cause the employee's wages to fall below the minimum wage.	Ohio Department of Labor website
Oklahoma	The employer may deduct wage overpayments from a current employee's wages in one of two ways: (1) lump sum cash repayment or (2) installments over a term not to exceed the length of the term in which the erroneous payments were made. The employee must agree in writing as to which of the above methods will apply. The employee may also elect to use a combination of the above two methods if the employer agrees. Upon termination of the employment agreement, any remaining balance of overpayment may be considered an offset to any final wages otherwise due the employee.	OAC §380:30-1-11
Washington	If a wage overpayment is not detected within 90 days, the employer cannot adjust an employee's current or future wages to recoup the overpayment. The employer must provide advance written notice and documentation of the overpayment to the employee before any adjustment is made. This notice must include the terms under which the overpayment will be recouped. For example, an employer may offer to split the deductions for overpayment over multiple pay checks or deduct the entire amount at once. Recouping the overpayment may reduce the employee's gross wages below the state minimum wage.	WAC §296-126-030
West Virginia	Wage deductions for wage overpayments are subject to the state's wage assignment rules.	West Virginia Wage Payment & Collection (WPC) Act, Payroll Deductions & Wage Assignments

* Much of this information was obtained by Ernst & Young LLP through an informal survey of state governmental websites. Although surveys are useful in determining how government departments currently treat an issue, answers and positions derived from such surveys are not binding upon the state, cannot be cited as precedent, and may change over time and hence cannot be relied upon. Consult your wage-hour advisor on the limitations that apply.

TaxAbility™

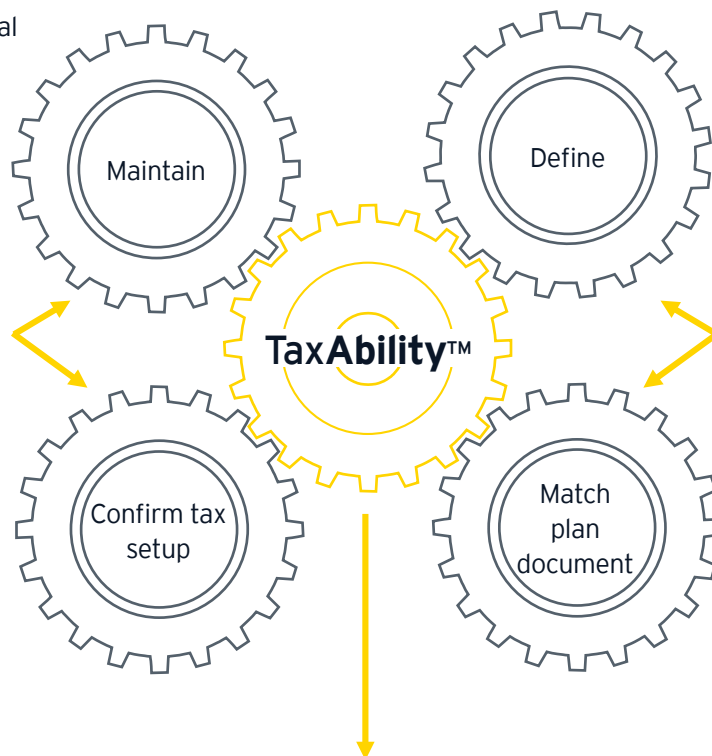
Payroll research innovated.

With TaxAbility™, we can help you to streamline the process of reviewing tax configuration settings for your earnings and deduction codes. Our research library contains fully sourced information for federal, state and local taxes for over 150 common earnings and deduction types. Learn more about TaxAbility™ in our [brochure](#).

- ▶ Refer to your **TaxAbility™** portal throughout the year for tax rules, plan documents and key information to support your tax configuration settings.

- ▶ Access white papers and other thought leadership from your **TaxAbility™** portal for updates and insights on payroll tax and reporting rules.

- ▶ An exception report is provided showing pay and deduction code settings that may be incorrect.
- ▶ Pay codes are verified for proper supplemental wage indicators.
- ▶ Special Form W-2 reporting information, if applicable, is provided for your pay and deduction codes.



- ▶ Align your pay and deduction codes to our standardized list of compensation types configured to comply with tax agency sources.

- ▶ Our compensation and benefits professionals can team to provide insights on plan design and operation compliance.

- ▶ Upload plan documents to your TaxAbility™ portal for hyperlinking to your pay and deduction codes.
- ▶ We work with you to identify those plans impacted by tax reform and the changes required; tax configuration schemes are then matched to your final plan documents to confirm they are correct.

TaxAbility™ documents are housed within our secure network.

Contact us for more information:

Kristie Lowery
+1 704 331 1884
kristie.lowery@ey.com

Kenneth Hausser
+1 732 516 4558
kenneth.hausser@ey.com

Debera Salam
+1 713 750 1591
debera.salam@ey.com

Ernst & Young LLP Employment Tax Advisory contacts

Bryan De la Bruyere
bryan.delabruyere@ey.com
+1 404 817 4384

Ken Hausser
kenneth.hausser@ey.com
+1 732 516 4558

Jennie DeVincenzo
jennie.devincenzo@ey.com
+1 732 516 4572

Kristie Lowery
kristie.lowery@ey.com
+1 704 331 1884


Ali Master
ali.master@ey.com
+1 214 756 1031

Debera Salam
debera.salam@ey.com
+1 713 750 1591



Connect with us

 Join us on LinkedIn @Payroll Perspectives from EY

 Tour our services on ey.com

EY | Building a better working world

EY exists to build a better working world, helping create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via ey.com/privacy. EY member firms do not practice law where prohibited by local laws. For more information about our organization, please visit ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

© 2022 Ernst & Young LLP.
All Rights Reserved.

SCORE No. 16245-221US
CSG No. 2205-4047857
ED None

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, legal or other professional advice. Please refer to your advisors for specific advice.

ey.com