Taxes and Bonuses

Millions of individuals in the United States are awarded bonuses in their workplaces. If you happen to be among this group, here is a comprehensive guide on understanding what a bonus entails, its taxation, and potential strategies to alleviate the tax implications on additional income and bonuses you might acquire.

What is a bonus?

As per the IRS, **a bonus is defined as remuneration provided to an employee for services rendered, granted in addition to their regular compensation, such as their salary.** Despite being subject to income taxes, the IRS does not classify bonuses as standard wages.

Generally, bonuses are disbursed on specific occasions, such as holidays, or incorporated into compensation schemes, like achieving specific sales targets. Various bonus types encompass annual, merit, referral, relocation, sign-on, and retention bonuses.

Supplemental wages, including bonuses, are categorized by the IRS as such and may be subject to distinct federal withholding regulations.

How are bonuses taxed?

The IRS has two main ways employers can calculate withholding taxes on supplemental wages: The **percentage method (flat rate) and aggregate method.**

The percentage method

The percentage method is also called the "flat-rate method." It's the more popular of the two with employers since it's much easier to figure out.

Put simply, with the percentage method, your supplemental wages are run as a separate payroll. There is an added expense to running an extra payroll for many companies, but employers prefer this more straightforward method despite the extra cost.

This is also why many organizations limit how often they pay bonuses, commissions, and other supplemental wages.

Again, states tax supplemental wages at different rates, so investigate your state and local rules and regulations.

The major drawback to the percentage method applies most often to high-earning employees. Their tax liability may be greater than their withholdings, which could lead to a surprise bill during tax season. Read more about that below.

The aggregate method

The aggregate method is the other way to calculate withholding taxes on supplemental wages.

With this one, your employer combines your regular and supplemental wages into your gross pay for a pay period and withholds taxes based on your W-4. The employer only must run one payroll, but it can be much more complicated for employers to calculate.

The aggregate method tends to be more accurate than the percentage method but can still lead to an employer withholding too much. So, a tax refund would be more likely than a tax bill, but this would mean a smaller paycheck for you as an employee up front.

Regardless of how you withhold income tax on supplemental wages, they're subject to Social Security, Medicare, and other taxes.

Bonus tax rates in 2023

In 2023, the federal withholding rate for supplemental wages is 22%, up to $1 million. It's important to note that this $1 million limit does not include a regular salary income.

If you receive a large bonus—over $1 million—you'll have 22% in federal tax withheld on the first million, then 37% on bonus funds above the first million.

How to report bonuses on tax returns

Your bonus will be added to your total income for the year. When it comes time to file your annual taxes, your total income, including your bonus, gets taxed according to your effective tax rate. Employers withhold taxes on your paycheck throughout the year to prepay that tax on your behalf. If you've had enough withheld, you won't owe anything. If you've withheld too much or too little, that might mean a tax bill or a refund.

For employees, the total amount you received in bonuses for the year will be combined with other earned income and listed in Box 1 of your Form W-2.

For independent contractors or the self-employed, if you earn an award and the payment was $600 or more during the year, you should receive a Form 1099-NEC, Nonemployee Compensation.

- You'll report Box 1 income, such as incentive payments on Schedule C, which you'll send with Form 1040.
- Entering the total on Schedule C combines this income with other income on Form 1040.

Tips on lowering tax on bonus

The first method for lowering your tax liability is to reduce your taxable income. You may do this in any number of ways, such as:

- Using the bonus to invest in your IRA or 401(k) to get a tax break.
- If you think you'll be taking a significant pay cut next year—for example, if you're ready to retire or go part-time—ask your employer to defer your bonus until the following year to lower your overall tax liability.
- Put part of the bonus toward a health savings account (HSA) to reduce your gross income.

The other method for lowering your tax liability is to itemize your deductions. You may choose to:

- Use your bonus to pay for out-of-pocket medical expenses that aren't reimbursable. It's important to note that for this to be applicable, your expenses would have to be over 7.5% of your adjusted gross income (AGI), and you would need to itemize your expenses when filing your taxes.
- Make a qualified donation or donations to a charity.

While you'll always pay tax on your bonuses, you can find ways to lower your tax burden by postponing, deferring the bonus, or generating deductions.

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