

# Taxation of Christmas Bonuses for Your Employees



Are you thinking of giving your employees a holiday bonus? What's the best way to handle these year-end bonuses? Can they be handled 'under the table'? Do you have to include them as wages on their W-2?

The answer to this question is quite simple. Any additional compensation to your employees over and above their standard salary or hourly rates is considered to be taxable compensation. The bonus is considered wages and must be reported as payroll on the employee's W-2 and is subject to all applicable payroll taxes – federal and state withholding, FICA, Medicare and the related employer taxes.

On your books and records, the bonus is reported as wages on the income statement and it is fully deductible as a valid tax deduction if it is handled this way. Payments to your employees made in cash (and not reported) or recorded as other expenses are not tax deductible, and may cause unforeseen issues if the IRS or state audits your books.

Many employers like to give a flat dollar bonus amount. You can do this by choosing the amount of the bonus you want hand to your employee and "gross-up" the amount. Most payroll services and payroll software can handle this calculation. By grossing up the flat dollar net amount, you are including the estimated taxes into the amount so that, after taxes, the amount is what you want to provide your employee.

The only way you could exclude the bonus payment from the employees' W-2, not pay associated employer payroll taxes, and still get a tax deduction on your business tax return, is to make the bonus as a profit sharing bonus through your 401(k) profit sharing plan. Although your employees don't get the bonus in cash or check, the bonus is completely non-taxable to the employee until they withdraw the funds from their plan, and you avoid paying the payroll taxes associated with paying the bonus in cash or check and including it on their W-2.