

## IRS Issues Guidance on Reporting Section 409A Deferred Compensation

The IRS and Treasury Department provided guidance to employers with respect to reporting (1) nonqualified compensation deferrals, and (2) amounts includible in gross income due to a failure to satisfy the requirements of Section 409A of the Internal Revenue Code of 1986, as amended (the "Code"), in the 2005 or 2006 tax years. **Notice 2006-100** (the "Notice") provides that employers do not need to report amounts deferred under nonqualified deferred compensation plans on IRS Forms W-2 or 1099-MISC for either 2005 or 2006. **However, amounts that are includible in gross income under Code Section 409A for both 2005 and 2006 tax years must now be reported on the appropriate form.**

### Background

Last December the IRS announced that the reporting of amounts deferred during 2005 was waived, but the reporting of amounts includible in income during 2005 under Section 409A was merely suspended until future notice. The suspension has ended. The Notice provides *interim guidance* on how to calculate the includible amount for 2005 and 2006. The Notice also provides guidance on (1) an employer's obligation to meet the income tax withholding requirements for amounts includible in 2006, and (2) an employee's obligation to report and pay taxes on amounts includible for 2005 and 2006. Since 2005 returns should have been filed by now, amended returns will be required, if no other guidance provides relief.

### Reporting Includible Income

**2006** - Amounts includible in income in 2006 under Section 409A must be reported both in box 1 and box 12 of IRS Form W-2 for the applicable year, using code "Z", and withholding applies to such income inclusions even if no cost or property is paid. Withholding will be at the supplemental wage withholding rate if the employee also has regular wages from the employer for the calendar year. In addition, the withholding must be reported on line 2 of IRS Form 941. For non-employees the amount includible is reportable in both box 7 and box 15b of Form 1099-MISC for the applicable year.

**2005** – For amounts that should have been included in 2005, an original and a corrected Form W-2 or 1099-MISC must be filed for 2005 using the guidance in the Notice to determine the amounts. The 2005 returns must be filed by the deadline for the 2006 similar forms. Withholding tax requirements do not apply to amounts that are included in 2005 income reporting under the Notice.

### Employer's Withholding Obligation

An employer is required to withhold from amounts includible in an employee's gross income in 2006 under Section 409A resulting from (1) the failure to satisfy Section 409A requirements, or (2) actual or constructive receipt of amounts deferred. Such amounts withheld must be deposited by the employer with its other payroll tax deposits. Under the Notice, if the employer does not withhold income tax from such amounts as of December 31, 2006 (or withholds less than the required amount), the employee will receive a tax credit under Code Section 31 for 2006 (credit for amounts withheld from wages by an employer) only if the following occurs: (1) the employer withholds or recovers the underpayment from the employee not later than February 1, 2007, and reports such amount as wages for the quarter ending December 31, 2006 on Forms W-2 and 941, **or** (2) the employer pays the required withholding on behalf of the employee (with no corresponding deduction from wages) and reports both the amount includible under Section 409A and the tax withholding payment as wages on Forms W-2 and 941 for 2006. The withholding amounts must be paid to the IRS not later than the due date of Form 941 for the quarter ending December 31, 2006.

### Withholding on 2005 and 2006 Amounts Includible – Interim Guidance

Under the Notice's interim guidance, the amount that is includible in the employee's income for 2006 equals the total amount deferred under any arrangement subject to Section 409A as of December 31, 2006 that is not subject to a substantial risk of forfeiture, *minus* any amount that was previously reported for 2005 (on Form W-2 or 1099-MISC), *plus* any amount actually paid or made available to the employee during 2006. It is important to remember the plan aggregation rules under the Proposed Regulations or Notice 2005-1 must be applied to determine the amount of the income inclusion. Separate methods are provided for calculating amounts under account balance plans, non-account balance plans, stock rights, and other deferred amounts, as follows:



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1. **Account Balance Plans.** For the typical account balance nonqualified deferred compensation plans, the amount subject to withholding under Code Section 409A equals the amount that would be includible under Code Section 3121(v) (FICA taxes) if the entire account balance, including gains and losses, was FICA taxable as of December 31, 2006.
2. **Nonaccount Balance Plans.** For defined benefit-type nonqualified deferred compensation plans, the amount subject to withholding under Code Section 409A equals the amount that is reasonably ascertainable and thus subject to **withholding** for FICA tax purposes, equal to the present value of all future payments to which the employee has obtained a legally binding right, determined as of December 31, 2006.
3. **Stock Rights.** For stock rights (options and stock appreciation rights) that are subject to taxation under Section 409A, (e.g., discounted options) the amount subject to withholding equals the "spread" amount as of December 31, 2006.
4. **Other Deferred Amounts.** For any other deferred amounts subject to Section 409A, the amount subject to withholding must be determined under a reasonable, good faith application of a reasonable, good faith method. However, for any amounts that can be bifurcated into, for example, an "account balance portion" and an "other portion," the method described above for account balance plans must be used to determine the amount includible under the account balance portion of the arrangement.

The IRS and Treasury are working on general guidance with respect to the calculation of includible amounts; consequently the methods described in the Notice are to be considered *interim guidance only* for purposes of 2006 reporting.

#### Employee's Obligation to Report and Pay Tax

Employees must report as income and pay taxes on amounts includible in gross income for 2006, and, to the extent not already reported, for 2005, by filing an amended income tax return by the due date of his or her 2006 return (including extensions), unless relief is provided. The amount reportable is determined under the same methods as described above with respect to employer reporting and withholding. *The employee's obligation to report and pay taxes is independent of the employer's obligation to withhold and report.* In addition, the employee must pay the 20% excise tax resulting from income inclusions due to a failure to satisfy Section 409A requirements, plus interest at the underpayment rate plus 1% from the date of original deferral (which is treated as January 1, 2005 under the Notice). The employer is not obligated to withhold the 20% additional tax.

If you have any questions regarding the foregoing, please feel free to contact one of the attorneys listed below.

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