
IRS Issues Interim Reporting and Withholding Guidance under Section 409A

2006-12-04

On November 30, 2006, the Internal Revenue Service issued Notice 2006-100 (the Notice), which provides interim guidance to employers and other payers regarding their reporting and withholding obligations for calendar years 2005 and 2006 with respect to deferrals of compensation and amounts includible in gross income under Section 409A of the Internal Revenue Code (the Code). The notice also provides guidance to employees and other service providers regarding their income tax reporting and tax payment obligations with respect to amounts includible in income under Section 409A for 2005 and 2006.

As explained in more detail below, the Notice provides the following interim guidance for 2005 and 2006:

- The amount includible in income as a result of a violation of Section 409A generally is determined as of December 31 of each year.
- Employers and payers are required to report amounts includible in income in each such year as a result of a violation of Section 409A; however employers are only required to withhold income and employment taxes with respect to such amounts for 2006. No withholding of the Section 409A penalty tax or interest is required.
- Employers and payers are not required to report amounts deferred during such years under a nonqualified deferred compensation plan subject to Section 409A.
- Employees and service providers are required to report amounts includible in income as a result of Section 409A violations for such years and to pay the associated taxes, including the Section 409A penalty tax and interest.

For full text of our email alert summarizing the effect of this guidance on persons subject to the disclosure requirements under Section 16 of the Securities Exchange Act of 1934 who hold discounted stock options, please click [here](#).

Background

The American Jobs Creation Act of 2004 (the Act), added Section 409A to the Code. Section 409A provides that all amounts deferred under a nonqualified deferred compensation plan for all taxable

years are currently includible in gross income to the extent that they are not subject to a substantial risk of forfeiture and not previously included in income, unless strict timing and documentary requirements are satisfied. A violation of Section 409A results in the assessment of a 20% penalty tax and interest on the employee or service provider, in addition to regular income and employment taxes.

The Act also amended other sections of the Code in order to impose on employers and payers reporting and withholding obligations with respect to nonqualified deferred compensation subject to Section 409A. In particular, the Act requires employers and payers to report all deferrals under a nonqualified deferred compensation plan on Form W-2 or Form 1099, as applicable, and expands the definition of “wages” subject to withholding to include any amount includible in gross income of an employee under Section 409A.

Although Section 409A generally became effective on January 1, 2005, the Internal Revenue Service suspended reporting and withholding obligations under Section 409A for calendar year 2005, subject to the possibility that employers and other payers might be required to issue corrected information returns once further guidance was issued. That further guidance is contained in Notice 2006-100.

Amount Includible in Income As a Result of a Section 409A Violation

General. Notice 2006-100 provides that, generally, the amount includible in income as a result of a violation of Section 409A equals the portion of the total amount deferred under a nonqualified deferred compensation plan that, as of December 31 of the calendar year, is not subject to a substantial risk of forfeiture and has not been included in income in a previous year—plus any additional amounts of deferred compensation paid or made available to the employee or service provider under the plan during such calendar year. The amount includible does not include any amounts deferred that were earned and vested prior to January 1, 2005, and that are not otherwise subject to Section 409A as a result of the effective date provisions. The Notice also provides the following specific guidance:

Account Balance Plans. For an account balance plan that violates Section 409A, the amount includible in income equals the amount that would be treated as deferred under the FICA rules as of December 31—if the entire account balance (including all principal amounts, adjusted for income, gain or loss credited to the employee’s account) as of December 31 were treated as the principal amount credited to the employee’s or service provider’s account on December 31.

Non-Account Balance Plans. For non-account balance plans where the amount deferred is reasonably ascertainable, the amount deferred as of December 31 equals the present value of all future payments to which the employee or service provider has obtained a legally binding right as of December 31, calculated in accordance with the FICA rules.

Stock Options and Stock Appreciation Rights. For stock options and stock appreciation rights subject to Section 409A, the amount includible equals the fair market value of the underlying stock as of December 31 less (i) the exercise price; (ii) the amount, if any, paid for the option or right; and (iii) any amount previously included in income with respect to the option or right.

All other includible amounts must be determined under a reasonable, good faith application of a reasonable, good faith method.

Effect on Employers and Other Payers

General. Notice 2006-100 requires employers and other payers to report amounts includible in income as a result of Section 409A violations during 2006, and requires them to file corrected information returns reporting 2005 violations. Employers are also required to withhold income and employment taxes (but not the Section 409A penalty tax or interest) for 2006 violations. The specific rules are as follows:

Reporting of Includible Amounts. Employers and payers are required to report amounts includible in income as a result of Section 409A violations for calendar years 2005 and 2006 in the following manner:

- For 2005, employers are required to report the amount as wages on an original or corrected Form 941, Employer's Quarterly Federal Tax Return, and an original or corrected Form W-2. Payers are required to report the amount as nonemployee compensation on an original or corrected Form 1099-MISC. The information returns should be prepared in the same manner as for 2006, described below, and should be filed or issued by the deadlines for filing and issuing such returns for 2006.
- For 2006, employers are required to report the amount as wages paid on line 2 of Form 941, in box 1 of Form W-2, and in box 12 of Form W-2 using code Z. Payers are required to report the amount as nonemployee compensation in both box 7 and box 15b of Form 1099-MISC. The information returns should be filed or issued in accordance with generally applicable deadlines.

Failure to file and issue original or corrected information returns for 2005 and 2006, as applicable, may subject employers and payers to penalties.

Withholding on Includible Amounts. No withholding is required for 2005. For 2006, employers are required to withhold on amounts includible in the income of their employees as a result of Section 409A violations using the supplemental withholding rates if the employee has received other wages from the employer during the calendar year. No withholding of the Section 409A penalty tax or interest is required.

If, as of December 31, 2006, the employer has not withheld on amounts includible in income as a result of a Section 409A violation, or has withheld less than the required amount, then the employer may follow one of the following two options in order to have additional amounts treated as timely withheld for 2006:

- The employer can withhold or recover from the employee the amount of undercollection after December 31, 2006, and before February 1, 2007, provided that the amount includible in income as a result of the Section 409A violation is timely reported on the employer's Form 941 for the quarter ended December 31, 2006, and is reported on the employee's

Form W-2 for 2006.

- The employer can pay the income tax liability on behalf of the employee (which payment is treated as additional wages subject to withholding), provided that the amount includible in income as a result of the Section 409A violation, the amount of taxes paid by the employer on behalf of the employee and any additional gross up amounts are timely reported on the employer's Form 941 for the quarter ending December 31, 2006, and are reported on the employee's Form W-2 for 2006. The withholding amount will be treated as timely deposited by the employer if it is paid to the IRS by the due date for the Form 941 for the quarter ending December 31, 2006.

Reporting of Deferral Amounts. Employers and other payers will not be required to report amounts deferred under a nonqualified deferred compensation plan subject to Section 409A on original or corrected Forms W-2 and 1099 issued for calendar years 2005 and 2006.

Effect on Employees and Other Service Providers

General. Notice 2006-100 provides that employees and other service providers must report as wages and pay taxes on any amounts required to be included in income as a result of Section 409A violations during 2006, and must file amended returns for 2005 to report any violations during such year and to pay the associated taxes. The Notice includes the following specific guidance:

- For 2005, employees and service providers can avoid penalties for failure to pay taxes (including failure to pay the 409A penalty tax) by filing amended returns reporting the amount required to be included as a result of the Section 409A violation, and paying the associated tax liability by the due date for their 2006 income tax return, including extensions.
- For 2006, employees and service providers are required to timely file their income tax returns reporting any amounts required to be included in income as a result of a Section 409A violation and are required to timely pay the associated taxes (including the 409A penalty tax).
- The amount includible in income as a result of a Section 409A violation is determined in the manner set forth above and, in addition to all regular income and employment taxes, is subject to a 20% penalty tax under Section 409A and interest at the underpayment rate plus 1% accruing from the year deferred or, if later, the first taxable year in which such amount is no longer subject to a substantial risk of forfeiture.
- Penalties may, and interest will, apply to the extent that the amount of income includible as a result of the Section 409A violation is underreported or the amount of taxes due is underpaid.

Our Recommendations

Both employers and payers, and employees and service providers, should undertake an immediate and comprehensive review of their nonqualified deferred compensation arrangements in light of Notice 2006-100 to determine their reporting, withholding and tax payment obligations. While the transition relief for operational and documentary compliance for all nonqualified deferred

compensation arrangements has been extended until December 31, 2007—except with respect to certain discounted stock options and stock appreciation rights subject to retroactive repricing concerns—compliance with the rules under Notice 2006-100 will likely be the only way to avoid penalties for failure to report, withhold and pay taxes for 2005 and 2006 (as applicable). As a result, if a nonqualified deferred compensation arrangement is not timely or properly brought into compliance with Section 409A by December 31, 2007, the penalty relief afforded by Notice 2006-100 may no longer be available.

For more information on this or other tax matters, please see our prior [tax publications](#), or contact:

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