

Client Alert

Latham & Watkins Tax Department

Internal Revenue Service Issues Guidance on Reporting and Withholding Under Section 409A for 2006

"Notice 2006-100 is important for employers that must report and withhold taxes from deferred compensation amounts that are includible in gross income under Section 409A(a) as a result of a failure to comply with the distribution requirements of Section 409A(a), or that are includible in gross income under the offshore trust and employer financial health provisions of Section 409A(b)."

On November 30, 2006, the Internal Revenue Service issued Notice 2006-100, which provides guidance on the federal income tax reporting and withholding requirements for deferrals of compensation and amounts includible in gross income under Section 409A of the Internal Revenue Code (the Code).

As discussed in our previous Client Alerts,¹ Section 409A imposes sweeping new rules for nonqualified deferred compensation plans. Guidance and transition relief were provided by the Internal Revenue Service and US Department of the Treasury in Notice 2005-1, proposed regulations promulgated on October 4, 2005 under Section 409A and Notices 2005-94, 2006-33 and 2006-79.

Notice 2006-100 is important for employers that must report and withhold taxes from deferred compensation amounts that are includible in gross income under Section 409A(a) as a result of a failure to comply with the distribution requirements of Section 409A(a), or that are includible in gross income under the offshore trust and employer financial health provisions of Section 409A(b).

Notice 2006-100 provides further transition guidance by:

- extending the relief from the

requirement to report annual deferrals through 2006;

- explaining how the withholding and reporting requirements apply to amounts includible in gross income under Section 409A in 2006;
- explaining how the withholding and reporting requirements apply to amounts includible in gross income under Section 409A in 2005 which were not previously reported;
- explaining how to calculate amounts includible in gross income under Section 409A.

Background

Section 409A(a) of the Code imposes new distribution requirements on nonqualified deferred compensation plans (NQDCPs). Amounts deferred under a NQDCP that fails to comply, in form or operation, with these requirements are includible in gross income to the extent such amounts are vested and were not previously included. Section 409A(b) provides that, if a NQDCP is funded with an offshore trust, or assets are restricted to the payment of NQDCP benefits in the event of a change in an employer's financial health, the amounts deferred under the NQDCP are includible in gross income to the extent vested.² Amounts includible in gross income

under Section 409A(a) or (b) are subject to income tax at regular rates, an additional 20 percent income tax and interest at the underpayment rate plus 1 percent.

The Internal Revenue Service issued interim guidance on the reporting and withholding requirements under Section 409A in Notices 2005-1 and 2005-94. Sections 6041 and 6051 of the Code require that an employer or payer report the deferral of compensation for a year for an employee or other service provider, regardless of whether the amounts are includible in gross income. Section 3401(a) of the Code treats an amount includible in an employee's gross income under Section 409A as the payment of "wages" for federal income tax reporting and withholding purposes.

Employer Reporting and Wage Withholding for 2006

Notice 2006-100 provides the following guidance regarding the federal income tax withholding and reporting for employers for 2006 with respect to deferrals of compensation and amounts includible in gross income under Section 409A of the Code. Similar guidance applies for non-employer payers.

2006 Annual Deferrals

The requirement that an employer report amounts deferred under an NQDCP on Form W-2 (box 12, code Y) is suspended for amounts deferred in calendar year 2006. Notice 2005-94 provided similar reporting relief for amounts deferred during calendar year 2005.

Reporting and Withholding on Amounts Includible in Gross Income

Compensation amounts deferred for employees under a NQDCP that are includible in gross income under Section 409A are treated as "wages" for

federal income tax withholding. Thus, if amounts deferred are includible, because the NQDCP fails to comply in form or operation with the distribution requirements of Section 409A(a), or because of Section 409A(b), the employer must treat the includible amounts as "wages."

Most NQDCPs are intended to comply with Section 409A and, consequently, amounts deferred under such NQDCPs should not be includible under Section 409A(a) or (b). However, if an NQDCP fails to comply, and amounts deferred are includible in gross income for calendar year 2006 under Section 409A, the employer must treat the includible amounts as "wages" paid. The employer must withhold federal income taxes at the applicable rate. (That is, the tax withholding rate is not increased for the additional 20 percent income tax and underpayment interest under Section 409A.) The "wages" are to be reported on Form 941 (the employer's quarterly federal tax return) and on the employee's Form W-2 (box 1 and box 12, code Z).

Calculation of Amounts Includible under Section 409A(a) for 2006

The compensation amount includible in gross income for calendar year 2006, for a NQDCP that fails to comply with Section 409A(a), will be the portion of the total amount deferred for the employee that, as of December 31, 2006, is vested (see next section) and has not been included income in a prior year. The amount includible for 2006 also will include amounts paid during 2006. Amounts properly reported on an employee's 2005 Form W-2 may be treated as included in a prior year and thus need not be included in 2006. "Grandfathered" amounts not subject to Section 409A (amounts deferred that were earned and vested prior to January 1, 2005) are not includible in gross income under Section 409A.

Determining Amounts Includible in Income under Section 409A(a) for 2006

The amount includible in gross income under Section 409A(a) as of December 31, 2006, in the case of an account balance plan, is based on the employee's total account balance as of December 31, 2006. For a nonaccount balance plan, if the amount deferred is reasonably ascertainable, the amount includible under Section 409A(a) is determined based on the present value of the future payments to which the employee has a right as of December 31, 2006. In both cases, the Treasury Regulations under Section 3121(v)(2) of the Code, relating to FICA taxation for NQDCPs, are applied to determine the amounts includible.

In the case of a stock right, such as a discounted stock option, the amount includible in gross income under Section 409A(a) as of December 31, 2006 is based on the amount the employee would include in income if the stock right were exercised as of December 31, 2006. Thus, the amount includible generally will be the fair market value of the stock, less the exercise price. Notice 2006-100 does not address how the amount includible is to be determined if the stock right is exercised prior to December 31, 2006, but this suggests that the amount includible should be the fair market value of the stock at exercise, less the exercise price.

For all other deferred compensation amounts, the amount includible in gross income under Section 409A(a) must be determined under a reasonable, good faith application of a reasonable, good faith method.

Wage Payment Date for Amounts Includible under Section 409A(a) for 2006

If a compensation amount includible in gross income under Section 409A is actually or constructively received by

an employee during calendar year 2006, that amount is treated as a payment of "wages" when received by the employee. The employer must withhold taxes and report the "wages" at that time.

A compensation amount that is includible under Section 409A(a) during calendar year 2006, but is not actually or constructively received by the employee, is treated a payment of "wages" as of December 31, 2006 for federal income tax withholding and reporting purposes. If an employer fails to withhold sufficient federal income taxes on this payment of "wages" as of December 31, 2006, the employer may withhold the required taxes before February 1, 2007. Alternatively, the employer may pay the required tax withholding (without a deduction from the employee) and treat this amount as additional "wages."

Amounts Includible in Gross Income under Section 409A(a) for 2005

Notice 2005-94 provided that an employer was not required to include in an employee's "wages" amounts includible in gross income under Section 409A of the Code, if such amounts were not received during calendar year 2005. Notice 2005-94 also suspended the requirement that an employer report amounts includible in gross income under Section 409A for 2005. An employer must now report such includible amounts by furnishing an original or corrected Form W-2 for 2005 by January 31, 2007. Amounts includible in gross income for 2005 are to be determined in the manner provided under Notice 2006-100. An employer will not be liable for income tax withholding with respect to previously unreported amounts includible in gross income under Section 409A if the amounts are reported in accordance with Notice 2006-100.

Amounts Includible in Income under Section 409A(b)

Amounts includible in gross income under Section 409A(b) of the Code must be determined under a reasonable, good faith application of a reasonable, good faith method. Amounts includible in an employee's gross income under Section 409A(b) must be treated as "wages" for federal income tax withholding and reporting purposes. Certain amounts that otherwise would be includible under Section 409A(b) are subject to transition relief under Notice 2006-33.

Protection from Future Additional Reporting and Withholding for 2005 and 2006

An employer that complies with Notice 2006-100 regarding computing the amounts includible in gross income under Section 409A of the Code for calendar years 2005 and 2006, and withholding and reporting, will not be liable for additional income taxes or penalties as a result of future guidance. Also, the employer will not be required to furnish corrected reporting as a result of future guidance. If an employer fails to comply with Notice 2006-100, the employer may be subject to additional liability for income tax withholding and penalties and have additional reporting obligations.

Service Provider Requirements with Respect to Amounts Includible in Gross Income under Section 409A

Notice 2006-100 provides that an employee or other service provider must report as income and pay taxes

due on amounts includible in gross income under Section 409A of the Code for calendar year 2006. Also, if the employee or service provider has not reported amounts includible in gross income under Section 409A for calendar year 2005, the employee or service provider must file an amended return and pay any taxes due. The Internal Revenue Service will not assert penalties if the employee or service provider files the amended return for 2005 and pays any additional taxes by the due date for the employee's or service provider's 2006 income tax return.

The amounts reported by the employee or service provider are to be calculated in the manner provided under Notice 2006-100. If the employee or service provider fails to report and pay taxes due with respect to amounts includible in gross income under Section 409A for calendar year 2005 or 2006 in accordance with Notice 2006-100, the Internal Revenue Service may assert additional income taxes and penalties. Interest will apply to any underpayments or tax resulting from a failure to include amounts includible in gross income under Section 409A for calendar year 2005 or 2006.

Effect of Compliance with Section 409A under the Transition Relief of Notice 2006-79

Notice 2006-79 generally extends the deadline for amending an NQDCP to comply with Section 409A(a) of the Code until December 31, 2007 (the extension does apply to certain discounted stock rights). Although Notice 2006-100 does not specifically discuss the treatment of amounts deferred under NQDCPs that have not yet been amended, if an NQDCP is timely amended under Notice 2006-79, amounts deferred under the NQDCP should not be includible in an employee's gross income under Section

409A(a) for calendar year 2005 or 2006. If, however, an NQDCP is not timely amended, or fails to comply in operation, amounts may be includible in gross income under Section 409A(a) for such years.

Endnotes

¹ Latham & Watkins operates as a limited liability partnership worldwide with an affiliate in the United Kingdom and Italy, where the practice is conducted through an affiliated multinational partnership.
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² Section 409A(b) also applies to a NQDCP funded with a domestic trust during certain restricted periods relating to an employer's single employer defined benefit pension plan.

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