

December 1, 2006

**IRS Waives Reporting of 409A Deferrals for 2006,
But 2005 and 2006 Violations of 409A Trigger Last Minute
Reporting and Withholding Obligations**

As anticipated, yesterday the IRS announced in Notice 2006-100 that employers will not be required to report on 2006 Forms W-2 (or 1099-MISC) amounts deferred in 2006 that are subject to Code section 409A. However, the IRS decided not to waive reporting of section 409A violations that occurred in 2006 or 2005 or the withholding requirements related to 2006 violations. We summarize below what this "interim guidance" means for employers and employees.

Reporting of Deferred Amounts

Employers generally must report the annual amount deferred under a nonqualified plan subject to section 409A on an employee's Form W-2 with a Code Y in box 12 (Form 1099-MISC for independent contractors). Last year, the IRS issued Notice 2005-94 making Code Y reporting optional for 2005. Yesterday's Notice does the same for 2006. Because the IRS has yet to provide guidance on how to calculate the "deferred amounts" to be reported, employers will understandably be relieved by this guidance.

Violations of Section 409A and Includible Amounts

If a violation of section 409A occurs with respect to an employee participating in a nonqualified plan, all vested amounts deferred for the employee under the plan that are subject to section 409A become immediately includible in the employee's taxable income (the "Includible Amount"). Thus, the employee will owe federal income tax on the Includible Amount in the year of the violation. The employee will also owe an additional tax equal to 20 percent of the Includible Amount and interest.

The Notice provides rules on how to calculate the Includible Amount for an employee based on a 2006 violation under a nonqualified plan. Generally, the Includible Amount equals the amount of plan benefits received by the employee in 2006 plus the vested "amount remaining deferred" under the plan at December 31, 2006. For violations involving a retirement plan, the "amount remaining deferred" is based on rules in the FICA tax area (Code §3121(v)(2)). For violations involving stock rights (e.g., discount options), the "amount remaining deferred" is generally equal to the spread on the stock right at December 31, 2006. For other violations (e.g., transfer to a foreign trust after March 21, 2006), a reasonable, good faith approach is required.

GROOM LAW GROUP, CHARTERED

1701 Pennsylvania Ave., N.W. • Washington, D.C. 20006-5811
202-857-0620 • Fax: 202-659-4503 • www.groom.com

As feared, the Notice makes clear that the plan aggregation rules announced in Notice 2005-1 and the proposed regulations under section 409A apply for purposes of determining the Includible Amount. Thus, a violation under one arrangement subject to 409A (e.g., a discount option) causes amounts deferred under all similar arrangements subject to 409A (e.g., other discount options) to be includible in income.

Reporting and Withholding on 2006 Violations

Employers are required to report Includible Amounts for an employee based on a violation of section 409A during 2006. These amounts must be reported in boxes 1 and 12 of 2006 Form W-2 with a Code Z in box 12. Employers are also required to report Includible Amounts for an independent contractor based on a 2006 violation of section 409A (reporting in box 7 and 15b of 2006 Form 1099-MISC).

Employers must also withhold federal income taxes on such Includible Amounts for employees. The IRS provides detailed guidance in the Notice on the withholding and deposit requirements for such amounts and confirms that no additional withholding is required with respect to the 20 percent additional tax and interest. In brief, the IRS guidance includes two relief provisions to assist employers in meeting their withholding obligations, provided that the taxes are deposited by January 31, 2007.

Transition relief available under section 409A should dramatically limit the number of 2006 violations. However, the IRS has taken the position that the exercise in 2006 of certain options or stock appreciation rights ("SARs"), in particular discount options or SARs, will result in a violation. *Thus, employers whose employees exercised discount options in 2006 will need to act quickly to meet these requirements.*

Reporting on 2005 Violations

Last year, the IRS waived reporting of 409A violations occurring in 2005, but warned that employers might be required in the future to file amended 2005 Forms W-2 to report these violations. Unfortunately, the IRS is now requiring such amended returns. Thus, employers must file corrected Forms W-2 or 1099-MISC reporting Includible Amounts resulting from a 2005 violation (determined in the same manner as for 2006 violations) by the fast approaching due date for 2006 returns.

No federal income tax withholding is required with respect to Includible Amounts related to 2005 violations.

Given the particularly liberal transition relief available under section 409A during 2005, including relief for the exercise of discount options, there should be few reportable violations.

Effect of Employer Compliance With Notice

While Notice 2006-100 is only "interim guidance" on these issues, employers who comply with the Notice will avoid reporting and withholding penalties. They will also not be required to revisit 2005 and 2006 reporting and withholding if future IRS guidance provides different rules (e.g., on calculation of Includible Amounts).

Guidance for Employees

Employees are required to report and pay regular income taxes, the 20 percent additional tax, and interest on Includible Amounts (calculated as described above) for 2005 and 2006. If an employee did not do so with his 2005 return, he will be required to file an amended 2005 return (Form 1040-X) and pay any additional taxes due. An amended 2005 return needs to be filed by the due date for the 2006 return, including extensions. The Notice provides guidance on the calculation of interest and warns employee of estimated tax penalties for failure to adequately withhold for 2006.

Similar to the relief provided employers, employee will not be subject to penalties for underreporting (and underpaying taxes, and related interest) with respect to Includible Amounts for 2005 and 2006 if they report and pay any taxes due with respect to such amounts in accordance with the Notice requirements.

FICA Taxes Not Addressed

The Notice makes clear that it has no impact on the FICA treatment of nonqualified deferred compensation subject to Code section 3121(v)(2) and does not address FICA treatment for other amounts (e.g., discount options).

Request for Comments

As noted above, the Notice provides interim guidance on these reporting and withholding issues. The IRS continues to work on further guidance on these topics and specifically requests comments on these issues.

* * *

If you have any questions regarding this Notice or about compliance with section 409A, please contact the Groom attorney you normally work with or one of the following:

Eric Cotts (202) 861-6616
Liz Dold (202) 861-5406
Jeff Kroh (202) 861-5428
Lou Mazawey (202) 861-6608
John McGuinness (202) 861-6625
Bill Sweetnam (202) 861-5427
Brigen Winters (202) 861-6618