

## IRS Issues Proposed Regulations Regarding Section 409A Violations and Defers Reporting Requirements

December 11, 2008

On December 5, 2008, the Department of Treasury released proposed regulations regarding the calculation of the amount of deferred compensation includible in income upon a violation of section 409A of the Internal Revenue Code (the Code), and the additional taxes resulting from the violation. (The proposed regulations can be accessed online at <http://frwebgate1.access.gpo.gov/cgi-bin/TEXTgate.cgi?WAISdocID=022854338689+0+1+0&WAISaction=retrieve>.) On December 10, 2008, the Internal Revenue Service issued Notice 2008-115, which provides transition guidance with respect to 2008 reporting and withholding requirements. (Notice 2008-115 can be accessed online at <http://www.irs.gov/pub/irs-drop/n-08-115.pdf>.)

If a nonqualified deferred compensation plan fails to comply with Code section 409A in form or in operation, all amounts deferred pursuant to that plan (and all plans aggregated with that plan) are immediately includible in income unless those amounts were previously included in income or are subject to a substantial risk of forfeiture (i.e., are not vested). The income tax on the amount includible in income is increased by 20% of the amount includible in income plus an additional amount equal to interest on the underpayments, using the interest rate on underpayments plus one percentage point, and determined by assuming that the deferred compensation should have been included in gross income for the later of the year of deferral or the year during which the deferred compensation vested. State tax penalties may also be applicable.

The proposed regulations contain detailed rules regarding each step of the calculation, and rules for applying that calculation to each type of arrangement subject to Code section 409A. Although they contain several helpful provisions, the proposed regulations will also create additional administrative burdens and complexity. Below, we discuss several key provisions of the proposed regulations.

- **End of the year rule.** The amount includible in income would be the present value of all amounts payable calculated as of the last day of the taxable year during which the violation occurred, regardless of the date of noncompliance. If a violation occurs early in a year (e.g., in January), amounts deferred later during that same year would also be includible in income even if there were no section 409A violations with respect to those later deferrals.

- **Effect of distributions during the year.** Amounts distributed during the year of noncompliance would be includible without regard to (i) whether the distribution complied with section 409A or (ii) whether the distribution occurred before or after the violation. As a result, a violation late in a year (e.g., in December) would result in additional taxes on amounts distributed at any time during the year.
- **Short-term deferrals.** On the last day of a taxable year, certain payments may qualify as short-term deferrals if paid on or before the end of the relevant two-and-one-half-month period. Any payments that qualify as short-term deferrals would not be included in the section 409A includible amount. If those amounts are subsequently not paid within the short-term deferral period, they would be included in the section 409A includible amount for the year during which the short-term deferral period expired (typically, the next calendar year).
- **Effect of notional investment losses.** Notional investment losses that occur during a taxable year (as well as actuarial and other similar reductions) will reduce the present value of the amount payable under a plan determined as of the end of the year and, therefore, are effectively netted against any gains that occur during the same taxable year because of notional investment gains, additional deferrals, or other additions to the amount payable under the plan. As with the other provisions mentioned above, this rule would apply to all notional losses during the year without regard to whether a deemed loss occurs before or after the date of any violation.
- **Deduction for certain includible amounts.** The proposed regulations provide a deduction to service providers to the extent that the amount paid to the service provider is less than the amount previously included in income as a result of a violation of section 409A if those amounts are later forfeited or permanently lost, provided that the service provider does not retain a right to any amount deferred under the plan. This deduction would be available if the employer was insolvent or bankrupt at the time payment was due as well as for reductions in the amount paid due to deemed investment losses.
- **Significant differences with Code section 3121(v).** If the proposed regulations become final, employers would likely have to create and implement new procedures for tracking and calculating the section 409A includible amounts, as the section 409A calculations differ significantly from the calculation required by Code section 3121(v) for purposes of determining Federal Insurance Contributions Act (FICA) taxes on deferred amounts.

One important difference is the treatment of earnings. For purposes of section 409A, earnings on previously deferred amounts are also treated as deferred compensation subject to section 409A. Accordingly, the proposed regulations would require any earnings when reporting or taxing deferred amounts to be included in income. In contrast, once FICA tax has been paid on deferred amounts in accordance with Code section 3121(v), subsequent earnings are generally not treated as additional deferrals.

Another key difference is the proposed treatment of certain conditions on the future payment of deferred amounts. For purposes of section 409A, the proposed regulations would require using reasonable assumptions regarding the probability that any conditions would be satisfied and the use of other assumptions relating to the time, form, and amount of payment.

## Effective Date

The proposed regulations will be effective once finalized and, prior to that time, reliance on the proposed regulations constitutes compliance with Notice 2008-115, described below. The Treasury Department has requested written comments on the proposed regulations by March 9, 2009.

## Notice 2008-115

Notice 2008-115 generally extends the reporting and withholding guidance provided in Notice 2006-100 and Notice 2007-89 applicable to 2005, 2006, and 2007; however, the Notice provides that compliance with the proposed regulations will also constitute compliance with the Notice. The Notice is effective for 2008 and is expected to remain in effect for subsequent years until the proposed regulations are finalized and effective. Morgan Lewis issued a LawFlash on October 26, 2007 reviewing Notice 2007-89, which can be accessed at [http://www.morganlewis.com/pubs/EB\\_IRSExtendsReporting\\_LF\\_26oct07.pdf](http://www.morganlewis.com/pubs/EB_IRSExtendsReporting_LF_26oct07.pdf).

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