

IRS Extends Reporting and Withholding Rules for Another Year: Rules for 2007

October 26, 2007

The IRS issued Notice 2007-89 on October 23, 2007, which provides guidance on (i) reporting and withholding compensation that is deferred in 2007, (ii) reporting and withholding amounts includible in income under section 409A of the Code (409A) in 2007, and (iii) income tax reporting and tax payment for amounts includible in income under 409A in 2007.

On November 30, 2006, the IRS issued guidance relating to reporting and wage withholding requirements for 409A includible amounts in calendar years 2005 and 2006. (See our LawFlash issued December 1, 2006:

http://www.morganlewis.com/pubs/EB_DeferredCompIncome_ActionReq_LF_01dec06.pdf). Notice 2007-89 essentially extends the reporting and withholding rules from 2006 to 2007. For 2007 the following withholding and reporting rules apply:

- Amounts deferred in 2007: Reporting of deferrals is not required for 2007. Accordingly, employers do not need to report amounts deferred in 2007 in box 12 of Form W-2 using code Y. Similarly, a payer is not required to report amounts deferred under a nonqualified deferred compensation plan in 2007 under box 15A of Form 1099-MISC.
- Amounts includible in income: An employer must report amounts includible in income under 409A in boxes 1 and 12 of Form W-2. The employer should use code Z for box 12. For nonemployees, a payer must report amounts includible in income pursuant to 409A in box 7 of Form 1099-MISC and box 15b of Form 1099-MISC. The amounts includible in income under 409A can be calculated in the following ways:
 - All compensation deferred under a plan that as of December 31, 2007 is no longer subject to substantial risk of forfeiture is includible in income to the extent that such amounts have not previously been included in income. In addition, any 409A deferred amounts that were paid or made available to the service provider during 2007 are includible in income. Amounts properly reported on a 2005 or 2006 Form W-2 or Form 1099-MISC should not be reported again.
 - For account balance plans, the amount deferred as of December 31, 2007 is the entire amount in the plan as of such date. The same calculation method applies for reporting on a Form 1099-MISC.
 - For nonaccount balance plans where the amount deferred is reasonably ascertainable, the amount deferred as of December 31, 2007 equals the present value of all future

payments to which the employee or service provider has a legally binding right on December 31, 2007. An amount is reasonably ascertainable when the amount, form, and commencement date of the benefit payments are known. If these facts are known, the existence of alternative forms of payments will not make a payment not reasonably ascertainable.

- For a plan that provides stock rights, the amount deferred as of December 31, 2007 equals the amount that the service provider would be required to include in income if the stock were immediately exercisable and exercised on December 31, 2007.
 - For all other deferred amounts, the amount deferred as of December 31, 2007 must be determined under a reasonable, good-faith application of a reasonable, good-faith method.
 - Notice 2007-89 does not extend the transition relief provided to the application of section 409A(b) of the Code to certain trust arrangements outstanding as of March 31, 2006.
- Income tax reporting and tax payment: Section 3401 of the Code treats amounts includible in income under 409A as “wages.” An employer must report amounts includible in income as wages for income tax withholding on line 2 of Form 941 (an employer’s Quarterly Federal Tax return). For purposes of calculating the amount of income tax required to be deducted and withheld, amounts includible in income for 2007 under 409A are supplemental wages regardless of whether regular wages are paid during the calendar year. Accordingly, estimated tax payments may be required to avoid penalties under section 6654 of the Code.
 - Amounts includible in gross income under 409A in 2007 that are actually or constructively received by an employee during 2007 are considered paid when received by the employee for purposes of withholding, depositing, and reporting the income under section 3401(a) of the Code. Amounts that are neither actually nor constructively received (i.e., imputed income) are treated as paid on December 31, 2007.
 - If as of December 31, 2007 an employer does not withhold income tax or withholds too little, the employee will receive credit for 2007 if the employer follows one of the following two alternatives:
 - The employer withholds and recovers from the employee any amount of undercollection before February 1, 2008 and reports the amounts that were neither actually nor constructively received, but are includible as income, as wages for the quarter ending December 31, 2007 on the employer’s Form 941 and in box 1 of the employee’s Form W-2.
 - The employer pays the income tax withholding liability on behalf of the employee (without deduction from the employee’s wages or other reimbursement from the employee). In this case, the employer reports the wages income and the income tax withholding liability for the quarter ending December 31, 2007 on the employer’s Forms 941 and 940 and in box 1 of the employee’s Form W-2. Wages include amounts that were not actually or constructively received but are includible in income for purposes of 409A and FICA, FUTA, and income tax withholding wages resulting from paying the income tax liability on behalf of the employee. If the income tax withholding liability is paid by the time the Form 941 for the quarter ending December 31, 2007 is filed, the income tax liability payment will be deemed to be timely.

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