

IRS Issues Guidance Regarding Deferred Compensation Income Reporting and Withholding: Action Required for 2005 and 2006

December 1, 2006

Yesterday, the IRS, in Notice 2006-100, issued guidance related to reporting and wage withholding requirements for calendar years 2005 and 2006 with respect to deferred compensation arrangements under Section 409A of the Internal Revenue Code of 1986, as amended (the Code). Notice 2006-100 supersedes Notice 2005-94, which alerted employers and payers last year that they might have to file amended information returns to report amounts includible in income in for 2005.

[As noted in prior Morgan Lewis LawFlashes](#), Section 409A was added to the Code in the fall of 2004 and imposes a variety of restrictions on nonqualified deferred compensation arrangements with such restrictions effective, in general, on and after January 1, 2005. Deferred compensation arrangements that violate Section 409A requirements result in the imposition of a 20% additional tax on the individual benefiting from the arrangement, as well as regular income tax liability and a possible penalty interest assessment.

The good news for employers is that the IRS is not requiring reporting for 2005 or 2006 of deferred compensation amounts subject to Section 409A where such amounts are not taxable in 2005 or 2006. The bad news is that the IRS is requiring employers to report amounts that are taxable under Section 409A for 2006, and even 2005 (which may require filing amended returns), and is requiring withholding on those amounts.

Key Provisions of Notice 2006-100 include:

1. Service Recipient Reporting and Withholding. Employers and other payers need not report annual deferrals of compensation that are not includible in income under Section 409A on Form W-2 or Form 1099-MISC for 2005 or 2006. However, amounts includible in income under Section 409A for 2005 and 2006 must be reported on Form W-2 (in box 12, using code Z) or Form 1099-MISC (in boxes 7 and 15b), as applicable.

Section 3401(a) of the Code provides that for income tax withholding purposes the term “wages” includes any amount includible in gross income of an employee under Section 409A, and payment of such amount is treated as having been made in the taxable year in which the amount is includible in gross income. Thus, for calendar year 2006, an employer must treat amounts includible in gross income under Section 409A as wages for income tax withholding purposes. If the employee has

received other regular wages from the employer during the calendar year, amounts includible in gross income under Section 409A are supplemental wages for purposes of determining the amount of income tax required to be deducted and withheld under Section 3402(a) of the Code. Under the Code, if the sum of an employee's supplemental wage payments made to the employee during the calendar year exceeds \$1,000,000, the excess is subject to withholding at 35% (or the highest rate of income tax for the year). If the sum of the supplemental wages paid to the employee during the calendar year is less than or equal to \$1,000,000, in general, an employer is required to withhold income tax on the supplemental wages at a flat rate of 25%. The amount required to be withheld is not increased on account of the additional income taxes imposed under Section 409A(a)(1)(b). Employees should thus be aware that estimated tax payments may be required to avoid penalties.

- 2006 Requirements: Amounts includible in gross income under Section 409A that are *either* actually *or* constructively received (without regard to the application of Section 409A) by an employee during calendar year 2006, are considered payment of wages by the employer when received by the employee for purposes of withholding, depositing, and reporting the income tax at source on wages.

Amounts includible in gross income under Section 409A that are *neither* actually *nor* constructively received (without regard to the application of Section 409A) by the employee during calendar year 2006 (409A imputed income), are treated as payment of wages on December 31, 2006 for purposes of withholding, depositing, and reporting the income tax at source on wages under Section 3401(a). If as of December 31, 2006 the employer has not withheld income tax from the employee on such wages, or withholds less than the amount of income taxes required to be withheld from the employee, the employee will receive credit for 2006 if the employer follows one of two possible alternatives:

- (i) the employer withholds or recovers from the employee the amount of the undercollection after December 31, 2006 and before February 1, 2007, and reports as wages for the quarter ending December 31, 2006 such amounts that were the relevant amount of 409A imputed income on Form 941 for that quarter and in box 1 of the employee's Form W-2 for 2006; or
- (ii) the employer pays the income tax withholding liability on behalf of the employee (without deduction from the employee's wages or other reimbursement by the employee), and reports the gross amount of wages and the income tax withholding liability for the quarter ending December 31, 2006 as including such amounts that were neither actually nor constructively received but are includible in income under Section 409A as well as the wages resulting from paying the income tax on the employee's behalf on Form 941 and in box 1 of the employee's Form W-2 for 2006.

For purposes of the deposit requirements associated with such wages, if the income tax withholding liability with respect to such wages is paid to the IRS by the due date of the Form 941 for the quarter ending December 31, 2006 on which the wages are reported, then the amount of income tax withholding liability will be considered to have been deposited in accordance with applicable IRS rules. Thus, penalties for failure to deposit taxes will not be imposed with respect to such amount.

In general, amounts deferred as of December 31, 2006 in both account balance and nonaccount balance plans that are subject to Section 3121(v)(2) of the Code, track the income inclusion and calculation rules of Section 3121(v). With respect to a plan that is not subject to Section 3121(v)(2), and is a stock right as defined in the Section 409A proposed regulations (e.g., a stock option and a stock appreciation right), the amount deferred as of December 31, 2006 equals the amount that the service provider would be required to include in income if the stock right were immediately exercisable and exercised on December 31, 2006. In other words, with respect to a stock right outstanding on December 31, 2006, the amount deferred as of December 31, 2006 equals the fair market value of the underlying stock less the sum of the exercise price and any amount paid by the service provider for the stock.

- 2005 Requirements: Employers and payers, including those who relied on Notice 2005-94 for calendar year 2005, are required to file an original or corrected information return and furnish an original or corrected payee statement (W-2 or 1099-MISC) for calendar year 2005 reporting any previously unreported amount includible in gross income under Section 409A for calendar year 2005 as determined under guidance provided by Notice 2006-100 for calendar year 2006. The original or corrected information return and the original or corrected payee statement for calendar year 2005 must be filed and furnished by the deadlines applicable for filing an information return and furnishing a payee statement reporting amounts includible in income in calendar year 2006. (Generally, this means the original or corrected information return must be filed by February 28, 2007, and the original or corrected payee statement must be furnished by January 31, 2007.) An employer or payer is not liable for income tax withholding under Section 3403 of the Code or penalties for 2005 with respect to any previously unreported amounts of gross income includible under Section 409A reported on an original Form W-2 or Form 1099-MISC, or on Form W-2c or a corrected Form 1099-MISC for 2005 in accordance with the guidance provided by Notice 2006-100.

2. Service Provider Reporting. A service provider must report as income and pay any taxes due relating to amounts includible in gross income under Section 409A for calendar year 2006. In addition, if a service provider has not reported as income and paid any tax due relating to amounts includible in gross income under Section 409A for calendar year 2005, calculated in accordance with Notice 2006-100, the service provider must file an amended return and pay any taxes due relating to such amounts.

3. Good Faith Compliance. As a reminder, the IRS has yet to issue final regulations under Section 409A and thus far has issued only proposed regulations and Notice 2005-1. Plans adopted on or before December 31, 2007 will not be deemed to violate Section 409A so long as such plans are (a) operated in “reasonable, good faith compliance” with the provisions of Section 409A and applicable guidance issued prior to January 1, 2008; and (b) amended before January 1, 2008 to conform to the provisions of Section 409A and the final regulations. An employer or other payer who complies with the rules of Notice 2006-100 regarding computing amounts includible in gross income under Section 409A and withholding and reporting for calendar years 2005 and 2006 will not be liable for additional income tax withholding or penalties, or be required to file a subsequent corrected information return or furnish a corrected payee statement, as a result of future published guidance with respect to the computation of amounts includible in gross income under Section 409A.

4. Other Compliance Issues in 2006. Although plans that operate in “reasonable, good faith compliance” with the provisions of Section 409A and applicable guidance issued prior to January 1, 2008 will not be deemed to violate Section 409A, a major exception to this general rule is that public company option backdating remedies must be implemented by December 31, 2006 as to (i) executives or directors subject to Section 16(a) of the Securities Exchange Act of 1934; and (ii) if the company has reported or expects to report an incremental financial statement expense as a result of the discount rights. Even though this stricter rule is limited to discounted options granted to officers or directors, the imposition of a December 31, 2006 remedial period deadline poses very difficult compliance problems for many public companies, especially since many companies have not yet even identified the discounted options that must be remedied.

We expect the IRS to issue final regulations under Section 409A in early 2007. At that time, it will be critical for companies to be able to work diligently to bring their plans into compliance with the final regulations before January 1, 2008. Accordingly, we suggest that, to the extent they have not already done so, employers should commence review and inventorying of all arrangements subject to Section 409A (including traditional deferred compensation plans, severance and change in control arrangements, and equity compensation and other plans). In addition, it may be advisable to take action in 2006 with respect to certain deferred amounts, otherwise payable in 2007. We will supplement this LawFlash as additional Section 409A guidance is issued, and we are happy to assist with Section 409A compliance efforts. For further information, please contact your Morgan Lewis attorney or any of the following:

Chicago

Brian D. Hector	312.324.1160	bhector@morganlewis.com
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Dallas

Riva T. Johnson	214.466.4107	rjohnson@morganlewis.com
Erin Turley	214.466.4108	eturley@morganlewis.com

New York

Craig A. Bitman	212.309.7190	cbitman@morganlewis.com
Gary S. Rothstein	212.309.6360	grothstein@morganlewis.com

Palo Alto

S. James DiBernardo	650.843.7560	jdibernardo@morganlewis.com
Zaitun Poonja	650.843.7540	zpoonja@morganlewis.com

Philadelphia

Robert L. Abramowitz	215.963.4811	rabramowitz@morganlewis.com
I. Lee Falk	215.963.5616	ilfalk@morganlewis.com
Robert J. Lichtenstein	215.963.5726	rlichtenstein@morganlewis.com
Vivian S. McCardell	215.963.5810	vmccardell@morganlewis.com
Joseph E. Ronan	215.963.5793	jronan@morganlewis.com
Steven D. Spencer	215.963.5714	sspencer@morganlewis.com
Mims Maynard Zabriskie	215.963.5036	mzabriskie@morganlewis.com
David B. Zelikoff	215.963.5360	dzelikoff@morganlewis.com

Pittsburgh

John G. Ferreira	412.560.3350	jferreira@morganlewis.com
R. Randall Tracht	412.560.3352	rtracht@morganlewis.com

San Francisco

Mark H. Boxer	415.442.1695	mboxer@morganlewis.com
Eva P. McComas	415.442.1249	emccomas@morganlewis.com

Washington, D.C.

Althea R. Day	202.739.5366	aday@morganlewis.com
Gregory L. Needles	202.739.5448	gneedles@morganlewis.com

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