



# *The Washington Report* **BENEFITnews**

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## **IRS Issues 2008 Reporting and Withholding Guidance Under Code Section 409A**

The Revenue Service has issued IRS Notice 2008-115, which provides interim guidance for purposes of complying with the reporting and withholding requirements under Revenue Code section 409A for 2008 and possibly beyond. The section 409A deferred compensation rules impose reporting and withholding requirements that were intended to be effective with respect to amounts deferred on or after January 1, 2005. In IRS Notices 2005-94, 2006-100 and 2007-89, the Revenue Service provided relief and guidance for complying with the reporting and withholding requirements for 2005, 2006 and 2007. Notice 2008-115 essentially provides for an extension to 2008 of the guidance provided in the earlier notices. That guidance will continue to apply to future years until further guidance is issued.

### Background

The new rules generally require that all deferrals for a year must be separately reported on an IRS Form 1099-Misc or Form W-2, as applicable, regardless of whether such compensation is includible in gross income under 409A. In addition, amounts includible under 409A in the gross income of an employee are treated as wages for federal income tax withholding purposes. These new reporting and withholding requirements generally apply to amounts deferred in calendar years beginning after December 31, 2004 (including income attributable to such amounts deferred, whether actual or notional,) and amounts includible in gross income under 409A after that date.

Prior to the issuance of Notice 2008-115, the IRS had addressed the new reporting and withholding requirements in Notices 2005-1, 2005-94, 2006-100 and 2007-89.

Notice 2005-1 provided interim guidance on the mechanics of reporting nonqualified deferred compensation on either a Form W-2 or Form 1099-MISC (IRS Notice 2005-1; Q&As-24 through 38).

Notice 2005-94 suspended the reporting and withholding requirements of 409A for 2005, subject to further guidance.

Notice 2006-100 permanently waived the requirement that deferrals during calendar years 2005 and 2006 be reported. However, amounts includable in an employee's gross income under 409A for 2006 were treated as wages and were subject to income tax withholding (without regard to the additional 20% tax under 409A). In addition, Notice 2006-100 provided that any income not reported for 2005 (pursuant to Notice 2005-94) must be reported in 2006 for 2005 by filing a corrected Form W-2 or 1099-MISC. Notice 2006-100 also included interim guidance for determining the amounts includible in income under 409A and guidance for employees to report any amounts includible in gross income under 409A on their income tax returns.

Notice 2007-89 generally extended the guidance provided in Notice 2006-100 to the 2007 calendar year.

Notice 2008-115 essentially extends the guidance provided in the prior notices to 2008. In addition, Notice 2008-115 provides that it will remain in effect for future calendar years until the IRS issues further guidance.

On December 5, 2008, the IRS issued proposed regulations under 409A which address the calculation of the amount includible in income under 409A(a) and the calculation of the additional taxes that apply if the requirements of 409A are not satisfied (i.e., an interest tax plus an additional 20% tax). Notices 2007-89 and 2008-115 include interim guidance that address these same matters.

#### Waiver of Deferral Reporting Requirements for 2008

Notice 2008-115 permanently waives the deferral reporting requirements for 2008. Thus, employers will not be required to report the amount of deferrals that were made in calendar year 2008. In addition, this waiver may apply to a future calendar year if further guidance is not issued before the beginning of the future calendar year. In Notice 2008-115, the IRS indicated that it anticipates that deferrals will not have to be reported until the calendar year beginning after the proposed income inclusion regulations are finalized.

However, as discussed further below, to the extent an amount is includible in gross income under 409A, it generally will be subject to the reporting and withholding requirements applicable to wages and subject to the special rules and guidance provided in Notice 2008-115.

#### Amounts Includible in 2008

Notice 2008-115 provides the following key reporting and withholding guidance with respect to amounts includible in gross income in 2008 (and possibly later years) under 409A:

(1) General Rules: An employer must treat amounts includible in gross income under 409A as wages for income tax withholding purposes. The employer is required to report such amounts in box 1 of Form W-2 and also as 409A income in box 12 of the Form W-2 using code "Z." The amounts includible are supplemental wages for purposes of determining the amount of income tax required to be deducted and withheld, regardless of whether the employer has paid the employee any regular wages during the calendar year of the payment. In addition, the amount required to be withheld is not increased on account of the additional taxes imposed by 409A (20% plus an additional tax based on a hypothetical interest calculation).

(2) Nonemployees: With respect to nonemployees (e.g., independent contractors), the payor must report amounts includible under 409A as nonemployee compensation in box 7 of Form 1099-MISC and must also report such amounts as 409A income in box 15b of the Form 1099-MISC. There are no withholding requirements with respect to amounts includible for nonemployees.

(3) Amount Includible - General Rules: The amount includible in gross income under 409A and required to be reported (and withheld upon in the case of employee wages) equals the portion of the total amount deferred under the plan that, as of December 31, 2008, is not subject to a substantial risk of forfeiture and has not been included in income in a previous year, plus any amounts of deferred compensation paid or made available to the employee during the 2008 calendar year. For this purpose, an amount is treated as previously included in income if properly reported by the employer or payer on a 2005, 2006 or 2007 Form W-2 or Form 1099-MISC.

(4) When Amounts Are Considered Paid for Purposes of the Withholding Rules: Amounts that are either actually or constructively received during 2008 are considered a payment of wages when received by the employee for purposes of withholding, depositing, and reporting the income tax on wages. Amounts that are neither actually nor constructively received by the employee during 2008 are treated as a payment of wages on December 31, 2008 for purposes of the wage withholding rules. If an employer does not withhold the proper amount with respect to amounts that are neither actually or constructively received during 2008, the underwithholding can be "corrected" using one of the following two options:

(A) The employer withholds or recovers from the employee the amount of the underwithholding after December 31, 2008 and before February 1, 2009, and reports as wages for the quarter ending December 31, 2008 the amounts that were neither actually nor constructively received but are includible in income under 409A in box 1 of the employee's Form W-2 for 2008; or

(B) 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 income tax withholding liability for the quarter ending December 31, 2008 as including such amounts that were neither actually nor constructively received but are includible in income under 409A, as well as the FICA, FUTA and income tax withholding wages resulting from paying the income tax on the employee's behalf in box 1 of the employee's Form W-2 for 2008.

(5) Specific Guidance for Determining Amounts Includible in Income Under 409A(a): Notice 2008-115 provides the following specific guidance for purposes of determining the amounts includible in income under 409A(a):

(A) Account Balance Plans: The amount deferred is generally the account balance as of December 31, 2008. For this purpose, the plan aggregation rules apply, except that an elective account balance plan is not aggregated with a non-elective account balance plan.

(B) Non-account Balance Plans: Where the amount deferred is reasonably ascertainable (as determined in accordance with the FICA regulations under Code section 3121(v)(2)), the amount deferred as of December 31, 2008 equals the present value of all future payments to which the employee has obtained a legally binding right as of December 31, 2008, calculated as if the employee had obtained all of such rights on December 31, 2008. Notice 2008-115 provides additional guidance for purposes of determining when an amount is reasonably ascertainable.

(C) Stock Rights: The amount deferred equals the amount that the employee would be required to include in income if the stock rights were immediately exercisable and exercised on December 31, 2008 - which generally equals the fair market value of the underlying stock less the sum of the exercise price and any amount paid by the employee for the stock right.

(D) All Other Deferred Amounts: The amount deferred must be determined under a reasonable, good faith application of a reasonable, good faith method. Notice 2008-115 provides additional guidance for purposes of determining whether the reasonable, good faith standards are met.

As mentioned above, on December 5, 2008, the IRS issued proposed income inclusion regulations, which provide more detailed guidance regarding the amounts that must be included in income under 409A(a). The regulations are proposed to be generally applicable for taxable years beginning on or after the date the regulations are finalized. In addition, before the proposed regulations become final, the IRS has indicated that taxpayers may rely on them only to the extent provided in future guidance. In Notice 2008-115, the IRS indicated that until the proposed regulations are finalized, for purposes of complying with the reporting and withholding requirements, employers can rely on either the interim guidance in Notice 2008-115 or the proposed regulations. However, if an employer relies on the proposed regulations, the employer must comply with all of the requirements of the proposed regulations.

(6) Guidance for Service Providers: Notice 2008-115 also includes guidance for service providers (e.g., employees, independent contractors) with respect to amounts that are required to be included in gross income under 409A. Employees must report all amounts required to be included under 409A and for purposes of determining such amounts, the same general principles that apply to employers (as discussed above) apply to employees. However, Notice 2008-115 provides that the responsibility of the employee to determine such amounts is independent of whether the employer or payer has complied with the requirements of the notice. As such, the notice emphasizes that, even if the employee includes in income the same amount reported by the employer or payer, the employee has not necessarily complied with the notice.

(7) Guidance for Determining the Additional Taxes Imposed by 409A(a): If an amount is required to be included in gross income under 409A, the tax imposed on such income is increased by the sum of two additional taxes: (A) an additional tax equal to the interest, using the IRS's underpayment rate plus 1%, that would have been imposed during the deferral period if the deferred compensation had been includible in income when first deferred (or not subject to a substantial risk of forfeiture) ("additional interest tax"); and (B) an additional tax equal to 20% of the deferred compensation. For purposes of computing the additional interest tax, Notice 2008-115 provides that employees may treat amounts deferred under a plan that were originally deferred on or before January 1, 2005 (the general effective date of 409A) but became subject to 409A due to the material modification of the plan after October 3, 2004 as deferred on January 1, 2005. As a result, the additional interest tax is not computed with respect to periods before January 1, 2005 in such situations.

(8) Guidance for Determining Amounts Included Under 409A(b): An employee may also be required to include amounts in income under Code section 409A(b), which generally applies to a transfer of assets to a trust or similar arrangement, or to a restriction of assets, for purposes of paying nonqualified deferred compensation, if such trust or assets are located outside the United States, if such assets are transferred during a restricted period with respect to a single-employer defined benefit plan sponsored by the employer, or if such assets are restricted to the provision of benefits under a nonqualified deferred compensation plan in connection with a change in the employer's financial health.

IRS Notice 2006-33 provided transition guidance related to the application of 409A(b) to certain arrangements outstanding as of March 21, 2006. This transition guidance essentially provided that eligible arrangements that would otherwise be subject to the additional taxes under 409A(b) would not become subject to 409A(b) if they became compliant by January 1, 2008.

IRS Notice 2008-115 provides that in determining the amount that must be included in income under 409A(b), employers must make a reasonable, good faith application of a reasonable, good faith method.

#### Future Guidance and Comments on Notice 2008-115

The IRS emphasized that the notice is only intended to provide interim guidance with respect to amounts included in gross income under 409A. The IRS recently issued proposed regulations regarding the income inclusion requirements and the additional 409A taxes. With respect to the income inclusion aspects of Notice 2008-115, the IRS indicated that comments should be submitted in accordance with the preamble to the proposed regulations, which provide that a public hearing on the proposed regulations is scheduled for April 2, 2009, and written comments and outlines of topics to be discussed at the public hearing must be submitted no later than March 9, 2009. With respect to the matters addressed in Notice 2008-155 other than the income inclusion aspects, the IRS requested that comments should be submitted by March 29, 2009.

**THE ABOVE ADVICE WAS NOT INTENDED OR WRITTEN TO BE USED, AND IT CANNOT BE USED BY YOU FOR THE PURPOSES OF AVOIDING ANY PENALTY THAT MAY BE IMPOSED BY THE INTERNAL REVENUE SERVICE.**

In the event that this *Washington Report* is also considered to be a "marketed opinion" within the meaning of the IRS guidance, then, as required by the IRS, please be further advised of the following:

**THE ABOVE ADVICE WAS WRITTEN TO SUPPORT THE PROMOTIONS OR MARKETING OF THE TRANSACTIONS OR MATTERS ADDRESSED BY THE WRITTEN ADVICE, AND, BASED ON THE PARTICULAR CIRCUMSTANCES, YOU SHOULD SEEK ADVICE FROM AN INDEPENDENT TAX ADVISOR.**

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