

Client Alert

A report
for clients
and friends
of the firm **January 2007**

Reporting and Wage Withholding Guidance under Section 409A

The Treasury Department and the Internal Revenue Service (the "IRS") issued Notice 2006-100 providing interim guidance to employers, other payers and service providers regarding reporting and wage withholding requirements for calendar years 2005 and 2006 with respect to deferrals of compensation and amounts includible in gross income under Section 409A of the Internal Revenue Code of 1986, as amended (the "Code"). Notice 2006-100 provides relief from reporting deferrals subject to Code Section 409A ("Section 409A") that are not includible in income during 2005 and 2006, and supersedes Notice 2005-94 (which generally suspended employer and other payer (referred to herein collectively as "employers") reporting and wage withholding with respect to deferrals of compensation and amounts includible in gross income under Section 409A for calendar year 2005).

Section 409A generally is effective for amounts deferred after December 31, 2004 (and amounts deferred prior to January 1, 2005 which do not fall within special grandfathering rules). Previous published guidance provided transition relief for complying with the new Section 409A requirements; first through December 31, 2005, then generally through December 31, 2006, and then until January 1, 2008, at which time the final regulations (which are expected to be issued in the first quarter of 2007) are scheduled to become effective. For a summary of the provisions of Section 409A and other published guidance, please refer to our previous Client Alerts entitled, "Recent Legislation Impacts Deferred Compensation and More," "Treasury and IRS Issue Guidance on Nonqualified Deferred Compensation," "Update on New Deferred Compensation Rules: Proposed Regulations Issued Under Code Section 409A," and "Additional 409A Transitional Relief

Provided Until January 1, 2008." These Client Alerts are available on our website at www.proskauer.com.

The key provisions of Notice 2006-100 include the following:

No Reporting for 2005 and 2006 Annual Deferrals that Comply with Section 409A. In general, for 2005 and 2006, employers are not required to report amounts deferred under a nonqualified deferred compensation plan subject to Section 409A in such years on Form W-2 or Form 1099-MISC, as applicable, if such amounts are not includible in gross income under Section 409A in 2005 or 2006.

Reporting and Withholding for Amounts Includible in Gross Income under Section 409A.

- To the extent that amounts deferred under a nonqualified deferred compensation plan are includible in the gross income of an employee under Section 409A, employers must treat such amounts as wages for income tax withholding purposes. For 2006, such amounts will be treated as supplemental wages for withholding purposes if the employee received other regular wages during the year. Amounts includible in an employee's income under Section 409A for 2006 must be reported on Form W-2 (in box 12, using Code Z) and on Form 941 (line 2). For amounts includible in an employee's income in 2005 that were not reported in 2005, such amounts must be reported on an original or corrected 2005 Form W-2 prior to the reporting deadline for 2006. An employer is not liable for (i) income tax withholding or (ii) late filing penalties with respect to newly reported 2005 amounts reported in accordance with Notice 2006-100. The amount required to be withheld for 2006 is not increased on account of additional income taxes imposed under Section 409A.
- For non-employees, an employer is required to report to a non-employee any amount that is

includible in gross income under Section 409A that is not treated as wages. For 2006, such amount must be reported on Form 1099-MISC (in boxes 7 and 15b). For 2005, such amount must be reported on an original or corrected Form 1099-MISC prior to the reporting deadline for 2006.

Calculation of Amounts Includible in Income under Section 409A(a) for 2006. The amount includible in gross income in 2006 under Section 409A and required to be reported by the employer equals the portion of the total amount deferred under the plan that, as of December 31, 2006, 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 service provider under the plan during the calendar year 2006. Amounts includible in gross income under Section 409A(a) include only amounts deferred that are subject to Section 409A.

Amounts Includible in Income under Section 409A(a) for 2005. An employer or other payer who is required to file an original or a corrected information return and furnish an original or a corrected payee statement (Form W-2 or Form 1099-MISC (as applicable)) for calendar year 2005 must calculate the amounts includible in gross income using the rules provided in Notice 2006-100 for calendar year 2006.

Wage Payment Date of Amounts Includible in Income under Section 409A for 2006.

- Amounts includible in income under Section 409A in 2006 that are either actually or constructively received (disregarding the application of Section 409A) by an employee in 2006 are considered a payment of wages 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 (disregarding the application of Section 409A) by an employee in 2006 are treated as a payment of wages on December 31, 2006 for purposes of withholding, depositing, and reporting the income tax at source on wages.
- If, as of December 31, 2006, the employer does not withhold income tax from the employee on such wages, or withholds less than the amount of income tax required to be withheld, the employee will receive credit for 2006 if the employer follows one of the following two possible options:
 - (i) the employer withholds or recovers from the employee the amount of the undercollection before February 1, 2007, and reports as wages for the

quarter ending December 31, 2006 such amounts that were neither actually nor constructively received, but that are includible in income under Section 409A, on Form 941 for that quarter and Form W-2 for 2006; or

- (ii) the employer pays the income tax withholding liability on behalf of the employee (without deduction from wages or reimbursement of the employer) and reports the gross amount of wages and 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 income tax on the employee's behalf on Form 941 and Form W-2 for 2006.

Calculating Amounts Includible in Gross Income under Section 409A for 2006. The total amount deferred under a plan as of December 31, 2006 for purposes of determining the amount required to be included in gross income under Section 409A is calculated in accordance with the following rules:

- **Account Balance Plans and Non-Account Balance Plans.** In general, the amount deferred in both account balance and non-account balance plans is determined in accordance with the rules set forth under Section 3121(v) of the Code and the regulations thereunder. In the case of an account balance plan, that amount is based on the employee's account balance. In the case of a non-account balance plan, that amount, if reasonably ascertainable, is based on the present value of the future payments to which the employee has a legally binding right.
- **Amounts Deferred under Stock Rights Covered by Section 409A.** 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. Accordingly, for a stock right outstanding as of December 31, 2006, the amount deferred as of that date 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 right.
- **Other Deferred Amounts.** The amount deferred as of December 31, 2006 must be determined under a reasonable, good faith application of a reasonable, good faith method reflecting reasonable, good faith assumptions with respect to any contingencies as to timing or amount of any payment. Generally, the use of an assumption with respect to a contingency that results

in the amount deferred being the lowest potential value of the future payment will be presumed not to be reasonable in the absence of clear and convincing evidence to the contrary.

Amounts Set Aside in Foreign Situs Trusts. Where amounts have been transferred to a trust under an arrangement that triggers the income inclusion and additional taxes under Section 409A(b), or the arrangement otherwise triggers the income inclusion and additional taxes under Section 409A(b), and the transfer is not eligible for the relief in Notice 2006-33 (for example because the transfer occurred after March 21, 2006), employers must make a reasonable, good faith application of a reasonable, good faith method to determine the amount includible in income for purposes of reporting. Employers must treat the amount includible in income as wages for federal income tax withholding and reporting purposes.

Protection from Future Reporting or Withholding for 2005 and 2006. In general, an employer that complies with the rules of Notice 2006-100 regarding computing the amounts includible in gross income under Section 409A, reporting for calendar year 2005 and withholding and reporting for 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. If an employer does not apply the rules in Notice 2006-100, the employer may be subject to additional liability for income tax withholding and penalties and may have to file a corrected information return or furnish a corrected payee statement.

Service Provider Requirements for Amounts Includible in Gross Income under Section 409A. 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, the service provider must file an amended return and pay any taxes due relating to such amounts. If the service provider files the amended return and pays any taxes due by the due date for the service provider's 2006 income tax return, the IRS will not assert any penalties. If the service provider does not report and pay taxes due on amounts includible in gross income under Section 409A for calendar year 2005 or 2006, the IRS may assert additional income taxes and tax penalties. The determination as to whether a service provider has complied with the requirements of Notice 2006-100 is

made independently from the determination as to whether the employer has complied with the requirements of the notice. As a result, it is possible for a service provider to be in violation of the requirements of Notice 2006-100 even if the service provider includes in income the same amount reported by the employer.

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The Employee Benefits and Executive Compensation Law Practice Group at Proskauer Rose LLP counsels clients on the full spectrum of benefit and compensation issues, communicating technical and complex legal concepts in an intelligible, pragmatic manner.

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