

IRS ISSUES YEAR END GUIDANCE UNDER SECTION 409A

The IRS seemed intent on clearing its backlog of guidance under section 409A before the holidays. The waning days of 2008 saw the issuance of (1) Notice 2008-115, essentially extending the guidance from previous years for tax reporting and withholding on amounts subject to section 409A; (2) Notice 2008-113, expanding the correction procedures established in late 2007 for certain limited violations of section 409A; and (3) proposed regulations for calculating the amounts subject to tax and the amounts of additional taxes due in the event of section 409A violations. Here are some of the highlights.

Reporting and Withholding

Notice 2008-115 extends for 2008 (and perhaps future years) the rules that have applied for 2005, 2006 and 2007. The Internal Revenue Code generally requires that all amounts of deferred compensation subject to section 409A be reported on Form W-2 or Form 1099-MISC, whether or not those amounts are currently includable in taxable income because of a violation of section 409A. Interim guidance, including Notice 2008-115, requires reporting only such amounts that are currently includable in taxable income because of a section 409A violation. Deferred compensation that complies with section 409A need not be reported. This guidance is expected to remain in effect until the proposed regulations (see below) are finalized and effective for the calculation of amounts includable in income and the additional taxes on those amounts due to section 409A violations. Notice 2008-115 itself provides guidance for calculating amounts currently includable in taxable income because of section 409A violations, generally by reference to the rules for FICA tax reporting of deferred compensation, but notes that compliance with the recently proposed regulations on the subject is a permissible alternative.

Correction Procedures for Section 409A Violations

In late 2007 the IRS published Announcement 2007-100, providing correction procedures for certain relatively minor violations of section 409A. Specifically, if corrected within the same taxable year in which the violation occurs, service providers and service recipients may, without incurring any of the penalty taxes that make section 409A so punitive, correct (1) erroneous payment of an amount that should have been deferred or should have remained deferred for a longer period; (2) deferral of an excess amount that should have been paid in cash; (3) failure to impose a six-month delay on payments to key employees following separation from service; and (4) discounted exercise prices for stock options or stock appreciation rights. The permissible correction period for erroneous cash payments that should have been deferred or should have remained deferred for a longer period, and for deferral of excess amounts that should have been paid in cash, is extended to the end of the service provider's second taxable year following the year of the violation, if the amount in question does not exceed the annual limit on 401(k) deferrals (\$16,500 for 2009). In that case, however, the service provider must pay the additional 20% tax under section 409A, but not the premium interest tax.

Announcement 2007-100 has now been superseded by Notice 2008-113, which generally retains the correction procedures permitted by Announcement 2007-100 and extends relief to additional categories of violations. This extended relief includes the following:

- Erroneous payments or deferrals relating to service providers who are not "insiders" may be corrected in the taxable year immediately following the taxable year in which the violation occurs, without incurring any penalty taxes under section 409A. In the case of erroneous payments, extended repayment periods are permitted in the event of financial hardship, if specified conditions, including the payment of interest, are satisfied. "Insiders" are directors, officers, or 10% shareholders of the service recipient, determined under the principles of Section 16 of the Security Exchange Act of 1934, whether or not the service

recipient is a publicly traded company. This relief is also available for discounted stock options or stock appreciation rights, so long as the correction is made before the stock right is exercised.

- Erroneous payments or deferrals may be corrected by the end of the second taxable year of the service provider following the taxable year in which the violation occurred, without regard to the amount involved or whether the service provider is an insider. In this case, however, the service provider must pay the 20% additional tax under section 409A, but not the premium interest tax.
- A special transition rule applies for non-insiders. A violation relating to an erroneous payment or deferral, or a discounted stock option or stock appreciation right, occurring before 2008 may be treated as if it occurred during 2008, and may be corrected by the end of 2009 without incurring any penalty taxes under section 409A.

Proposed Regulations for Calculating Amounts Includable in Taxable Income and Penalty Taxes for 409A Violations

If a nonqualified deferred compensation plan violates section 409A in form or operation, all amounts deferred under that plan, including amounts deferred under any plan required to be aggregated with that plan, are currently includable in taxable income unless subject to a substantial risk of forfeiture (i.e., not vested) or previously included in income. The amount includable in income is subject to regular income tax, an additional 20% tax, and a tax equal to interest on the tax underpayments, calculated using the interest rate for tax underpayments plus one percentage point, and assuming that the amount should have been included in taxable income for the later of the year of deferral or the year that the deferred compensation vested. These proposed regulations provide detailed, complex rules for calculating the amounts of taxable income and the amounts of tax in the event of section 409A violations. Here are some of the key points:

- The amount includable in taxable income is the present value of all amounts vested and payable as of the last day of the taxable year in which the violation occurs, regardless of the actual date of the violation. This may include, for example, amounts deferred after the date of the violation. Amounts deferred and earnings accrued in subsequent years, however, will not be subject to section 409A penalties, unless there are additional violations in those subsequent years.
- The amount includable in taxable income will be reduced by deemed investment losses or actuarial losses and increased by deemed investment gains or actuarial gains during the year of the violation, as well as by losses and gains for previous years.
- Distributions during the year of the violation are included in the taxable amount of deferred compensation for purposes of calculating the penalty taxes. This is the case even if the distributions themselves complied with section 409A.
- Amounts that may qualify as short-term deferrals if paid within two and one-half months after the end of the year of the violation are not included in the amount of taxable deferred compensation for the year of the violation. If those amounts are not paid within the relevant two and one-half month period, however, and there is a section 409A violation in a subsequent year, the amounts may be included in the later penalty calculation.
- A service provider may be entitled to a tax deduction for amounts subject to section 409A penalties, if those amounts have been forfeited or permanently lost as of the time the service provider no longer has a right to any amount deferred under the plan. These losses or forfeitures could result from investment losses, inaccurate estimates in calculating taxable deferred compensation, or the service recipient's inability to pay (e.g., due to bankruptcy).
- Because each taxable year is analyzed separately, section 409A penalties attributable to a violation in a closed tax year would be time-barred.
- The calculation assumptions and methodology under the proposed regulations differ in many respects from the methodology for assessing and calculating FICA tax on deferred compensation. These differences may require new payroll or other recordkeeping systems for tracking and calculating deferred compensation.

If you have questions or would like additional information about any of this recent guidance under section 409A, please feel free to contact Brian Dougherty at (215) 587-5919 or bdougherty@postschell.com.

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