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Executive Compensation & Benefits

December 21, 2006

Client Alert

IRS Issues Interim Guidance on 2005 and 2006 Reporting and Withholding Requirements Under Section 409A

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The Internal Revenue Service (“IRS”) has issued Notice 2006-100, which provides interim guidance to employers and payors on their reporting and wage withholding requirements for calendar years 2005 and 2006 with respect to deferred compensation and amounts includible in gross income under section 409A of the Internal Revenue Code (the “Code”). The Notice supersedes IRS Notice 2005-94, which waived employers’ and payors’ reporting requirements for 2005 annual deferrals that are subject to section 409A. Notice 2006-100 extends that waiver through calendar year 2006 for deferrals that comply with section 409A, but requires reporting of amounts includable in income due to violations of section 409A that occurred in 2005 or 2006, and withholding on 2006 includable amounts.

No Need to Report 2005 or 2006 Deferrals That Are Section 409A Compliant

Notice 2005-1, which was issued in December 2004, had provided that an employer should report annual deferrals under a nonqualified deferred compensation plan in box 12 of Form W-2 using Code Y. For non-employees, Notice 2005-1 provided that payors should report such deferrals in box 15a of Form 1099-MISC. Notice 2005-94, which was issued in December, 2005, had waived the employers’ and payors’ reporting requirements for 2005 annual deferrals because the IRS had yet to provide guidance on how to calculate the deferred amounts that needed to be reported.

As the IRS still has not provided such guidance, Notice 2006-100 extends the waiver of the employers’ and payors’ reporting requirements with respect to section 409A-compliant deferrals through calendar year 2006, thus making the reporting of such deferrals on Form W-2 or 1099-MISC optional for both 2005 and 2006.

Reporting is Required for Amounts Includable in Income under Section 409A for 2005 or 2006

Generally, if a deferred compensation plan violates the requirements of section 409A during a calendar year, all vested amounts under the plan (and all other plans of the same type that must be aggregated with the plan) become immediately includable in taxable income and subject to a 20% tax penalty (plus interest), whether or not such amounts have been actually or constructively received. Notice 2005-94 suspended employers' and payors' reporting and withholding requirements for such includable amounts resulting from violations of section 409A that occurred in 2005.

Notice 2006-100 now requires reporting of amounts includable in gross income due to violations of section 409A that occurred in either 2005 or 2006.

Calculation of Includable Amounts. Notice 2006-100 provides guidance on determining the amount of deferred compensation that must be included in gross income due to violations of section 409A and clarifies that only amounts that are subject to section 409A are includable. Thus, grandfathered amounts are not taken into account. Generally, the amount that must be included in gross income due to a section 409A violation is the sum of the amount actually or constructively received during the applicable calendar year plus any vested amounts that remain deferred as of December 31 of such year, less any grandfathered amounts.

The method for determining the amount that remains deferred as of December 31 varies depending on whether the plan involved is an account balance plan, a non-account balance plan, a stock right or other deferred amount, as follows:

- **Account Balance Plans.** The amount remaining deferred is generally the vested account balance as of December 31.
- **Non-Account Balance Plans.** Where the amount is "reasonably ascertainable" within the meaning of the FICA tax rules, the amount remaining deferred is the present value of all future payments to which the employee has obtained a legally binding right as of December 31, 2006.
- **Stock Rights Covered by Section 409A.** The amount remaining deferred is the amount that the holder would be required to include in income if the stock right were immediately exercisable and exercised on December 31. Thus, the amount that remains deferred for an outstanding stock right will generally equal the spread on the stock right as of December 31.
- **Other Deferred Amounts.** For deferred amounts not otherwise addressed in Notice 2006-100, the amount deferred as of December 31 must be determined under a reasonable, good faith application of a reasonable, good faith method.

Note: Applying the plan aggregation rules of Notice 2005-1 and the proposed regulations under section 409A, a section 409A violation in one type of plan or arrangement would cause amounts deferred under all other plans or arrangements of the same type to be included in income. Thus, for example, if an employee participates in more than one account balance plan maintained by the same employer and, during 2006, a violation of section 409A with respect to that employee occurs in one such plan, but not the others, the employee's entire aggregate vested account balance (excluding grandfathered amounts) as of December 31, 2006 under all such plans, including the compliant plans, must be included in income for 2006.

Reporting 2006 Includable Amounts. For 2006, an employer must report amounts includible in gross income under section 409A as wages paid on line 2 of Form 941 and in box 1 of Form W-2. An employer must also report such amounts as section 409A income in box 12 of Form W-2 using Code Z. For non-employees, any amount that is includible in gross income under § 409A that is not treated as wages under § 3401(a) must be reported in box 7 of Form 1099-MISC.

Reporting 2005 Includable Amounts. According to Notice 2006-100, employers and payors who relied on Notice 2005-94 and did not report section 409A income in 2005 must now file original or corrected information returns and furnish original or corrected payee statements (Form W-2 or 1099-MISC, as applicable) for 2005 reporting any previously unreported amounts includible in income under section 409A for 2005 in the same manner that 2006 amounts are reported. Failure to file the 2005 information returns and furnish the 2005 payee statements by the applicable 2006 deadlines may result in penalties under Code sections 6721 and 6722.

Withholding is Required on 2006 Section 409A Income Only

Employers must withhold income tax on section 409A amounts includable in gross income for 2006, but not on the tax penalties or interest related to such amounts. Gross income includable under section 409A will be deemed supplemental wages for purposes of determining the amount of income tax required to be withheld if the employee has received other regular wages from the employer during the calendar year.

Section 409A amounts that are actually or constructively received during 2006 are considered paid on the date received for purposes of withholding, depositing, and reporting requirements under Code section 3401(a). Section 409A amounts that are includible in gross income in 2006 but are neither actually nor constructively received during 2006 are treated as paid on December 31, 2006.

No withholding is required on previously unreported 2005 section 409A income that is reported in accordance with Notice 2006-100.

Relief for Failures to Timely Withhold. Notice 2006-100 also describes two corrections that can be used by employers who do not withhold on 2006 section 409A income by December 31, 2006, or who withhold less than the required amount. Each correction relieves the employer from penalties for failure to timely deposit 2006 taxes, provided that the under-withheld amounts are deposited no later than January 31, 2007.

Service Provider Requirements with Respect to Section 409A Includible Amounts

Notice 2006-100 requires service providers to report as income and pay any taxes due on amounts includible in gross income under section 409A for calendar year 2006. For amounts that were includable in 2005, but were not reported and paid, the service provider must file an amended return and pay any taxes due on such amounts. In order to avoid penalties, amended returns for 2005 must be filed and the additional taxes must be paid, by the due date of the service provider's 2006 return.

If you have any questions, or if you need assistance in complying with the reporting and holding requirements described in this Alert, please contact your regular Pillsbury contact or any member of our Executive Compensation and Benefits group.

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