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One Minute Memo™

IRS Issues Notice on Wage Withholding/Reporting Obligations Under Section 409A

The IRS recently issued guidance to employers and payers on their reporting and wage withholding requirements for calendar years 2005 and 2006 with respect to deferrals of compensation and amounts includible in gross income under Internal Revenue Code Section 409A (Section 409A). Issued on November 30, 2006, Notice 2006-100 (the Notice) supersedes Notice 2005-94. Notice 2005-94 suspended employer reporting and wage withholding requirements for deferred compensation under Section 409A for calendar year 2005.

Summary

In brief, Notice 2006-100 provides:

• Amounts includible in income under Section 409A for 2005 and 2006 (*i.e.*, Section 409A violations) must be reported on Form W-2 or Form 1099-MISC, as appropriate. Corrected 2005 information returns and payee statements are required, as necessary.

• Employers and other payers *need not report annual deferrals of compensation that are not includible in income for 2005 or 2006.*

• Guidance is provided on how to meet income tax withholding requirements for amounts includible in income under Section 409A for 2006. An employer may withhold or recover from the employee the amount of the under-collection after December 31, 2006 and before February 1, 2007. Alternatively, the employer may pay the income tax withholding liability on behalf of the employee and report the resulting wages. In both instances, reporting must occur on Form 941 for the quarter ending December 31, 2006 and on the employee's 2006 Form W-2.

• Guidance is provided to service providers on their income tax reporting and tax payment requirements for amounts includible in gross income under Section 409A for 2005 and 2006. If amounts are due for 2005, interest and penalties may be avoided if the service provider files an amended 2005 return and pays any taxes by the due date for the service provider's 2006 income tax return (including extensions).

• The Notice provides interim rules for 2005 and 2006 on calculating amounts includible in gross income under Section 409A.

Concerns

Although Notice 2006-100 provides much needed guidance, several concerns have arisen in relation to discounted stock options, stock appreciation rights and other equity vehicles subject to Section 409A following the Notice's release:

Equity Transitional Corrections and Aggregation Rules

Notice 2006-100 does not explicitly state that employers who have cured problems in their equity plans under

Notice 2005-1 by amending or terminating participation in the plan in 2005 are exempt from reporting. However, that is presumed to be the case.

In addition, due to the aggregation rules under the Section 409A proposed regulations, reporting implications may vary greatly depending upon the corrective action taken with respect to non-compliant equity plans and the timing of the corrective action. For example, Section 409A proposed regulations provide that, separately determined for each employee, all similar arrangements shall be aggregated into one plan. All amounts deferred by an employee under discounted stock options, stock appreciation rights and/or other equity-based compensation will be treated as deferred under a separate single plan. Proposed Treasury Regulation Section 1.409A-1(c)(2)(i)(D). Therefore, under these provisions, a violation of Section 409A with respect to a portion of the employee's plan (*e.g.*, a violation with respect to any of the discounted options) will trigger income inclusion and penalties on the entire amount in that plan (*i.e.*, all of the discounted options).

For (i) employers that wished to retain a discount element and sought to comply with Section 409A by fixing a year later than 2006 in which all options would be exercised and (ii) those employers that have yet to take corrective action, the impact of Notice 2006-100 will vary for each employee depending upon whether such employee exercised any options in 2006. If an employee exercised a discounted option in 2006 (either prior to the adoption of an amendment to fix the year of exercise after 2006 or under an option that was not amended) then the plan aggregation rules would treat the exercised options and all remaining discounted options awarded to that employee as a single deferred compensation plan of that employee. Notice 2006-100 would then appear to require the value of all such discounted stock options (measured as of December 31, 2006) to be included as 2006 taxable income for that employee.

If an employee has not exercised a discounted option or SAR in 2006, then previous corrective action should be effective to bring that employee's plan into compliance with Section 409A.

Valuation Date

Notice 2006-100 requires employers to value plans as of December 31, 2006, which is a Sunday. Values may vary greatly over the course of several days and it is unclear whether an employer should look back to December 29 or forward January 2 in valuing options and reporting violations.

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It is currently unclear whether or when the IRS will provide clarification on the above issues. However, the Treasury Department and the IRS requested comments in relation to the Notice which must be submitted by February 28, 2007. Notwithstanding the above, Notice 2006-100 is yet another piece of guidance to be factored into the "reasonable, good faith compliance".

If you have any questions or wish to discuss the IRS requirements, please contact the Seyfarth Shaw employee benefits group attorney with whom you regularly work or any employee benefits group attorney on the website at www.seyfarth.com.