

December 29, 2008

New Section 409A Guidance on Income Inclusion and Reporting and Withholding Obligations

The Treasury and the Internal Revenue Service recently issued two pieces of related guidance (Notice 2008-115 and a separate set of proposed regulations) addressing reporting, withholding, and income inclusion requirements under Section 409A. The provisions addressing income inclusion (and how to calculate the amount to be included) are particularly noteworthy because it is the first attempt by the Treasury and the IRS to provide employers and taxpayers with guidance as to how Section 409A's tax rules work in practice. And while many practitioners believe that the rules for income inclusion will need to be further fleshed out by the Treasury and the IRS before the proposed regulations can be finalized, the new rules are a much needed (if not helpful) starting point.

Notice 2008-115

Notice 2008-115 addresses reporting and withholding obligations under Section 409A for 2008. It does not significantly change the guidance already issued addressing reporting and withholding obligations under Section 409A for 2007 and prior years.

Still No Obligation to Report Deferrals. There is still no obligation for employers or payers to report the deferral of amounts that are subject to Section 409A. This rule will remain in place until the Treasury and the IRS issue further guidance (which is not expected any time soon). Once that guidance is issued, employers and payers will have to report the deferral of amounts subject to Section 409A on Form W-2s and Form 1099-MISCs, as applicable. We expect that this reporting obligation will apply prospectively.

Obligation to Report Amounts Includible in Income Under Section 409A. Employers and payers are obligated to report (on the Form W-2 or Form 1099-MISC, as applicable) amounts that are includible in income under Section 409A.

- The amount that must be reported is equal to (1) the total amount deferred under the "plan" (which may be an aggregate of multiple arrangements under the Section 409A regulations) for the taxpayer, minus (2) amounts deferred under the plan that, as of December 31 of the tax year at issue, are subject to a "substantial risk of forfeiture" (defined under the Section 409A regulations), minus (3) amounts deferred under the plan that have already been included in income in a prior year. If any amounts were paid out to the taxpayer during the tax year at issue, those amounts are included in (1) above.
- The Notice contains a handful of rules for calculating the amount that has been deferred under a plan as of a given tax year. To the extent there is no rule on point, the Notice requires that a "reasonable, good faith application of a reasonable, good faith method" be used. While the Proposed Regulations (discussed below) are not yet effective, they contain more detailed and expansive rules for performing the necessary calculations. The Notice allows employers and payers to rely on the Proposed Regulations for purposes of calculating the amount includible in income, provided that all the rules of the Proposed Regulations that are applicable are used. Employers and payers cannot rely only on the rules that are favorable to them and the taxpayer.

- Amounts that are not subject to Section 409A (for example, “grandfathered” amounts) are not included in the above calculation.
- To the extent an amount is includible in income under Section 409A but is not actually or constructively received by the taxpayer during the tax year at issue, then that amount is treated as if it were paid to the taxpayer on December 31 of that year.
- Different rules may apply for amounts includible in income under Section 409A(b) (which is the portion of Section 409A that relates to offshore funding of deferred compensation accounts, funding of deferred compensation accounts using impermissible financial health triggers, and funding of deferred compensation accounts for certain executives at a time when the employer or its controlled group has a sufficiently underfunded pension plan).

Obligation to Withhold on Amounts Includible in Income Under Section 409A. Employers must withhold on amounts includible in income under Section 409A. Those amounts are treated as supplemental wages for purposes of determining how much income tax to withhold.

- Employers are not required to withhold additional amounts to account for any additional tax or interest imposed on the taxpayer under Section 409A.

Taxpayer Obligation to Report and Pay Taxes on Amounts Includible in Income Under Section 409A. Employees and independent contractors must include on their tax returns any amounts that are includible in income under Section 409A for the applicable tax year. The rules for calculating the amount of income to be included are almost identical to the rules noted above for calculating the amount of income to be reported.

- Taxpayers will also need to calculate and include on their tax returns the additional 20% tax and interest under Section 409A.

- Taxpayers should be aware that, with respect to any tax year in which they must report income under Section 409A, they may have to pay estimated taxes if not enough income taxes are being withheld from their compensation.

The Proposed Regulations

The Proposed Regulations address the calculation of amounts includible in income under Section 409A(a) (rules for calculating amounts includible in income under Section 409A(b) will be addressed at a future date — see above note about the scope of Section 409A(b)). The Proposed Regulations also address the calculation of the additional taxes and interest under Section 409A. An amount may become includible in income under Section 409A(a) either because the written plan terms do not comply with Section 409A or because the plan was not operated in compliance with Section 409A (even if the plan’s terms are in compliance with Section 409A). While there is overlap between the contents of the Notice summarized above and the Proposed Regulations, the Proposed Regulations offer far greater detail.

Amount Includible in Income. The formula for determining the amount includible in income under the Proposed Regulations is substantively the same as the formula under the Notice. The Proposed Regulations, however, contain the following additional rules not addressed in the Notice:

- Each taxable year is analyzed separately. As a result, a Section 409A violation in one tax year will not “taint” deferrals under the plan for future tax years. The flip-side to this rule is that, if there are Section 409A violations in multiple tax years, the taxpayer could not simply include all amounts in income in the latest tax year. Instead, the taxpayer would have to allocate the appropriate amounts to each tax year, which may require that the taxpayer file amended returns for the earlier tax years.

- Amounts that have not yet been paid as of the end of the tax year but which may qualify as a short-term deferral if they are ultimately timely paid are not included in the calculation for the earlier tax year. If, however, the amounts are not timely paid in the following year and there is a Section 409A violation, those amounts will be included in the following tax year's calculations.
- Whether an amount is subject to a substantial risk of forfeiture, and thus subtracted from the amount includible in income, is determined as of the last day of the tax year. As a result, amounts that vest during a tax year after the Section 409A violation has occurred will nonetheless be subject to Section 409A's harsh tax treatment (discussed further below).
- Frequently, amounts subject to Section 409A are payable upon the earlier to occur of multiple events (and often with different times and/or forms of payment depending on the payment event). Calculating the amount to include in income under those circumstances is not straightforward. The Proposed Regulations contain a series of rules and assumptions to be used when those circumstances present themselves.
- In determining the amount includible in income, the Proposed Regulations use a present value concept and allow for the consideration of the probability that a certain payment event or vesting condition may not occur. However, no discount is permitted for a risk of forfeiture that is not a "substantial risk of forfeiture" (as defined in the Section 409A regulations). This would apply, for example, where severance payments are conditioned upon a "good reason" resignation that does not meet Section 409A's definition of a substantial risk of forfeiture. As a result, it is entirely possible that a taxpayer will have to include in income and pay taxes on amounts that the taxpayer may never earn or be paid (see below discussion for some relief provided to the taxpayer in such event).
- In addition to general rules, the Proposed Regulations contain special rules for determining the amount includible in income under account balance plans (such as a traditional salary or bonus deferral plan), non-account balance plans (such as an excess defined benefit plan), reimbursement and in-kind benefits arrangements (which may be subject to Section 409A), stock rights (stock options and SARs), and split-dollar life insurance arrangements.
 - **Additional 20% Tax.** Section 409A imposes a tax that is equal to 20% of the amount includible in income as a result of the Section 409A violation. This tax is in addition to the ordinary income tax on the amount includible in income.
 - **Additional Interest Tax.** Section 409A also imposes another tax (besides the 20% penalty tax) that is equal to the interest that would have accrued on the amount of the deferred compensation had that amount been included in income when it was first deferred (or, if later, when it was no longer subject to a substantial risk of forfeiture). The interest is calculated using the federal underpayment rate plus one percentage point.
- The Proposed Regulations provide rules for allocating deferred amounts among prior tax years. The further back in time the amounts get allocated, the greater this additional "interest tax" will be. The Proposed Regulations include a taxpayer-favorable assumption that deferred amounts paid to the taxpayer in prior years are paid from the earliest deferrals made under the plan (in effect, a first-in-first-out assumption), thereby reducing the "oldest" amounts under the plan that would be subject to the interest tax for longer periods of time.
- In allocating amounts to prior tax years to determine the amount of the "underpayment" that resulted by not including those amounts in income for those prior tax years, taxpayers must take into account the affect that those underpayments, if made at the time, would have

had on the taxpayer's tax returns for those tax years, including deductions and loss carryovers.

Amounts Already Included in Income. There will be situations where a taxpayer has included in income under Section 409A amounts that the taxpayer has not yet received. To address this issue, the Proposed Regulations provide that, where an account contains both amounts that have been included in income under Section 409A and amounts that have not, subsequent distributions of those amounts will be treated as distributions that have already been included in income (this continues until all such amounts already included in income have been paid). Distribution of amounts that have already been included in income will not need to be included in income again at the time of distribution (i.e., no double taxation).

Forfeiture of Amounts Already Included in Income. One of the difficult (and for many, one of the incomprehensible) realities of Section 409A's rules is that, as noted above, a taxpayer may be forced to include amounts in income that the taxpayer ultimately never receives. In those cases, the taxpayer gets a deduction in a subsequent tax year for the amount of the deferred compensation that was already included in income, but only to the extent that the compensation is permanently forfeited or the right to the payment is permanently lost. The preamble to the Proposed

Regulations provides that, for an employee, this deduction would generally be treated as a miscellaneous itemized deduction (subject to the limits applicable to that deduction).

- This scenario could arise where a taxpayer was forced to include potential severance payments and benefits in income, only to terminate employment years later under circumstances where no severance is paid. It could also arise where a taxpayer was forced to include amounts in income, only to have the employer go bankrupt in a subsequent year before the unsecured amounts that were already included in income are paid to the taxpayer.

Effective Date. The Proposed Regulations will not become effective until they are finalized. It is too early to tell when that will be. However, should a taxpayer have a Section 409A problem in the interim that requires amounts to be included in income, the Proposed Regulations should at least be consulted to determine what the tax liability would be using its rules and assumptions. Recall that the Notice, which is currently effective, requires a "reasonable, good-faith application of a reasonable, good-faith method."

If you have any questions about Section 409A, this new guidance, or your executive compensation arrangements, please contact one of our partners listed below.

Our client alerts are for general informational purposes and should not be regarded as legal advice. If you would like additional information or have any questions, please contact:

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