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EBEC Law Update

January 6, 2009

**Proposed Regulations Regarding Calculation of
Amounts Includible in Income Under § 409A;
Notice Regarding Information Reporting and
Withholding for Deferred Compensation Under § 409A**

Proposed Regulations Regarding Calculation of Amount Includible in Income and Additional 20% Tax. In December 2008, the IRS issued proposed treasury regulations regarding the calculation of amounts includible in income and additional taxes under Internal Revenue Code § 409A where there is a failure to meet the § 409A requirements. Prop. Treas. Reg. § 1.409A-4.¹ The regulations will not be effective until after issuance of final regulations.²

(i) *Amounts Includible in Income for Year of 409A Failure.*

Under the proposed regulations, amounts includible in income in the employee's taxable year due to a failure to meet the requirements of § 409A in that year will be the total amount deferred under the plan for that year (as well as amounts paid to the employee in that year), except to the extent such deferred amounts are not vested or to the extent such deferred amounts were already included in income in a prior year. Prop. Treas. Reg. § 1.409A-4.

(ii) *Included in Taxable Year of Failure Based on Amount*

Deferred and Vested at End of Year. The tax will only apply to the taxable year of the 409A failure, but will not apply to later taxable years during which the plan complies with § 409A. The amount deferred is determined on the last day of the employee's taxable year, and thus if the amount vests during the year (not later than December 31), it will be includible in income. Prop. Treas. Reg. § 1.409A-4(a)(2). To the extent such amount was already properly included in income in a prior year, such amount need not be included in income in the current year. Prop. Treas. Reg. § 1.409A-4(a)(3)(i). For example, if a deferred compensation

¹ Preamble, 73 Fed. Reg. 74380 (Dec. 8, 2008).

² Note that the Preamble (73 Fed. Reg. at 74392) states that the proposed regulations will become effective for taxable years beginning on or after the issuance of final regulations, while the proposed regulations (Prop. Treas. Reg. § 1.409A-4(h)) state that they will become effective for taxable years ending on or after publication of the final regulations. Before such date taxpayers may rely on the proposed regulations only to the extent provided in further guidance. Preamble, 73 Fed. Reg. at 74392.

plan has a balance of \$100,000 at the end of 2011 and a balance of \$250,000 at the end of 2012, and in both years it does not meet the § 409A requirements, \$100,000 will be included in income in 2011 and \$150,000 will be included in income in 2012. Prop. Treas. Reg. § 1.409A-4(a)(3)(ii).

(iii) *Amounts Nonvested for Full Year(s) of Violation Escape Immediate Taxation.* As stated in the Preamble, under the above rules, if the amount deferred remains unvested at the end of the taxable year(s) of violation and only vests in subsequent years when there is no longer a 409A violation, there will be no immediate taxation or penalties at all. Preamble, 73 Fed. Reg. at 74382. The Preamble notes, however, that in providing this interpretation (that tax and penalties do not apply in years subsequent to the year of violation), it does not intend that this become a means for taxpayers to disregard the requirements of § 409A. Therefore, the proposed regulations provide an anti-abuse provision in § 1.409A-4(b)(7), as discussed below, that if the employer has a pattern or practice of permitting such impermissible changes in times and form of payment for nonvested deferred amounts, such provisions will be disregarded. Preamble, 73 Fed. Reg. at 74382.

(iv) *General Definition of Total Amount Deferred – Present Value of Future Payments (for Non-Account Balance Plans).* Except as otherwise provided, total amount deferred is defined as the present value (as of the last day of the taxable year) of future payments as well as any payments made to the employee during the taxable year. Prop. Treas. Reg. § 1.409A-4(b)(2)(i).³ This general rule would be applicable to non-account balance plans. The present value must be determined using reasonable actuarial assumptions. Prop. Treas. Reg. § 1.409A-4(b)(2)(ii).⁴ See below for definitions of total amount deferred applicable to other types of plans.

(v) *Where Amount is Not Knowable at End of Year.* Where the amount payable for purposes of determining the amount deferred is determined by a formula that is not knowable at the end of the taxable year, e.g., deferral of 1% of the employer's net profits for upcoming years, the amount payable is determined based on facts and circumstances as determined in good faith (taking into account contingencies). Prop. Treas. Reg. § 1.409A-4(b)(2)(iv).⁵

³ One can discount this amount for possibility of death. Id.

⁴ If unreasonable actuarial assumptions are used, the IRS will calculate present value using the applicable federal rate under Code § 1274(d) and applicable mortality table under Code § 417(e). Id. Crediting of earnings and losses under the plan (as of the last day of the year) will be respected only to the extent they reasonably reflect the value of the employee's rights under the plan. Prop. Treas. Reg. § 1.409A-4(b)(2)(iii).

⁵ Except as otherwise provided in the proposed regulations, the deferred amount is not discounted for restrictions on distribution or non-substantial risks of forfeiture (e.g., noncompetition). Prop. Treas. Reg. § 1.409A-4(b)(2)(v).

(vi) *Alternative Times or Forms of Payment.* Where there are alternative times or form of payment, the alternative with the highest present value will be used for calculation of the amount deferred. Prop. Treas. Reg. § 1.409A-4(b)(2)(vi)(A). For example, if an employee can receive a distribution on the earlier of Jan. 1, 2020 or termination, the amount deferred is based on the present value of the amount that would be payable if he terminated employment at the end of the current taxable year. Prop. Treas. Reg. § 1.409A-4(b)(2)(ix), Ex. 8. If eligibility for time and form of payment depends on status of the employee as of a future date, the employee is assumed to continue service until such future date. Prop. Treas. Reg. § 1.409A-4(b)(2)(vi)(B). For example, if an employee is eligible to receive payment at age 62 if still employed on that date, then he or she is deemed to continue to be employed and the deferral amount will be based on the most valuable form of payment. Prop. Treas. Reg. § 1.409A-4(b)(2)(ix), Ex. 1.⁶

(vii) *Payment Triggers.* If a payment trigger occurs before the end of the taxable year, the deferred amount is treated as payable at the time the payment is scheduled to be made. Prop. Treas. Reg. § 1.409A-4(b)(2)(vii)(A). If the payment trigger has not occurred by the end of the taxable year of the employee, the trigger is treated as occurring on the earliest possible date that it could occur. *Id.*⁷ Payment triggers can be disregarded if the triggers would cause the amount to be subject to a substantial risk of forfeiture or if there is an unforeseen emergency. Prop. Treas. Reg. § 1.409A-4(b)(2)(vii)(B).⁸

(viii) *Amounts That May Qualify as Short-Term Deferrals.* For purposes of calculating the total amount deferred for the taxable year, the right to payment that may, under the arrangements and the facts and circumstances as of the last day of the year, be a short-term deferral, is not included in the total amount deferred. Prop. Treas. Reg. § 1.409A-4(b)(2)(viii).

(ix) *Definition of Total Amount Deferred for Non-Account Balance Plans.* For account balance plans, the present value of amounts payable equals the amount credited to the employee's account as of the last day of the taxable year, including principal plus earnings. Prop. Treas. Reg. § 1.409A-4(b)(3)(i).⁹ If the earnings and losses are based on an unreasonably high rate of interest (and is not a predetermined actual investment), the proposed regulations require that the AFR be used. Prop. Treas. Reg. § 1.409A-4(b)(3)(ii).

⁶ In another example, the proposed regulations state that if not married at the current time, deferral amount is valued based on a single annuity and not a joint annuity that may apply if married at a later date. Prop. Treas. Reg. § 1.409A-4(b)(2)(ix), Ex. 2.

⁷ See also, Prop. Treas. Reg. § 1.409A-4(b)(2)(ix), Ex. 4 that if the employee has the right to accelerate payments, the earliest date he or she can accelerate to is treated as the payment date for deferral of compensation purposes. Prop. Treas. Reg. § 1.409A-4(b)(2)(ix), Ex. 4.

⁸ See also, Prop. Treas. Reg. § 1.409A-4(b)(2)(ix), Ex. 6.

⁹ One adds to this the amounts paid from such plan during the taxable year. *Id.*

(x) *Definition of Total Amount Deferred for Reimbursements and In-Kind Payments.* If amounts deferred are reimbursement arrangements or in-kind benefits that do not meet the 409A exemptions, then the total amount deferred will be based on the maximum amount of expense allowable by the plan at the earliest possible time that it could be incurred and payable. Prop. Treas. Reg. § 1.409A-4(b)(4).

(xi) *Definition of Total Amount Deferred for Stock Awards.* If a stock right is subject to § 409A, such as a discounted stock option or stock appreciation right, the total amount deferred is the excess of the fair market value over the exercise price on the last day of the taxable year, or if the stock option or SAR is exercised during the taxable year, the total amount deferred will be the excess of fair market value over exercise price on the date of exercise. Prop. Treas. Reg. § 1.409A-4(b)(6).¹⁰

(xii) *Anti-Abuse Provision.* The IRS can disregard the above rules for determining total amount deferred if it determines that the plan provisions have been established to eliminate or minimize the amount deferred. Prop. Treas. Reg. § 1.409A-4(b)(7).¹¹

(xiii) *Additional 20% Tax.* As stated above, amounts required to be included in income for the taxable year are subject to an additional 20% income tax. Code § 409(a)(1)(B)(i)(II); Prop. Treas. Reg. § 1.409A-4(c).

(xiv) *Premium Interest Tax.* Amounts required to be included in income for the taxable year are subject to interest (at the underpayment rate) on such amount plus 1% of the underpayments that would have occurred had the deferred compensation been includible in income for the taxable year first deferred and vested. Code § 409(a)(1)(B)(i)(I); Prop. Treas. Reg. § 1.409A-4(d)(1).¹²

¹⁰ The Preamble, 73 Fed. Reg. at 74399, states that the spread can be used rather than a more sophisticated measure (such as Black-Scholes), because it will balance out over the period of the deferral.

¹¹ For example, if the plan provides that the deferred amount is payable on separation from service but also provides that the amount will be forfeited on a separation from service occurring on the last day of the taxable year, this provision would be disregarded. *Id.*

¹² Prop. Treas. Reg. § 1.409A-4(d)(2) provides rules for identifying the taxable year in which amount was first deferred and vested, for purposes of the interest tax. See example at Prop. Treas. Reg. § 1.409A-4(d)(2)(ii) (where there are deferrals in years 1, 2, 3 and 4 of \$110,000, \$275,000, \$495,000 and \$770,000 respectively, and the 409A violation only occurs in year 4, only the \$770,000 is includible in income in year 4, but to calculate the premium interest tax must be allocated based on the years in which the first deferral amount occurred (provided it is also vested)).

See also, Prop. Treas. Reg. § 1.409A-4(d)(3) for calculation of hypothetical underpayment for the taxable year during which the first deferral took place (assuming it was vested), and see, Prop. Treas. Reg. § 1.409A-4(d)(4) for calculation of hypothetical premium underpayment interest.

(xv) *Payments of Deferred Compensation in Years After Year Included in Income under § 409A.* Under Code § 409A(c) any amount already included in gross income under § 409A need not be included in gross income (under any provision of the Code) in a later taxable year. As provided in the proposed regulations, the amount included in income under § 409A serves as the tax basis that is used to minimize the tax liability at the time of distribution. Prop. Treas. Reg. § 1.409A-4(f)(1).¹³ Plan aggregation rules under § 1.409A-1(c)(2) apply. Prop. Treas. Reg. § 1.409A-4(f)(2).

(xvi) *Permanent Forfeiture of Deferred Amount Previously included in Income.* If deferred compensation amounts includible in income under § 409A are ultimately forfeited (e.g., because the company is in default, or a noncompete was violated or due to investment losses), the employee is entitled to a deduction at the time of such forfeiture. Prop. Treas. Reg. § 1.409A-4(g).

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Information Reporting and Withholding for Deferred Compensation Plans Under § 409A. In December 2008, the IRS also issued Notice 2008-115, dealing with information reporting and withholding for deferred compensation plans under § 409A, and extending the transition period of earlier IRS notices during which § 409A compliant plans need not provide information reporting to after the above regulations are finalized.

Deferrals under a nonqualified deferred compensation plan must be reported on a Form 1099 or W-2, regardless of whether they are includible in gross income. Code §§ 6041(g)(1) & 6051(a)(13).¹⁴ If the amount of deferrals for a year does not exceed \$500, reporting is not required.¹⁵ As stated in the 2008 notice and in earlier notices, an employer must report the total amount of deferrals for the year that comply with § 409A as Code Y in box 12 of Form W-2 or in box 15a of Form 1099-MISC.¹⁶ For deferrals that do not comply with § 409A, IRS notices provide that beginning in 2005 the employer must report such noncompliant deferrals as wages in box 1 of Form W-2 or as compensation in box 7 of Form 1099-MISC, and must also include them as Code Z in box 12 of Form W-2 or in box 15b of Form 1099-MISC.¹⁷

¹³ For example, if \$10,000 deferred in year one is taxed under § 409A, and there is a distribution of \$5,000 in year three the entire amount would be excluded from income at that time. Preamble, 73 Fed. Reg. at 74390. See more examples at Prop. Treas. Reg. § 1.409A-4(f)(3).

¹⁴ For a nonaccount balance plan the amounts must also be reported once they become reasonably ascertainable. Notice 2005-1, Q&A 26. See also, Notice 2008-115.

¹⁵ Notice 2005-1, Q&A 27.

¹⁶ Notice 2005-1 Q&As 29, 30, 33 & 35, Notice 2006-100 and Notice 2008-15.

¹⁷ Notice 2005-1, Notice 2006-100 and Notice 2008-15.

Notice 2008-115 provides interim guidance on the inclusion of amounts taxable under § 409A into income, and on withholding of such amounts, and determining amounts includible in income under §

If, however, the deferrals are not includible in income (i.e., they are 409A compliant), the requirement to report the deferrals is waived with respect to deferrals made prior to the finalization of the regulations (regarding inclusion of income, discussed above). In such cases, IRS notices exempts taxpayers from reporting the 409A compliant amounts deferred (Code Y of box 12 of W-2 or of box 15a of 1099-Misc).¹⁸

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For more information on this, or related matters, contact Charles Shulman at the above numbers.

IRS Circular 230 Disclosure: To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter that is contained in this communication.

409A. It further provides that an employee who complies with rules of the notice will not be liable for additional tax as a result of future IRS guidance. The notice also provides that taxpayers may rely on the proposed regulations for calculation of taxes even to the extent contrary to Notice 2008-15.

Failure to include information required on Form W-2 can subject the employer to penalties under Code §§ 6721 & 6722 (absent reasonable cause under § 6724).

¹⁸ Notice 2006-100 and Notice 2007-89 provide that for 2005, 2006 and 2007 the employer and payers are exempt from reporting the deferrals that comply with § 409A. Notice 2008-15, § III.B exempts taxpayers from reporting the amounts deferred that comply with § 409A.