BRYAN CAVE
A Broader Perspective

Bulletin

Employee Benefits & Executive Compensation
Client Service Group

To: Our Clients and Friends

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FURTHER IRS GUIDANCE ON SECTION 409A: TAX CALCULATION, REPORTING, WITHHOLDING AND PAYMENT

In a recent client bulletin, we addressed IRS guidance on correction of certain operational failures to comply with section 409A of the Internal Revenue Code.

If a section 409A failure cannot be corrected, IRS Notice 2008-115 and Proposed Regulation §1.409A-4 contain guidance on how to calculate, report and withhold on the amount includible in the gross income of an affected employee or other service provider, and how to calculate the tax due.

The guidance addresses only violations related to impermissible deferral or acceleration of income, not section 409A funding issues. The guidance is subject to change, but it is useful as an interim roadmap and as evidence of the IRS's thinking.

The guidance applies to employees and independent contractors such as outside directors and consultants. Our discussion is limited to violations that affect employees.

HIGHLIGHTS

1. No change from prior guidance on the employer's reporting and withholding obligations (discussed below) until final guidance is issued.

2. Each year is addressed independently. Therefore a violation in one year does not taint other years. However, if a violation extends beyond one year, the tax consequences for each year must be considered separately.

3. Amounts previously taxed and not previously distributed, amounts subject to substantial risk of forfeiture at year end and amounts not yet deferred are not taken into account in calculating the tax.

4. The method for calculating additional interest tax is complicated, but it tends to favor the taxpayer. The IRS is seeking a safe harbor method to reduce the calculation burden.

5. Amounts recognized as section 409A income are applied to reduce income recognized in connection with distributions in later years.

REPORTING, WITHHOLDING AND PAYMENT DUTIES

The notice confirms prior guidance with respect to reporting, withholding and payment of tax.

The employer's duties. Until final guidance is issued, the employer is not required to report amounts deferred during a year in Box 12 of Form W-2.

If there is a violation of section 409A, the employer is required to report amounts includible in the affected employee's income as wages on Line 2 of Form 941 and Box 1 and Box 12 of Form W-2, and to withhold on these amounts at supplemental rates, whether or not the employee actually receives a distribution under the plan. The employer is not required to calculate or withhold the additional taxes imposed by section 409A.

The employee's duties. The affected employee has an independent duty to calculate the amount of section 409A income and the tax due and to pay all tax due. Because the employer is not required to calculate or withhold the additional tax imposed by section 409A, the employee might have to pay estimated taxes or increase the withholding election to avoid penalties on late payment.

CALCULATION

The notice confirms prior guidance on calculating the amount of income attributable to a section 409A violation and the amount of tax due. The proposed regulations contain detailed information on these calculations. Because the matters they address are complicated, it is possible that there will be significant changes when final regulations are issued.

CALCULATION OF SECTION 409A INCOME FOR A YEAR. BOTH THE EMPLOYER AND THE EMPLOYEE DO THIS CALCULATION.

409A income generally. Under the proposed regulations, the amount subject to inclusion in an affected employee's income includes only the employee's deferrals that have become vested during the year of violation and prior years as to which there was no violation. Years before 2005, when section 409A took effect, are disregarded.

Amounts included in the employee's income under section 409A for a prior year and not previously distributed, amounts subject to a substantial risk of forfeiture, such as a requirement of continued employment through a future date, and amounts not yet deferred under the plan are not includible in the employee's income for the year of violation. The IRS has authority to curb abuse in this area, such as a pattern of impermissible changes in time and form of payment tending to show that a purported substantial risk of forfeiture is not in fact substantial.

Calculating the amount. The proposed regulations require a three-step process for calculating the amount of income recognized on account of a violation of section 409A.

Step 1: Determine the amount of income recognized. The method of calculation depends on the type of plan.

For an account balance plan, such as an elective deferred compensation plan, the amount deferred is generally the employee's account balance at December 31 of the year, determined under the plan's valuation procedures. regardless of when during the year the section 409A violation occurred. If the employee has received a distribution during the year, the amount of the distribution is added to the December 31 account balance. Special rules apply if the plan's valuation date is changed during the year.

For a non-account balance plan, such as a defined benefit SERP, the present value of the future stream of payments due the employee is calculated, using reasonable mortality assumptions and reasonable current interest rates. If the employee has a choice of forms of payment, such as lump sum or monthly installments over a period of years, the form with the highest present value is used. If the form or time of payment is subject to a condition, the condition is deemed satisfied unless the condition is future service. If the form or time of payment is dependent on the employee's marital status, the employee's marital status at the end of the year of violation is used. Present value is not reduced because of a plan's unfunded status or because the employer may be insolvent and unable to make payment when due.

For stock rights, such as a stock option or stock appreciation right, the amount includible is generally the difference between the strike price and the value of the underlying stock as of December 31. If the option is exercised during the year, value on the date of exercise is substituted for December 31 value.

For separation pay arrangements, amounts payable only on involuntary separation that has not occurred during the year of section 409A violation are disregarded. Amounts payable on account of another trigger are valued based on the type of payment format: account balance, non-account balance, or reimbursement.

For reimbursement arrangements, if the value of the services to be provided is limited, the employee is presumed to use the entire value as soon as the plan permits, subject to rebuttal by the employee based on reasonableness. Medical expenses are not subject to this rule. If there is no limit on the value of the services, the calculation is based on a reasonable maximum taking into account the type of service.

For split-dollar arrangements, the amount deferred requires determination of the amount required to be recognized as income under the split-dollar rules. These rules have changed several times, each change having its own effective dates and grandfather provisions. The section 409A rules are applied to the income required to be recognized each year under the split-dollar rules governing the particular arrangement.

Step 2: Determine the portion of the account that is either nonvested as of December 31 or as to which the employee reported income under Section 409A for a prior year. Amounts that become vested during the year and are scheduled to be paid within 2-1/2 months after the end of the year are treated as non-vested for this purpose. If the amount is not actually paid within 2-1/2 months after the end of the year, a section 409A violation occurs in the next year.

Step 3: Subtract the amount determined under Step 2 from the amount determined under Step 1. The difference is the amount includible in the employee's gross income under section 409A for the year of violation.

CALCULATION OF THE ADDITIONAL TAX DUE UNDER SECTION 409A. ONLY THE EMPLOYEE DOES THIS CALCULATION.

This requires several steps, summarized here.

Calculating the additional 20% income tax. The additional 20% income tax is applied to the section 409A income recognized in Step 3 above.

Calculating the additional interest tax.

Step 1. Determine the applicable interest rate from the statute.

Step 2. Determine the amount of section 409A income recognized in Step 3 above.

Step 3A. Carry the income back to earlier years, earliest first, until fully applied.

Step 3B. Adjust carryback amounts for interim distributions and losses, earliest year first, until fully applied.

Step 4. Recalculate income tax due for each carryback year, taking into account the added section 409A income. The difference between this amount and the tax previously paid is an additional hypothetical section 409A income tax for the carryback year.

Step 5. Apply the interest rate to the hypothetical additional income tax for each carryback year, from the last day of the carryback year to the last day of the year of violation.

Step 6. Add the amounts calculated in Step 5. THIS IS THE AMOUNT OF THE TAX.

EFFECT OF SECTION 409A INCOME ON LATER DISTRIBUTIONS

An amount included in income under section 409A for a year is applied to reduce the amount recognized as income related to distributions under the plan in later years until fully applied. If any section 409A income remains unapplied after all possible distributions to the employee, then the employee may report the unapplied amount as a miscellaneous itemized deduction for the year of final distribution or the year in which the payment due becomes uncollectible. The employer may be required to adjust its deductions accordingly.

RELIANCE

Until final guidance is issued, the notice requires a reasonable good-faith application of a reasonable good faith method; it also prohibits selective reliance on favorable provisions of the proposed regulations and disregard of unfavorable provisions.

To discuss any aspect of this bulletin, please contact the lawyer with whom you regularly work or any other member of the Employee Benefits and Executive Compensation Client Service Group.

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