

CLIENT UPDATE

IRS Issues Reporting And Withholding Rules For Section 409A Deferred Compensation Arrangements

During December 2008, the Treasury Department and the IRS provided taxpayers with reporting and withholding guidance for calendar year 2008 and subsequent calendar years under §409A. In general, the guidance is similar to the guidance that the Treasury Department and the IRS previously provided for calendar years 2007, 2006 and 2005.

In late 2004, Congress enacted §409A, which affects elections to defer compensation and prohibits payouts of deferred compensation except in limited circumstances. Section 409A also prohibits funding deferred compensation with an offshore trust. Violating §409A results in a 20% excise tax to the recipient (among other penalties) at the time the deferred compensation vests or is paid.

Reporting Obligations. Payments made under deferred compensation arrangements during a calendar year continue to be reportable on the recipient's Form W-2 (using boxes 1 and 12 and code Z) or Form 1099-MISC (using boxes 7 and 15b), and on line 2 of the payer's Form 941 (quarterly payroll tax return). Amounts deferred under a "good" deferred compensation arrangement (that do not violate §409A and are not otherwise includible in income during the applicable calendar year) do not have to be reported.

Amounts Reportable. Generally, the vested portion of any deferral that violates §409A must be reported (if it has not been previously reported), plus any deferred compensation paid or made available to the recipient during the applicable calendar year. Special rules apply to various types of deferred compensation arrangements.

Withholding Obligations. If the recipient is an employee and received wages during the applicable calendar year, the amounts reportable for the applicable calendar year would be subject to a 25% withholding rate (or, if more than \$1.0 million, 35% on the excess over \$1.0 million). For non-employees, no withholding would be required. Withholding is also not required for §409A's 20% excise tax (or other penalties) where the deferred compensation arrangement does not comply with §409A. However, where the 20% excise tax is applicable, *employees* should be aware that they may need to make estimated tax payments to avoid any underpayment penalties and interest. (Note that these rules do not supersede an employer's FICA reporting or withholding obligations).

Amounts includible in income during a calendar year because they were paid or made available during such year are generally treated as income, so that applicable withholding

taxes will have been paid. Amounts includible in income during a calendar year due to a violation of §409A are generally treated as income at the end of such year. Where an insufficient amount has been withheld in respect of the applicable calendar year due to a violation of §409A, the employer may still (1) withhold or receive any shortfall from an employee before February 1 of the subsequent calendar year or (2) pay any shortfall on behalf of the employee without deducting such amount from any other compensation (or reimbursement by the employee). In either case, the employer must report such amount as income to the employee for the quarter ending December 31 of the applicable calendar year.

Individual Tax Reporting and Payments. A recipient must report as income and pay any taxes due on the amounts includible in income under §409A for the applicable calendar year. If the recipient does not report and pay taxes on this income, the IRS may assess penalties and interest.

If you have any questions relating to the new reporting rules or §409A, please contact your primary attorney at Morrison Cohen LLP or any of the following:

Brian Snarr

(212) 735-8831

**[bsnarr@
morrisoncohen.com](mailto:bsnarr@morrisoncohen.com)**

Alan Levine

(212) 735-8694

**[alevine@
morrisoncohen.com](mailto:alevine@morrisoncohen.com)**

Lisa Yoon

(212) 735-8754

**[lyoon@
morrisoncohen.com](mailto:lyoon@morrisoncohen.com)**

This memorandum is a summary for general information and discussion purposes only. It is not a full analysis of the matters presented, may not be relied upon as legal advice, and does not purport to represent the views of our clients or Morrison Cohen LLP.

© 2009 Morrison Cohen LLP