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Erik Ruselowski, *Assist. Director of Policy & Public Affairs*

2901 Telestar Court, Falls Church, Virginia 22042  
Toll Free: 1-888-275-0092    Fax: 703-641-8119  
[www.aalu.org](http://www.aalu.org)

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December 14, 2007

Subject: **Additional Analysis of IRS Guidance On 2007 Reporting and Withholding Under Code Section 409A**

Major References: [IRS Notice 2007-89](#)

Prior AALU Washington Reports: 07-106; 07-96; 07-94; 07-89; 07-83; 07-81; 07-66; 07-50; 07-48; 07-44; 07-41; 07-38; 07-34; 06-143; 05-127; 04-173; 04-172; 04-171

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*The deferred compensation rules under Revenue Code section 409A impose new reporting and withholding requirements that were effective with respect to amounts deferred on or after January 1, 2005. In IRS Notices 2005-94 and 2006-100 (see our Bulletins Nos. 05-127 and 06-143), the Revenue Service provided relief and guidance for complying with the reporting and withholding requirements for 2005 and 2006. The IRS recently issued Notice 2007-89 (see our Bulletin No. 07-96), which provides guidance for complying with the reporting and withholding requirements for 2007. This Bulletin provides a more detailed discussion of Notice 2007-89.*

## Background

The new rules generally require that all deferrals for a year must be separately reported on a Form 1099-Misc or Form W-2, as applicable, regardless of whether such compensation is includible in gross income under 409A. In addition, amounts includible in the gross income of an employee under 409A are treated as wages for federal income tax withholding purposes. These new reporting and withholding requirements generally apply to amounts actually deferred in calendar years beginning after December 31,

2004 (including income, whether actual or notional, attributable to such amounts deferred) and amounts includible in gross income under 409A after that date. For this purpose, amounts are considered actually deferred at the time the service provider has a legally binding right to the compensation.

Prior to the issuance of Notice 2007-89, the IRS had addressed the new reporting and withholding requirements in Notices 2005-1, 2005-94 and 2006-100.

Notice 2005-1 provided interim guidance on the mechanics of reporting nonqualified deferred compensation on either a Form W-2 or Form 1099-MISC (IRS Notice 2005-1; Q&As-24 through 38) (see our Bulletins Nos. 04-171; 04-172 and 04-173).

Notice 2005-94 suspended the reporting and withholding requirements of 409A for 2005, subject to further guidance (see our Bulletin No. 05-127).

Notice 2006-100 permanently waived the requirement that deferrals during calendar years 2005 and 2006 be reported (see our Bulletin 06-143). However, amounts includable in an employee's gross income under 409A for 2006 were treated as wages and were subject to income tax withholding (without regard to the additional 20% tax under 409A). In addition, Notice 2006-100 provided that any income not reported for 2005 (pursuant to Notice 2005-94) must be reported in 2006 for 2005 by filing a corrected Form W-2 or 1099-MISC. Notice 2006-100 also included interim guidance for determining the amounts includible in income under 409A and guidance for service providers (e.g., employees) to report any amounts includible in gross income under 409A on their income tax returns

Notice 2007-89 generally extends the guidance provided in Notice 2006-100 to the 2007 calendar year.

#### Waiver of Deferral Reporting Requirements for 2007

Notice 2007-89 permanently waives the deferral reporting requirements for 2007. Thus, employers will not be required to report the amount of deferrals that were made in calendar year 2007. However, as discussed further below, to the extent an amount is includible in gross income under 409A, it will generally be subject to the reporting and withholding requirements applicable to wages and subject to the special rules and guidance provided in Notice 2007-89.

#### Amounts Includible in 2007

Notice 2007-89 provides the following key reporting and withholding guidance with respect to amounts includible in gross income in 2007 under 409A:

(1) General Rules: An employer must treat amounts includible in gross income under 409A as wages for income tax withholding purposes. The employer is required to report such amounts in box 1 of Form W-2 and also as 409A income in box 12 of the Form W-2 using code "Z." The amounts includible are supplemental wages for purposes of determining the amount of income tax required to be deducted and withheld, regardless of whether the employer has paid the employee any regular wages during the calendar year of the payment. In addition, the amount required to be withheld is not increased on account of the additional taxes imposed by 409A (20% plus an additional tax based on a hypothetical interest calculation)

(2) Nonemployees: With respect to nonemployees (e.g., independent contractors), the payer must report amounts includible under 409A as nonemployee compensation in box 7 of Form 1099-MISC

and must also report such amounts as 409A income in box 15b of the Form 1099-MISC. There are no withholding requirements with respect to amounts includible for nonemployees.

(3) Amount Includible - General Rules: The amount includible in gross income under 409A and required to be reported (and withheld upon in the case of employee wages) equals the portion of the total amount deferred under the plan that, as of December 31, 2007, is not subject to a substantial risk of forfeiture and has not been included in income in a previous year, plus any amounts of deferred compensation paid or made available to the service provider during the 2007 calendar year. For this purpose, an amount is treated as previously included in income if properly reported by the employer or payer on a 2005 or 2006 Form W-2 or Form 1099-MISC.

(4) When Amounts Are Considered Paid for Purposes of the Withholding Rules: Amounts that are either actually or constructively received during 2007 are considered a payment of wages when received by the employee for purposes of withholding, depositing, and reporting the income tax on wages. Amounts that are neither actually nor constructively received by the employee during 2007 are treated as a payment of wages on December 31, 2007 for purposes of the wage withholding rules. If an employer does not withhold the proper amount with respect to amounts that are neither actually or constructively received during 2007, the underwithholding can be "corrected" using one of the following two options:

(A) The employer withholds or recovers from the employee the amount of the underwithholding after December 31, 2007 and before February 1, 2008, and reports as wages for the quarter ending December 31, 2007 the amounts that were neither actually nor constructively received but are includible in income under 409A in box 1 of the employee's Form W-2 for 2007; or

(B) The employer pays the income tax withholding liability on behalf of the employee (without deduction from the employee's wages or other reimbursement by the employee), and reports the gross amount of wages and income tax withholding liability for the quarter ending December 31, 2007 as including such amounts that were neither actually nor constructively received but are includible in income under 409A, as well as the FICA, FUTA and income tax withholding wages resulting from paying the income tax on the employee's behalf in box 1 of the employee's Form W-2 for 2007.

(5) Specific Guidance for Determining Amounts Includible in Income Under 409A: Notice 2007-89 provides the following specific guidance for purposes of determining the amounts includible in income under 409A:

(A) Account Balance Plans: The amount deferred is generally the account balance as of December 31, 2007. For this purpose, the plan aggregation rules apply, except that an elective account balance plan is not aggregated with a nonelective account balance plan.

(B) Nonaccount Balance Plans: Where the amount deferred is reasonably ascertainable (as determined in accordance with the FICA regulations under Code section 3121(v)(2)), the amount deferred as of December 31, 2007 equals the present value of all future payments to which the service provider has obtained a legally binding right as of December 31, 2007, calculated as if the service provider had obtained all of such rights on December 31, 2007. Notice 2007-89 provides additional guidance for purposes of determining when an amount is reasonably ascertainable.

(C) Stock Rights: The amount deferred equals the amount that the service provider would be required to include in income if the stock rights were immediately exercisable and exercised on

December 31, 2007 - which generally equals the fair market value of the underlying stock less the sum of the exercise price and any amount paid by the service provider for the stock right.

(D) All Other Deferred Amounts: The amount deferred must be determined under a reasonable, good faith application of a reasonable, good faith method. Notice 2007-89 provides additional guidance for purposes of determining whether the reasonable, good faith standards are met.

(6) Guidance for Service Providers: Notice 2007-89 also includes guidance for service providers with respect to amounts that are required to be included in gross income under 409A. Service providers must report all amounts required to be included under 409A and for purposes of determining such amounts, the same general principles that apply to employers (as discussed above) apply to service providers. However, Notice 2007-89 provides that the responsibility of the service provider to determine such amounts is independent of whether the employer or payer has complied with the requirements of the notice. As such, the notice emphasizes that, even if the service provider includes in income the same amount reported by the employer or payer, the service provider has not necessarily complied with the notice.

(7) Guidance for Determining the Additional Taxes Imposed by 409A: If an amount is required to be included in gross income under 409A, the tax imposed on such income is increased by the sum of two additional taxes: (A) an additional tax equal to the interest, using the IRS' underpayment rate plus 1%, that would have been imposed during the deferral period if the deferred compensation had been includible in income when first deferred (or not subject to a substantial risk of forfeiture) ("additional interest tax"); and (B) an additional tax equal to 20% of the deferred compensation. For purposes of computing the additional interest tax, Notice 2007-89 provides that service providers may treat amounts deferred under a plan that were originally deferred on or before January 1, 2005 (the general effective date of 409A) but became subject to 409A due to the material modification of the plan after October 3, 2004 as deferred on January 1, 2005. As a result, the additional interest tax is not computed with respect to periods before January 1, 2005 in such situations.

#### Future Guidance and Comments on Notice 2007-89

The IRS emphasized that the notice is only intended to provide interim guidance with respect to amounts included in gross income under 409A. The IRS is currently working on general guidance with respect to the income inclusion requirements, the additional taxes, and the reporting and withholding requirements of 409A. The IRS requested comments on all aspects of these requirements and indicated that any such comments should be submitted by February 13, 2008.

Any AALU member who wishes to obtain a copy of Notice 2007-89 may do so through the following means: (1) use hyperlink above next to "Major References," (2) log onto the AALU website at [www.aalu.org](http://www.aalu.org) and enter the *Member Portal* and select *Current Washington Report* for linkage to source material or (3) email Erik Ruselowski at [ruselowski@aalu.org](mailto:ruselowski@aalu.org) and include a reference to this *Washington Report*.

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