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A GUIDE TO NAVIGATING THE TREATMENT OF BONUSES UNDER §409A (PART 2)

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This article (Part 2) discusses the tax consequences to the employee and employer of a violation of §409A.[1] The primary example used in this article is an operational violation that occurs on an impermissible distribution on a change-in-control.

In two additional articles, (Part 1) provides a guide to navigating the rules for favorable tax treatment under §409A.[2] It focuses on cash bonuses, and does not address equity compensation. Part 3 focuses on whether under §404, an accrual method employer deducts a bonus in the year the employee performs the services, or in the subsequent year when the employer pays the bonus.

CONSEQUENCES OF §409A VIOLATION TO EMPLOYEE

A violation of §409A occurs when an arrangement's documentary provisions do not comply with §409A,[3] or the documentary provisions comply with §409A but the arrangement in operation does not.[4]

The consequences of a §409A violation, especially for employees, are harsh. In the taxable year in which a violation occurs, the employee includes in gross income all compensation deferred under the plan for that taxable year and all prior taxable years to the extent that the compensation is vested (not subject to a substantial risk of forfeiture), and was not previously included in gross income.[5] The employee pays regular income tax and an additional 20% income tax.[6]

In addition, the employee pays a premium interest tax on the underpayment of income tax that would have occurred had the deferred compensation been includible in gross income in the taxable year in which it was first deferred, or if later, the first taxable year in which the compensation is vested (not subject to a substantial risk of forfeiture).[7] The interest rate is the underpayment rate under §6621 plus one percentage point.[8] The purpose of the premium interest tax is to prevent the employee from receiving the economic benefit of deferred income inclusion that §409A-compliant deferrals receive.

IRS Issues Proposed and Reproposed Regulations

On December 8, 2008, the IRS issued proposed regulations on the consequences of §409A violations.[9] On June 22, 2016, the IRS issued reproposed regulations on the consequences of §409A violations deal-

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[1] All section references are to the Internal Revenue Code of 1986, as amended (Code), and the regulations thereunder.

[2] *See A Guide to Navigating The Treatment of Bonuses Under §409A (Part 1),* 46 Comp. Plan. J. 203 (Nov. 2, 2018).

[3] The IRS established a correction program for certain documentary violations in Notice 2010-3 and Notice 2010-80. *See generally* Rosina B. Barker & Kevin P. O'Brien, "Correcting Document Errors," *Section 409A Handbook* 31-1 (Regina Olshan & Erica F. Schohn eds., Bloomberg BNA 2018).

[4] The IRS established a correction program for certain operational violations in Notice 2008-113and Notice 2010-80. *See generally* Rosina B. Barker & Kevin P. O'Brien, "Correcting Operational Errors," in *Section 409A Handbook* 29-1 (Regina Olshan & Erica F. Schohn eds., Bloomberg BNA 2018).

[5] §409A(a)(1)(A); Notice 2008-115, §IV.A.

[6] §409A(a)(1)(B)(i)(II); Notice 2008-115, §IV.B.

[7] §409A(a)(1)(B)(i)(I), §409A(a)(1)(B)(ii).

[8] *Id.*

[9] *Further Guidance on the Application of Section 409A to Nonqualified Deferred Compensation Plans*, 73 Fed. Reg. 74,380 (Dec. 8, 2008).

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ing with the treatment of nonvested amounts (amounts subject to a substantial risk of forfeiture).[10]

Under the proposed regulations, the employee includes the vested deferred compensation in gross income in the year in which the violation occurs, but does not include it in gross income for any prior or subsequent years in which the violation does not occur.[11] For example, for a documentary violation of an impermissible definition of change-in-control, in the years after the year in which employer amends the plan to provide for a §409A-compliant definition, the employee does not include the deferred compensation in gross income. As another example, for an operational violation in the year in which an employee makes an untimely initial deferral election, the employee does not include the deferred compensation in gross income in subsequent years.

Furthermore, the employee includes the deferred compensation in gross income only to the extent that the deferred compensation is vested (not subject to a substantial risk of forfeiture). If the violation occurs in a taxable year in which the employee is not vested at the end of that year, and the violation is corrected before the taxable year of vesting, there is no tax consequence to the employee.[12] The IRS cautioned that to prevent taxpayers from using this rule to disregard §409A, if the facts and circumstances show that the employer has a pattern or practice of permitting impermissible changes in the time and form of payment for nonvested amounts, a deferral that is otherwise nonvested is not treated as nonvested.[13]

The IRS has tightened this anti-abuse rule in its reproposed regulations. A substantial risk of forfeiture is disregarded if any of the following occur:

> (1) An impermissible change under the §409A regulations is made to a provision for the time or form of payment of the deferral, and the employer has not made a reasonable, good faith determination that, absent the change, the provision fails to comply with §409A;
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> (2) The employer has engaged in a pattern or practice of permitting substantially similar failures to comply with §409A under one or more plans while deferrals under the plan are nonvested, and the facts and circumstances indicate that the deferral would be affected by the pattern or practice. Whether such a pattern or practice exists will depend on the facts and circumstances, including, but not limited to, whether the employer has taken commercially reasonable measures to identify and correct the substantially similar failures promptly upon discovery, whether the failures have affected nonvested deferrals with greater frequency than vested deferrals, whether the failures have occurred more frequently under newly adopted plans, and whether the failures appear intentional, are numerous, or repeat one or more similar past failures that were previously identified and corrected; or
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> (3) The correction of a failure to comply with §409A affecting the deferral is inconsistent with an applicable correction method (if one exists) under applicable guidance issued by the Treasury Department and the IRS, or the failure is not corrected in substantially the same manner as a substantially similar failure affecting a nonvested deferral under another plan sponsored by the employer. Solely with respect to the deferral, the requirements under applicable correction guidance for eligibility, income inclusion, additional taxes, premium interest tax, and information reporting by the employer or employee do not apply.[14]

Under the proposed regulations, for the taxable year in which a §409A violation occurs the employee includes in gross income an amount equal to the difference between: (1) the total amount deferred as of the last day of the taxable year; minus (2) any amount previously included in income. An amount is not treated as previously included in an employee's income unless the employer reported the amount on an information return and payee statement, or the employee included the amount in income;[15] and minus (3) amounts subject to a substantial risk of forfeiture as of the last day of the taxable year.[16]

Short-Term Deferral Elections

Amounts that on the last day of a plan year may satisfy the short-term deferral exemption are not treated as amounts deferred in that plan year. If an amount is not paid within the applicable 2½ month period and as a result does not satisfy the short-term deferral exemption, the amount is treated as a deferred amount for the year in which the applicable 2½ month period expires.[17]

> **Example:** A plan provides that the employer will pay an employee employed on December 31, 2017, a bonus by March 15, 2018. Since as of December 31, 2017, the bonus may satisfy the short-term deferral exemption, it is not included in the total amount deferred as of December 31, 2017. If the employer pays the bonus after March 15, 2018, the

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[10] *Application of Section 409A to Nonqualified Deferred Compensation Plans*, Prop. Reg. §1.409A-4(a)(1)(ii)(B), 81 Fed. Reg. 40,569, 40,584 (June 22, 2016).

[11] Prop. Reg. §1.409A-4(a)(1)(i), §1.409A-4(a)(1)(ii).

[12] §II. Effect of a Failure To Comply With Section 409A(a) on Amounts Deferred in Subsequent Years, 73 Fed. Reg. 74,380, 74,382 (Dec. 8, 2008).

[13] *Id.*

[14] Prop. Reg. §1.409A-4(a)(1)(ii)(B).

[15] Notice 2008-115, §III.B.1 and C.

[16] Prop. Reg. §1.409A-4(a)(1)(i).

[17] Prop. Reg. §1.409A-4(b)(2)(viii).

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bonus is included in the total amount deferred as of December 31, 2018.

Whether an amount is subject to a substantial risk of forfeiture is determined as of the last day of the taxable year. Therefore, if the substantial risk of forfeiture lapses before the end of the taxable year in which a §409A violation occurs, income inclusion occurs regardless of whether the substantial risk of forfeiture lapses before or after the §409A violation.[18]

The employer reports the amount included in income on the employee's Form W-2 for the taxable year in which the violation occurs using Code Z.[19] The employee reports this amount on line 7 of the employee's Form 1040. This occurs automatically when the employee enters the total wages from Box 1 of Form W-2. The employee reports the additional 20% income tax and any premium interest tax on line 62 (Box c) of the employee's Form 1040, and is identified as ''NQDC'' on that line.[20]

Generally, the total amount deferred is equal to the sum of: (1) the present value as of the last day of the taxable year of the amounts payable under the plan. In determining this amount for an operational violation, the plan aggregation rule applies; plus (2) any amounts deferred under the plan or plans that were paid to the employee during the taxable year.[21] For an account balance plan, the present value of the amount payable is generally the account balance as of the last day of the taxable year.[22]

Plan Aggregation

Under the plan aggregation rule, plans classified as similar under the §409A regulations are aggregated and treated as a single plan.[23] For example, an employer maintains an elective salary deferral plan and an elective bonus deferral plan. The two plans are aggregated and treated as a single plan. If the employer makes an impermissible distribution under the elective salary deferral plan, the deferrals under that plan are aggregated with the deferrals under the elective bonus deferral plan in determining the amount of inclusion in gross income, and the regular income tax, additional 20% income tax, and premium interest tax.

The §409A regulations require nonqualified plans of deferred compensation to be in writing.[24] The plan aggregation rule does not apply to the written plan requirement.[25] Accordingly, the plan aggregation rule affects the consequences of operational violations, but not documentary violations. If the elective salary deferral plan does not use a §409A-compliant definition of change-in-control, a documentary violation occurs. The elective salary deferral plan and elective bonus deferral plan are not aggregated, and are treated as separate plans. Only the deferrals and earnings in the elective salary deferral plan are taken into account in calculating the regular income tax, additional 20% income tax, and premium interest tax resulting from the §409A -noncompliant definition of change-in-control.

The exception to plan aggregation for documentary violations may be of limited benefit. When there is a documentary violation, an operational violation resulting from following §409A-noncompliant terms often occurs. Once an operational violation occurs, the plan aggregation rule applies.

Calculation of the premium interest tax entails the following four-step process:[26]

(1) Determine the amount of the income inclusion from the §409A violation.

(2) Allocate the amount in clause (1) to the years in which the income was deferred.

(3) Calculate the hypothetical underpayment of tax for the year to which any income is allocated. A hypothetical underpayment does not occur for amounts allocated to the year in which the §409A violation occurs. This is because the income tax return for that year includes in income the entire vested amount deferred. This amount by definition includes the portion allocated to the year of the §409A violation.[27]

(4) Calculate the premium underpayment interest.

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[18] Prop. Reg. §1.409A-4(a)(2)(i); *see also* CCA 201518013 (''In accordance with section 409A(a)(1)(A)(i), a failure applicable to deferred compensation subject to a substantial risk of forfeiture that lapses during the taxable year results in income inclusion of the deferred amount under section 409A, regardless of whether the failure is corrected during the same taxable year but before the substantial risk of forfeiture lapses.'').

[19] Notice 2008-115, §III.B.

[20] 2018 General Instructions for Forms W-2 and W-3, at 11-12, 16, 20 and 32; 2017 1040 Instructions, at 53.

[21] Prop. Reg. §1.409A-4(b)(1)-(2).

[22] Prop. Reg. §1.409A-4(b)(3)(i). Under Notice 2008-115, for an account balance plan, the amount deferred as of December 31 of a calendar year equals the amount that would be treated as an amount deferred under Reg. §31.3121(v)(2)-1(c)(1) on December 31 of that calendar year if the entire account balance under the plan (including all principal amounts, adjusted for income, gain, or loss credited to the employee's account) as of December 31 of that calendar year were treated as a principal amount credited to the employee's account. For purposes of this rule, an elective account balance plan under Reg. §1.409A-1(c)(2)(i)(A) is not aggregated with a nonelective account balance plan under Reg. §1.409A-1(c)(2)(i)(B). Notice 2008-115, §III.B.3.a.

Until the Treasury Department and the IRS issue further guidance, compliance with the proposed regulations regarding the calculations of the amount includible in income and the taxes under §409A will be treated as compliance with the requirements of Notice 2008-115, provided that the taxpayer complies with all the provisions of the proposed regulations. Notice 2008-115, §V.

[23] Reg. §1.409A-1(c)(2)(i).

[24] Reg. §1.409A-1(c)(3)(i)-§1.409A-1(c)(3)(vi).

[25] Reg. §1.409A-1(c)(3)(viii).

[26] Prop. Reg. §1.409A-4(d).

[27] Prop. Reg. §1.409A-4(d)(2)(ii), *Ex.* 1.

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If in the years before the §409A violation there were no payments, net deemed investment losses or other losses, or other amounts included in income, the amount deferred in a taxable year is generally equal to the incremental amount deferred for that year.[28]

The hypothetical underpayment is calculated as if the employer paid the employee the amount allocated to a taxable year in cash, and the employee did not include that amount in income for that year.[29] The employee's taxable income, credits, filing status, and other tax items for the year at issue are used. The calculation must take into account the adjustments that would have been made had the income inclusion occurred. Examples of adjustments are the limitation on itemized deductions, the additional use of carried over losses and charitable contributions, and additional alternative minimum tax.[30]

Example: Impermissible Distribution on A Change-in-Control

On December 15, 2012, the employee elects to defer a discretionary bonus for services to be performed in the 2013 calendar year to the earlier of a §409A-compliant change-in-control, and the employee's separation from service. On July 1, 2014, the employer awards the employee a bonus of $100,000. For 2014, the employee's account is credited with $2,500 of accrued earnings. On December 15, 2013, the employee elects to defer a discretionary bonus for services to be performed in the 2014 calendar year to the earlier of a §409A-compliant change-in-control, and the employee's separation from service. On July 1, 2015, the employer awards the employee a bonus of $150,000. For 2015, the employee's account is credited with $8,875 of accrued earnings. On May 1, 2016, the employer improperly distributes the entire $261,375 account balance on a §409A-noncompliant change-in-control. As of December 31, 2016, the employee's account balance is zero.

The 20% additional tax applies to the entire $261,375, which is equal to $52,275. The tax is imposed for the 2016 taxable year, and is due on April 15, 2017.

To calculate the premium interest tax, the employee must reconstruct his or her 2014 and 2015 income tax returns. The employee calculates the additional tax he or she would have owed had the $100,000 bonus and $2,500 in earnings been paid in 2014, and had the $150,000 bonus and $8,875 in earnings been paid in 2015. Assuming a 35% tax rate and that the employee would have owed an additional $35,875 in tax for 2014, the premium interest tax on this amount runs from April 15, 2015, the date that the tax for 2014 was due, through December 31, 2016. In addition, assuming that the employee would have owed an additional $55,606 in tax for 2015, the premium interest tax on this amount runs from April 15, 2016, the date that the tax for 2015 was due, through December 31, 2016.[31]

Because the interest rate on underpayments for the second, third, and fourth quarters of 2015 and the first quarter of 2016 was 3%, the premium interest tax rate for this period is 4% compounded daily.[32] Because the interest rate on underpayments for the second, third, and fourth quarters of 2016 was 4%, the premium interest tax rate for this period is 5% compounded daily. The premium interest tax on $35,875 is $2,837.11, and the premium interest tax on $55,606 is $2,018.30. The total amount of the premium interest tax is $4,855.41.

The imposition of the additional 20% tax and premium interest tax increases the risk that the employee will run afoul of the rules for payment of estimated income tax.[33]

If the employee does not timely remit the additional 20% tax and premium interest tax required to be shown on his or her Form 1040, interest is imposed on the underpayment.[34]

If the employee does not report the additional 20% tax or premium interest tax required to be shown on his or her Form 1040 and timely remit these taxes, a penalty of 0.5% of the tax per month for each month for which the tax is not paid, but not to exceed 25% of the tax in the aggregate, applies.[35] If the failure is due to reasonable cause and not willful neglect, the penalty is abated.[36]

If all or a portion of the underpayment of the additional 20% income tax and premium interest tax is attributable to negligence or disregard of rules or regulations, a penalty of 20% of the underpayment attributable to negligence or disregard of the rules or regulations applies.[37] Negligence includes any failure to make a reasonable attempt to comply with the Internal Revenue Code, and disregard includes any careless, reckless, or intentional disregard.[38] The penalty is abated for any portion of an underpayment if the taxpayer shows that there was reasonable cause for, and the taxpayer acted in good faith with respect to, that portion.[39]

The negligence penalty is equal to $11,426.08 ($52,275 + $4,855.41 = $57,130.41; $57,130.41 x .2 = $11,426.08).

If all or a portion of the underpayment of the additional 20% income tax and premium interest tax is substantial, a penalty of 20% of the underpayment applies. An underpayment is substantial if it exceeds the greater of 10% of the tax required to be shown on the

[28] Prop. Reg. §1.409A-4(d)(1).

[29] Prop. Reg. §1.409A-4(d)(3)(i).

[30] *Id.*

[31] Prop. Reg. §1.409A-4(d)(4)(ii), ex. 1 and 2.

[32] §6622(a).

[33] §6654.

[34] §6601(a), §6621; Notice 2008-115, §IV.A.

[35] §6651(a)(3); Notice 2008-115, §IV.A.

[36] *Id.*

[37] §6662(a), §6662(b)(1); Notice 2008-115, §IV.A.

[38] §6662(c).

[39] Reg. §1.6664-4(a).

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return, and $5,000.[40] Either the negligence penalty or the substantial underpayment penalty can apply, but not both.[41]

Consequences of a Violation Can Be Harsh

The consequences of a §409A violation to the employee apply regardless of whether the employee is responsible for the violation. Indeed, the employee is usually not responsible for documentary violations in a broad-based plan. The employee is rarely responsible for most operational violations, such an impermissible acceleration, or an impermissible delay in making a payment by the designated payment date.

Nevertheless, the employee incurs the harsh tax consequences for these violations. Moreover, many employment agreements, separation agreements, and broad-based plans contain a disclaimer by the employer of compliance with §409A or an exemption thereto, and any liability for the employee's taxes on a §409A violation. These documents also provide that the employee is solely liable for the payment of these taxes.[42] In the absence of a decision by the employer to indemnify the employee for his or her taxes that supersedes these provisions, and that is supported by consideration from the employee, the employee is left in a difficult position.

Moreover, when a §409A violation does not involve a distribution to the employee, such as a documentary violation due to a §409A-noncompliant definition of change-in-control, the employee is left in an even more difficult position. Because the employee does not receive a distribution, the employee has to come out-of-pocket to pay his or her taxes. In the absence of indemnification, one way to ameliorate the employee's position is the exception to the anti-acceleration rules for distributions on income inclusion on a §409A violation. Under this exception, a plan may provide for, or the employer in its discretion may make, an accelerated distribution that does not exceed the amount required to be included in income due to the §409A violation.[43]

Employer Indemnification of Employee

If the employer decides to indemnify the employee for his or her taxes, one way to ensure that there is consideration for the employer's promise when it supersedes prior disclaimers is for the employee to incur a detriment as the promisee. For example, the employee can forfeit 10% of base salary for one month. If the governing state wage payment statute prohibits the forfeiture of base salary, the employee can forfeit a portion of compensation that is not protected by the statute. For example, discretionary bonuses, and incentive compensation based on factors outside the scope of an employee's actual work, are often not protected by state wage payment statutes.[44]

However, the employee should be wary of waiving any election currently in effect to defer an amount of compensation. The waiver may run afoul of the requirement that a deferral election be irrevocable.[45] Furthermore, the permitted forfeiture of deferred compensation under Reg. §1.409A-3(f) may apply only to deferrals that have already occurred, and not to future deferrals.

If the terms of the indemnification, separate from the terms of the compensation that violate §409A, are nonqualified deferred compensation, the initial deferral election most likely to apply to the indemnification is the one for service recipient elections. When an arrangement does not give the employee the right to elect the time or form of payment, the employer must designate the time and form of payment by no later than the later of: (1) the time the employee first has a legally binding right to the compensation; and (2) the time the employee had to have made an initial deferral election had the employee been provided with the right to make this election.[46] When the employer decides to indemnify the employee for his or her taxes on a §409A violation is the time that the employee first has a legally binding right to the indemnification.

The §409A regulations provide a separate rule for tax indemnification payments and tax gross-ups on these payments. The separate rule satisfies the provisions for payments at a specified time or fixed schedule.[47] The separate rule requires that the arrangement provide that the payment will be made, and the payment is made, by the end of the employee's taxable year next following the employee's taxable year in which the employee remits the taxes.[48]

An employer's indemnification of an employee for his or her taxes on a §409A violation raises the issue of whether the indemnification precludes correction of certain operational violations under Notice 2008-113. Correction of certain violations requires that the employee repay the employer the amount erroneously paid or made available to the employee. A number of the corrections require that the employee pay the employer interest on the repayment, and pay a portion of the taxes triggered by the §409A violation. Notice 2008-113 states that an amount will not be treated as

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[40] §6662(d)(1)(A).

[41] §6662(b).

[42] *See* Colleen Hart, ''Plan Aggregation and Other Key Rules,'' in *Section 409A Handbook* 5-1, 8 (Regina Olshan & Erica F. Schohn eds., Bloomberg BNA 2018).

[43] Reg. §1.409A-3(j)(4)(vii).

[44] *See generally* Richard A. Lord, 3 *Williston on Contracts* §7:5 (4th ed. 2018) (''It is well settled that a detriment suffered by the promisee at the promisor's request and as the price for the promise is sufficient, despite the fact that the promisor is not benefited as well.'') (footnote omitted); Arthur J. Ciampi, *Are Law Firm Bonuses Considered 'Wages'?*, *New York Law Journal* (May 24, 2018) (

[45] Reg. §1.409A-2(a)(1).

[46] Reg. §1.409A-2(a)(2).

[47] Reg. §1.409A-3(i)(1)(v).

[48] *Id.*

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repaid if in connection with the repayment the employer pays the employee, or otherwise provides a benefit to the employee (including an obligation to pay an amount or provide a benefit in the future), intended as a substitute for all or part of the repayment.[49] Two commentators take the position that the employer's indemnification should not be a prohibited benefit:

> The prohibited-benefit rule ensures that the employee is not made better off by a mistaken payment. The apparent intent is consistent with the Notice's requirement that the employee in some cases pay purported interest when he or she repays a mistaken payment. The idea is that the employee cannot be made better off even by the imputed interest value of accelerated access to cash. But this purpose is not frustrated by the employer's making the employee whole for the resulting 409A tax. The gross-up does not make the employee better off for having received the mistaken payment; it only restores the employee to the economic position he or she would have enjoyed had the payment not been made.[50]

CONSEQUENCES OF §409A VIOLATION TO EMPLOYER

For the employer, a §409A violation triggers withholding and reporting obligations. The amounts included in the employee's gross income due to the violation are wages subject to withholding for regular income tax under §3402(a).[51] For determining the withholding rate, these amounts, and amounts paid in compliance with §409A or an exemption thereto, are supplemental wages. Supplemental wage treatment applies regardless of whether the employer paid the employee regular wages in the calendar year of income inclusion or the prior calendar year.[52]

Employer's Withholding for Nonqualified Deferred Compensation

The employer does not have a withholding obligation for the additional 20% income tax or the premium interest tax.[53] In addition, the employer does not have a withholding obligation for FICA taxes on a §409A violation.[54] Rather, the regular FICA withholding rules for nonqualified deferred compensation apply.[55] These rules provide that the employer must withhold FICA taxes on amounts deferred on the later of: (1) the date on which the services creating the right to the compensation are performed; and (2) the date on which the right to the compensation is no longer subject to a substantial risk of forfeiture.[56] The substantial risk of forfeiture determination is governed by the same principles that apply to transfers of property under §83.[57]

One of the exceptions to the anti-acceleration rules of §409A provides that a nonqualified deferred compensation plan may provide for, or the employer in its discretion may make, an accelerated distribution to pay the FICA taxes on the compensation deferred under the plan (the ''FICA Amount''). The exception also applies to: (1) the withholding amount for the income tax at source on wages imposed under §3401, or the corresponding withholding rules under state, local, and foreign law, due to payment of the FICA Amount; and (2) the additional income tax at source on wages due to the pyramiding §3401 wages and taxes. The total accelerated distribution cannot exceed the sum of the FICA Amount and the income tax withholding on the FICA Amount.[58]

Employers usually withhold regular income tax on supplemental wages at a flat rate. Depending on whether the supplemental wages paid by the employer to an employee in a calendar year exceed $1 million, either optional flat rate or mandatory flat rate withholding applies. Optional flat rate withholding applies if: (1) all supplemental wage payments previously paid by one employer to an employee in the calendar year do not exceed $1 million; (2) the supplemental wages are not paid concurrently with the employee's regular wages, or are separately stated on the employer's payroll records; and (3) income tax has been withheld from the employee's regular wages in the current or prior calendar year.[59] The employer is the entity that employs the employee, and all members of that entity's controlled group as determined under §52(a) and §52(b).[60]

The optional flat withholding rate is the third-lowest tax rate for taxable years beginning in the calendar year in which the supplemental wages are paid.[61] For taxable years beginning after December

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[49] Notice 2008-113, §III.E.

[50] Rosina B. Barker & Kevin P. O'Brien, ''Correcting Operational Errors,'' *Section 409A Handbook* 29-1, 9 (Regina Olshan & Erica F. Schohn eds., Bloomberg BNA 2018).

[51] §3401(a) (flush language).

[52] §3402(a); Reg. §31.3402(g)-1(a)(1)(i); Notice 2008-115, §III.B.

[53] Notice 2008-115, §III.B. In comparison, the employer must withhold for the 20% excise tax on excess parachute payments (as defined in §280G(b) and Reg. §1.280G-1, Q&A-3). §4999(c)(1).

[54] Employer's Supplemental Tax Guide, *2018 IRS Publication 15-A*, at 15.

[55] Notice 2008-115, §I.

[56] §3121(v)(2); Reg. §31.3121(v)(2)-1(a)(2)(ii).

[57] Reg. §31.3121(v)(2)-1(e)(3).

[58] Reg. §1.409A-3(j)(4)(vi).

[59] Reg. §31.3402(g)-1(a)(7)(i).

[60] Reg. §31.3402(g)-1(a)(3).

[61] §904(a) of the American Jobs Creation Act of 2004; Reg. §31.3402(g)-1(a)(7)(iii)(F).

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31, 2017, and before January 1, 2026, this rate is 22%.[62]

Mandatory flat rate withholding applies if a supplemental wage payment, together with all supplemental wages previously paid by one employer to the employee in the calendar year, exceed $1 million. Any portion of a supplemental wage payment that results in supplemental wages exceeding $1 million is subject to mandatory flat rate withholding.[63] This rate is the highest rate of tax under §1 for the taxable year beginning in the calendar year in which the supplemental wages are paid. For taxable years beginning after December 31, 2017, and before January 1, 2026, this rate is 37%.[64]

For any supplemental wage payment that results in the employee having received more than $1 million in supplemental wages for the calendar year, the employer may withhold on the entire supplemental wage payment at the 37% rate.[65]

Employer's Reporting Obligations

An employer must report the employee's inclusion of deferred compensation in gross income due to a §409A violation on line 2 of Form 941, the employer's quarterly federal tax return.[66] This amount equals the portion of the total amount deferred under the aggregated plans that, as of December 31 of the applicable calendar year, 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 employee during the calendar year.[67] An employer may treat an amount as previously included in income if the amount was properly reported on a Form W-2 or W-2c for a prior calendar year.[68]

As part of its Form 941 filing, the employer remits the amounts withheld for federal income taxes to the extent these taxes were not previously deposited.[69] If the employer does not timely remit the withholding taxes required to be shown on Form 941, interest is imposed on the underpayment.[70]

In addition, the employer must report the employee's inclusion of deferred compensation in gross income on a §409A violation in Box 1 of Form W-2 and Box 12 of Form W-2 using Code Z.[71] Because the amount included in gross income is not subject to FICA taxes, the employer does not report any amount in Boxes 3 through 6 of Form W-2. For an individual who is an independent contractor subject to §409A, such as an outside director, the service recipient reports amounts includible in gross income on a §409A violation in Box 7 and Box 15b on Form 1099-MISC.[72]

If the employer does not satisfy its federal income tax withholding obligations on a §409A violation, it remains liable for the taxes it should have withheld.[73] The employer's liability is abated if it shows that the employee reported the wage payments on his or her Form 1040, and paid all the federal income tax due on the Form 1040.[74] To abate the liability, the employer uses Form 4669, which is completed in part by the employer and in part by the employee, and is signed by the employee. Finally, regardless of the abatement of the employer's liability for withholding taxes, the employer continues to be subject to the penalties for failure to withhold.[75]

Penalties for Employer's Failure to Withhold and Report

In addition, if the employer does not satisfy its withholding and reporting obligations, the employer is subject to the following penalties: (1) failure to withhold; (2) failure to timely deposit withholding taxes; (3) failure to file correct information returns; (4) failure to furnish correct payee statements; and (5) underpayment of tax attributable to negligence or disregard of rules or regulations.

If the employer does not report and remit the withholding taxes required to be shown on its Form 941, a penalty of 0.5% of the tax per month for each month for which the tax is not paid, but not to exceed 25% of the tax in the aggregate, applies.[76] If the failure is due to reasonable cause and not willful neglect, the penalty is abated.[77]

If the employer fails to timely deposit any withholding taxes, it is potentially subject to a penalty

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[62] §1(j)(1) and §1(j)(2) (as added by §11001(a) of Public Law No. 115-97 (hereinafter the 2017 tax act); §904(a) of the American Jobs Creation Act of 2004; Reg. §31.3402(g)-1(a)(7)(iii)(F); Notice 2018-14, §IV; Notice 1036 (Jan. 11, 2018).

[63] Reg. §31.3402(g)-1(a)(2).

[64] §1(j)(1) and §1(j)(2) (as added by §11001(a) of 2017 tax act); §904(b) of the American Jobs Creation Act of 2004; Reg. §31.3402(g)-1(a)(2); Notice 1036 (Jan. 11, 2018).

[65] Reg. §31.3402(g)-1(a)(4)(iv).

[66] Notice 2008-115, §III.B.

[67] Notice 2008-115, §III.B.1.

[68] *Id.*

[69] Notice 2008-115, §III.B.2. Amounts includible in gross income under §409A(a) that are either actually or constructively received (disregarding the application of §409A) by an employee are considered a payment of wages by the employer when received by the employee for purposes of withholding, depositing, and reporting the income tax at source on wages under §3401(a). Amounts includible in gross income under §409A(a) that are neither actually nor constructively received (disregarding the application of §409A) by the employee during the applicable calendar year are treated as a payment of wages on December 31 of that calendar year for purposes of withholding, depositing, and reporting the income tax at source on wages under §3401(a). *Id.*

[70] §6205(b), §6601(a); Reg. §31.6205-1(c).

[71] §6051(a)(13), §6051(d); Notice 2008-115, §III.B.

[72] §6041(a), §6041(g)(2); Notice 2008-115, §III.B; 2018 Instructions for Form 1099-MISC, at 8-9.

[73] §3403; Reg. §31.3403-1.

[74] §3402(d); Reg. §31.3402(d)-1.

[75] *Id.*

[76] §6651(a)(3).

[77] *Id.*

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equal to the applicable percentage of the amount of the underpayment.[78] The applicable percentage is 2% if the failure is for not more than five days; 5% if the failure is for more than five days but not more than 15 days, and 10% if the failure is for more than 15 days.[79] Underpayment means the excess of the amount of the tax required to be deposited over the amount, if any, deposited on or before the date prescribed for the deposit.[80] If the failure is due to reasonable cause and not willful neglect, the penalty is abated.[81]

The IRS has taken the position that the penalty for failure to timely deposit withholding taxes does not apply ''in case of failure to deposit FICA and income taxes which should have been withheld from compensation paid to employees, but which were not withheld.''[82]

If the employer fails to file an information return by its due date, fails to include all the information required to be shown on the return, or includes incorrect information, then for any failure relating to a return required to be filed in 2019, the penalty is $270 for each return for which a failure occurs, but not to exceed $3,339,000 per calendar year.[83] For employees, the information return usually at issue is Form W-2 for reporting income tax withheld on wages.[84] For independent contractors, such as an outside director, the information return usually at issue is Form 1099-MISC.[85]

If the failure is corrected on or before the 30th day after the required filing date, then for any failure relating to a return required to be filed in 2019, the penalty is $50 per return in lieu of $270, but not to exceed $556,500 per calendar year.[86] If the failure is corrected after the 30th day, but on or before August 1 of the calendar year of the required filing date, then for any failure relating to a return required to be filed in 2019, the penalty is $110 per return in lieu of $270, but not to exceed $1,669,500 per calendar year.[87]

If a failure is due to intentional disregard of the filing requirement or the correct information reporting requirement, then for any failure relating to a return required to be filed in 2019, the penalty is the greater of $550, and 10% of the amount required to be reported correctly.[88] There is no calendar year cap on the penalty.[89] In addition, the penalty is not counted in determining the calendar year caps for failures that are not due to intentional disregard.[90]

Similar penalties apply if the employer fails to furnish a payee statement by its due date, fails to include all the information required to be shown on the payee statement, or includes incorrect information. For any failure relating to a statement required to be furnished in 2019, the penalty is $270 for each statement for which a failure occurs, but not to exceed $3,339,000 per calendar year.[91] For employees, the payee statement usually at issue is the employee's copy of Form W-2.[92] For independent contractors, such as an outside director, the payee statement usually at issue is the contractor's copy of Form 1099-MISC.[93]

If the failure is corrected on or before the 30th day after the date prescribed for furnishing the statement, then for any failure relating to a statement required to be furnished in 2019, the penalty is $50 per statement in lieu of $270, but not to exceed $556,000 per calendar year.[94] If the failure is corrected after the 30th day, but on or before August 1 of the calendar year in which the required furnishing date occurs, then for any failure relating to a statement required to be furnished in 2019, the penalty is $110 per return in lieu of $270, but not to exceed $1,669,500 per calendar year.[95]

If a failure is due to intentional disregard of the requirement to furnish a payee statement or the correct information reporting requirement, then for any failure relating to a statement required to be furnished in 2019, the penalty is the greater of $550, and 10% of the amount required to be reported correctly.[96] There is no calendar year cap on the penalty.[97] In addition, the penalty is not counted in determining the calendar year caps for failures that are not due to intentional disregard.[98]

If any portion of the employer's Form 941 or Form W-2 reflects an underpayment of the withholding tax

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[78] §6656(a).

[79] §6656(b)(1)(A).

[80] §6656(b)(2).

[81] §6656(a).

[82] Rev. Rul. 75-191.

[83] §6721(a); Rev. Proc. 2018-57, §3.57(1). For persons with average annual gross receipts for the most recent three taxable years of $5 million or less, the maximum is $1,113,000. §6721(d)(1)(A)-(2); Rev. Proc. 2018-57, §3.57(2).

[84] §6051(a), §6051(d); Reg. §301.6721-1(g)(2)(vii).

[85] §6041(a), §6041(g)(2); Reg. §301.6721-1(g)(2)(i).

[86] §6721(b)(1); Rev. Proc. 2018-57, §3.57(1). For persons with average annual gross receipts for the most recent three taxable years of $5 million or less, the maximum is $194,500. §6721(d)(1)(B), §6721(d)(2); Rev. Proc. 2018-57, §3.57(2).

[87] §6721(b)(2); Rev. Proc. 2018-57, §3.57(1). For persons with average annual gross receipts for the most recent three taxable years of $5 million or less, the maximum is $556,500. §6721(d)(1)(C), §6721(d)(2); Rev. Proc. 2018-57, §3.57(2).

[88] §6721(e)(1), §6721(e)(2)(A); Rev. Proc. 2018-57, §3.57(3).

[89] §6721(e)(3)(A).

[90] §6721(e)(3)(B).

[91] §6722(a); Rev. Proc. 2018-57, §3.58(1). For persons with average annual gross receipts for the most recent three taxable years of $5 million or less, the maximum is $1,113,000. §6722(d)(1)(A), §6722(d)(2); Rev. Proc. 2018-57, §3.58(2).

[92] §6051(a); Reg. §301.6722-1(d)(2)(xxii).

[93] §6041(d). Reg. §301.6722-1(d)(2)(iii).

[94] §6722(b)(1); Rev. Proc. 2018-57, §3.58(1). For persons with average annual gross receipts for the most recent three taxable years of $5 million or less, the maximum is $194,500. §6722(d)(1)(B), §6722(d)(2); Rev. Proc. 2018-57, §3.58(2).

[95] §6722(b)(2); Rev. Proc. 2018-57, §3.58(1). For persons with average annual gross receipts for the most recent three taxable years of $5 million or less, the maximum is $556,500. §6722(d)(1)(C), §6722(d)(2); Rev. Proc. 2018-57, §3.58(2).

[96] §6722(e)(1), §6722(e)(2)(A); Rev. Proc. 2018-57, §3.58(3).

[97] §6722(e)(3)(A).

[98] §6722(e)(3)(B).

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required to be shown on the return, and all or a portion of the underpayment is attributable to negligence or disregard of rules or regulations, a penalty of 20% of the underpayment attributable to negligence or disregard of the rules or regulations applies.[99] Negligence includes any failure to make a reasonable attempt to comply with the Internal Revenue Code, and disregard includes any careless, reckless, or intentional disregard.[100] The penalty is abated for any portion of an underpayment if the taxpayer shows that there was reasonable cause for, and the taxpayer acted in good faith with respect to, that portion.[101]

If all or a portion of the underpayment of the withholding tax is substantial, a penalty of 20% of the underpayment applies. For a corporation, an underpayment is substantial if it exceeds the lesser of: (1) 10% of the tax required to be shown on the return, or if greater, $10,000; and (2) $10 million.[102] For other taxpayers, an underpayment is substantial if it exceeds the greater of 10% of the tax required to be shown on the return, and $5,000.[103] Either the negligence penalty or the substantial underpayment penalty can apply, but not both.[104]

In the example, assume that the employer withheld at the 25% supplemental withholding rate in effect in 2016 on the $261,375 improperly distributed. The amount of the supplemental withholding is equal to $65,344. The employer also reported and remitted the withholding tax on a timely filed Form 941. Accordingly, the employer is not subject to the penalty for failure to pay withholding taxes.[105]

If the employer does not report the §409A violation on the employee's Form W-2, the employer is subject to a $250 penalty for the information return required to be filed with the IRS, and a $250 penalty for the Form W-2 payee statement required to be furnished to the employee.

If the employer's failure to report the §409A violation on the employee's Form W-2 is due to intentional disregard of the reporting requirement, the employer is subject to a penalty for the information return required to be filed with the IRS of the greater of $500, and 10% of the $261,375 required to be reported correctly, which is equal to $26,138. The employer is also subject to the increased penalty for the Form W-2 payee statement required to be furnished to the employee.

CONCLUSION

A violation of §409A results in harsh consequences to the employer, and even harsher consequences to the employee. The consequences should serve as a strong reminder of the importance of avoiding a violation of §409A.

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[99] §6662(a), §6662(b)(1).

[100] §6662(c).

[101] Reg. §1.6664-4(a).

[102] §6662(d)(1)(B). A corporation does not include an S corporation or a personal holding company under §542. *Id.*

[103] §6662(d)(1)(A).

[104] §6662(b).

[105] §6651(a)(2), §6651(a)(3).

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