

HR Law/Employee Benefits

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**IRS Issues Important Guidance on Pension Protection Act and Code Section 409A**

The Internal Revenue Service (“IRS”) and the Treasury Department recently issued (1) transitional guidance under the Pension Protection Act (“PPA”), clarifying the PPA’s employer stock diversification and notice requirements in Notice 2006-107; and (2) guidance on the reporting and wage withholding requirements for calendar years 2005 and 2006 with respect to deferrals of compensation and amounts includable in gross income under Section 409A of the Internal Revenue Code of 1986, as amended (the “Code”) in Notice 2006-100.

**Employer Stock Diversification and Notice Requirements**

Under the PPA, defined contribution plans (other than certain employee stock ownership plans) must provide participants who have at least three years of service with the right to divest employer contributions made in the form of employer securities, and reinvest those amounts in diversified investments. (Employees must be able to diversify their own employee contributions immediately.) Plan sponsors are required to provide participants with a notice of their diversification rights no later than 30 days before the first date upon which the individuals are eligible to exercise their rights. The recently issued guidance provides a model diversification notice and clarifies that no notice is required before January 1, 2007.

The guidance also clarifies that the diversification requirements do not apply to certain diversified mutual funds and similar investment vehicles that are independent of the employer. Further, an employee stock ownership plan (“ESOP”) is subject to the PPA’s diversification requirements only if (1) it holds any contributions or earnings to which Sections 401(k) or 401(m) of the Code apply, or (2) if it is a portion of a plan that holds any amounts that are not part of the ESOP.

The guidance prohibits plans from placing restrictions on investments in employer securities that are not placed on other investments. This rule will be phased in, permitting some existing restrictions or conditions to continue through March 30, 2007. A transitional rule, effective through 2007, permits certain restrictions on employer stock investments that do not apply to (1) a stable value fund, or (2) an investment that is not a generally available investment. The model notice confirms that it is permissible to have a “restriction that is reasonably designed to ensure compliance” with securities laws.

**Withholding and Reporting Wages Under 409A**

Relief From Reporting Deferrals Not Includable in Income. Employers and payers are *not* required to report on Form W-2 or Form 1009-MISC amounts deferred during 2005 and 2006 that are not includable in gross income because Section 409A requirements were satisfied.

Reporting and Withholding Amounts Includable in Income. Employers and payers *are required* to report on Form W-2 or Form 1009-MISC and withhold with respect to amounts deferred in 2005 and 2006 that are includable in gross income due to failure to meet Section 409A requirements. With respect to employees, these amounts will be treated as wages under Section 3401 of the Code. However, in the case of employees who have received other regular wages from the employer during the calendar year, such amounts will be considered supplemental wages subject to supplemental wages withholding rules under Section 3402 of the Code. Amounts reported with respect to nonemployees will be equal to the amount includable in gross income under Section 409A, which is not treated as wages under Section 3401 of the Code. To comply with this requirement for calendar year 2005, employers and payers, including those that relied on Notice 2005-94, must file an original or corrected information return and furnish an original or

corrected payee statement for 2005. Failure to file information returns and furnish payee statements may result in the penalties provided for such cases under the Code. The deadlines for filing with respect to calendar year 2006 are also applicable to calendar year 2005. The notice provides interim rules for calculating amounts includable in gross income under Section 409A.

**Service Providers.** Service providers are required to report as income and pay taxes on all amounts includable in gross income under Section 409A for both calendar years calculated in accordance with the interim rules given in the notice.

**Future Relief.** Complying with the notice will shield employers and payers from any further obligation to withhold reports and file or furnish corrected information or payee statements related to amounts includable in gross income under Section 409A for these years, arising out of any future guidance published on this issue.

*Please contact one of the members of the Gardner Carton & Douglas Employee Benefits Practice Group if you have any questions regarding this Client Memorandum.*

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