

*Pension*  
ANALYST

# Compliance Bulletin

January 2006



## Year-End Guidance for Nonqualified Deferred Compensation Plans

### IRS Suspends Withholding and Reporting Requirements for 2005

For 2005, the IRS has suspended the wage withholding and information reporting requirements that apply to certain nonqualified deferred compensation amounts under the American Jobs Creation Act of 2004 (AJCA). However, future guidance may require employers to file corrected information returns and furnish corrected withholding statements for 2005 to report amounts includible in income that are not reported due to this temporary suspension of the reporting rules.

In [Notice 2005-1](#), the IRS had indicated that beginning with deferrals made in 2005, employers would have to report all section 409A nonqualified deferred compensation deferrals made during a calendar year in box 12 of employees' Forms W-2, using code Y, even if those amounts are not taxable. This requirement applies to both defined contribution-type plan and defined benefit-type plans. However, amounts that are not "reasonably ascertainable" under defined benefit-type plans do not have to be reported until they are reasonably ascertainable.

In addition, all payments made from nonqualified deferred compensation plans must be reported in box 1 of Form W-2. Payments that do not meet the section 409A requirements must also be reported in box 12 of Form W-2, using code Z. All amounts distributed in a tax year must be reported, regardless of when they were contributed to the plan.

Similarly, employers must report all section 409A deferrals made by an individual who is not an employee (e.g., a Director or an independent contractor) during a calendar year in box 15a of Form 1099-MISC. All payments made from nonqualified deferred compensation plans to an individual who is not an employee must be reported in box 7 of Form 1099-MISC. Payments that do not meet the section 409A requirements must also be reported in box 15b of Form 1099-MISC.

[IRS Notice 2005-94](#) suspends these reporting and withholding obligations for calendar year 2005 as follows:

- Employers do not have to report nonqualified deferred compensation deferrals made in 2005 on an employee's Form W-2 or on a non-employee's Form 1099-MISC.
- Employers do not have to include as wages, or report in boxes 1 and 12 of Form W-2, payments made from nonqualified deferred compensation plans that the employee has neither actually nor constructively received during 2005. Likewise, employers do not have to report such amounts paid to individuals who are not employees in boxes 7 or 15b of Form 1099-MISC.

If future IRS guidance requires employers to file corrected information returns and furnish corrected withholding statements for 2005 to report amounts not reported under these suspension provisions, the IRS

will not impose penalties on the amounts includible in an employee's or non-employee's gross income in 2005 as long as the individual reports and pays any taxes due on these amounts during the grace period provided in that guidance. However, the individual will be required to pay interest on the late payment of those taxes. The IRS expects to issue additional reporting and withholding guidance during the first half of 2006.

If Prudential makes the benefit payments for your nonqualified deferred compensation plan, we will continue to produce Forms W-2 and 1099-MISC as we have in the past, reflecting the payment amounts in box 1 of Form W-2 and box 7 of Form 1099-MISC.

### **Pennsylvania Law Revises Tax Treatment of Nonqualified Deferred Compensation Benefits**

A 2004 ruling by the Commonwealth Court of Pennsylvania held that, for purposes of Pennsylvania personal income tax, voluntary employee contributions to an unfunded nonqualified deferred compensation plan were constructively received in the year earned. As a result, these amounts were subject to Pennsylvania income tax in the year in which the employee performed services, rather than the year the amounts were actually paid from the plan to the employee. In response to this surprising ruling, Pennsylvania House Bill No. 176 was signed into law on July 7, 2005. Effective for tax years beginning after December 31, 2002, this new law adopts the federal constructive receipt rules for purposes of applying Pennsylvania's personal income tax. It also adopts the nonqualified deferred compensation plan rules contained in AJCA (i.e., Code section 409A).

As a result of these changes, if an employer withheld Pennsylvania taxes on nonqualified deferred compensation contributions made by an employee in 2003 or 2004, the employee may request a refund of those amounts. Refund requests must be made within three years from the date the tax was paid.

Effective for tax years beginning after December 31, 2004, elective deferral amounts contributed to a nonqualified deferred compensation plan that complies with the AJCA section 409A rules are not subject to Pennsylvania taxation at the time of contribution. However, distributions of these amounts, and related earnings, are subject to Pennsylvania income tax at the time of distribution. These amounts likely do not qualify for Pennsylvania's exclusion from income as "old age or retirement benefits."

Employees who made nonqualified deferred compensation plan contributions between January 1, 2003, and December 31, 2005, should consult their tax advisors to determine whether they need to make adjustments to their Pennsylvania personal income taxes, for either overpayment or underpayment of taxes. Beginning January 1, 2006, if Prudential makes benefit payments from your nonqualified deferred compensation plan to employees who live in Pennsylvania, we will work with you to properly identify taxable and nontaxable distribution amounts.

It is important to note that nonqualified deferred compensation plan contributions that are not considered to be elective deferrals continue to be taxable at the time the contributions are made. However, they should qualify for the "old age or retirement benefits" exclusion at distribution and are not also taxable at that time.

### **Gulf Opportunity Zone Act of 2005 (GOZA) Revises Nonqualified Plan Requirements**

The Gulf Opportunity Zone Act of 2005 (GOZA) includes some technical corrections to AJCA. One of these corrections is clarification that the requirement for the delayed payment date to be at least five years from the original payment date when a participant elects to defer distributions applies to *all* payments, not just the initial payment.

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