



The Biweekly
Payroll
Compliance
Publication
Of The
American
Payroll
Association

PAYROLL CURRENTLY

Volume 17

Issue # 2

January 23, 2009

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Federal Contractors' Mandatory Use of E-Verify Delayed

The applicability date for Federal Acquisition Regulation (FAR) amendments requiring insertion of a clause into federal contracts committing contractors to use the E-Verify system to verify that new hires and current employees working on government contracts are eligible to work in the U.S. has been postponed from January 15, 2009, to February 20, 2009 [74 F.R. 1937, 1-14-09; <http://edocket.access.gpo.gov/2009/pdf/E9-651.pdf>].

On or after February 20, 2009, contracting officers:

- Must include the clause in solicitations issued and contracts awarded; and
- Must modify existing indefinite-delivery/indefinite-

quantity contracts to include the clause for future orders if the remaining period of performance extends beyond August 20, 2009, and the amount of work or number of orders expected under the remaining performance period is substantial.

Note: The FAR amendments were issued on November 14, 2008 (see **PAYROLL CURRENTLY**, Issue No. 24, Vol. 16). On December 23, the U.S. Chamber of Commerce filed a lawsuit seeking (1) a declaration that the regulations, and the executive order they implement, are illegal and void, and (2) an injunction barring their enforcement (see **PAYROLL CURRENTLY**, Issue No. 1, Vol. 17). The case is pending. ■

Obama Policy Agenda Likely to Have Big Impact on Payroll Departments

Even before his administration formally began, President Obama created a "policy agenda" identifying priorities he hopes to implement in the coming months [<http://change.gov/agenda>]. Note that none of these agenda items have been translated into legislation and voted on by Congress. Details are still under discussion and are not yet available. It is clear, however, that several of these items, if enacted into law, would have a big impact on the payroll department:

- **Increase the minimum wage.** This proposal would raise the minimum wage to \$9.50 an hour by 2011 and index it to inflation.

- **Making Work Pay tax cut.** This proposal would permanently cut taxes by \$500 per person (\$1,000 per family). Ideas under discussion for implementing this proposal include reduced federal income tax withholding,

and a payroll tax holiday (see "Inside Washington" for January 2009), and rebate checks (based on tax year 2007 returns).

- **Tax cut for seniors.** This proposal would eliminate all income taxation of seniors making less than \$50,000.

- **Reverse certain Bush tax cuts.** This proposal would reverse most of the Bush tax cuts for the wealthiest taxpayers (i.e., families making over \$250,000). Ideas under discussion for implementing this proposal include immediate reversal of certain provisions of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 vs. allowing them to "sunset" (i.e., expire) on January 1, 2011.

- **Earned Income Tax Credit expansion.** This proposal would expand the EITC so that full-time workers making minimum wage would get a benefit of more than three

Payroll Solutions

Q. An employee recently won a lawsuit against our company for unlawful sex discrimination in violation of Title VII of the Civil Rights Act of 1964. The judgment includes an award of back pay for amounts the employee should have earned during the years in issue. How should I report this?

A. *Rules for IRS reporting.* Report the back pay award on your current quarterly Form 941, and on the employee's Form W-2 for the year the award was paid, in Boxes 1, 3, and 5. When an employee wins a lawsuit or settlement against an employer for alleged violations of federal or state employment laws (e.g., wage-hour, anti-discrimination), the amounts awarded are often considered to be back pay for wages unlawfully denied. As such, the IRS has generally ruled that they are subject to federal income tax withholding and social security, Medicare, and FUTA taxes.

In most instances, taxable back pay awards should be treated as wages in the year paid rather than the year earned for income withholding and employment tax purposes. Other amounts awarded by a court, such as interest, court costs, and attorneys' fees, are not treated as wages if they are distinguished from the back pay award.

Different rules for SSA reporting. Do not prepare Form W-2 or W-2c to allocate this back pay award to earlier years for social security wage purposes. Instead, prepare a special report and send it to: Social Security Administration, Office of Central Operations, Metro West, Attn: Back Pay (DERO) Analyst Staff, 300 North Greene Street, Baltimore, MD 21202.

For social security coverage and benefit purposes, all back pay is wages except amounts specifically designated otherwise, such as compensatory damages, interest, penalties, and legal fees. However, the determination of when the back pay is credited as earnings depends on whether the back pay is awarded under a statute. The SSA credits back pay awarded under a statute, such as the Civil Rights Act, as wages for allocation purposes to an individual's earnings record in the period it should have been paid. Wages not credited to the proper year may result in lower social security benefits or the failure to qualify for benefits. Unless you notify SSA of the proper allocation of the back pay, it will be posted to the employee's earnings record in the year it is reported on Form W-2.

For more information on reporting back pay, see *The Payroll Source*®, pp. 3-63 to 3-68.

times what they can currently claim. If they are paying child support to support their children, their benefit would be doubled. The proposal would also reduce the EITC marriage penalty.

- **Family and Medical Leave Act expansion.** This proposal would expand the FMLA to cover businesses with 25 (currently 50) or more employees. The proposal would also permit leave for more purposes, including participation in children's academic activities (24 hours per year), leave for workers who care for individuals who reside in their home for six months or more, and leave for employees to address elder care, domestic violence, and sexual assault.

- **Extend paid sick time benefits.** This proposal would require that employers provide seven paid sick days per year.

- **Encourage states to adopt paid leave.** This proposal would establish a fund to assist states with start-up costs and to help states offset the costs of paid leave systems.

- **National Health Insurance Exchange.** This proposal is to establish an exchange with a range of private insurance options as well as a new public plan based on benefits available to members of Congress that will allow individuals and small businesses to buy affordable health coverage.

- **Small Business Health Tax Credit.** This proposal is for a new tax credit to help small businesses provide affordable health insurance to their employees.

- **Coverage of catastrophic health costs.** This proposal would cover a portion of the catastrophic health costs businesses pay in return for lower premiums for employees.

- **Large employer health care mandate.** This proposal would require large employers that do not offer coverage or make a meaningful contribution to the cost of health coverage for their employees to contribute a percentage of payroll toward the cost of their employees' health care.

- **American Jobs Tax Credit.** This proposal is for a

new temporary tax credit available during 2009 and 2010. Existing businesses would receive a \$3,000 refundable tax credit for each additional full-time employee hired in the U.S.

- **UI benefit extension and temporary suspension of taxes on these benefits.** This proposal would extend unemployment insurance benefits for 13 weeks and temporarily suspend taxes on UI benefits in order to increase relief.

- **Automatic pension plan enrollment.** Under this proposal, workers would automatically be enrolled in their workplace pension plans. An employer that does not currently have a plan would be required to enroll employees in a direct deposit IRA account compatible with existing direct deposit payroll systems. Employees could opt out of these plans.

- **Penalty-free hardship withdrawals from IRAs and 401(k) plans.** This proposal would allow withdrawals in 2008 (retroactively) and 2009 of 15% up to \$10,000 from retirement accounts without penalty (although subject to normal taxes).

- **Retirement savings incentives.** This proposal would match 50% of the first \$1,000 of savings for families that earn less than \$75,000. The savings match would be automatically deposited into designated personal accounts.

- **Increase immigration quotas.** This proposal would increase the number of legal immigrants in order to meet the demand for jobs.

- **Remove incentives to enter the U.S. illegally.** This proposal involves a pledge to crack down on employers that hire illegal aliens.

☞ **APA OFFERS ASSISTANCE TO NEW ADMINISTRATION IN IMPLEMENTING ECONOMIC STIMULUS PACKAGE** – In a January 12 letter to President-elect Obama, APA Executive Director Dan Maddux offered to assist in

upcoming efforts to implement an economic stimulus package: “We are prepared to be a sounding board for your team as you hammer out the details of your economic stimulus plan. In the past, we have shown Congress and previous administrations how proposed tax changes affect employers, their automated payroll systems, and their employees’ paychecks. We are confident that our input will help your team craft stimulus measures that will maximize benefits to taxpayers and minimize costs for employers.

This will provide a double benefit, by reducing the burden on American business and easing implementation while simultaneously saving money on that implementation. It will be a win-win for everyone.” To read the letter and an attachment with “Recommendations for Successful Delivery of an Economic Stimulus Via Workers’ Paychecks,” go to www.americanpayroll.org/pdfs/gov/09a15apa_letter_president-elect_obama.pdf. ■

IRS Issues 2009 Forms W-2 and W-3 and Instructions

The IRS has issued the 2009 Form W-2, *Wage and Tax Statement*, and Form W-3, *Transmittal of Wage and Tax Statements* (see *The Payroll Source*®, starting at p. 8-54). These forms, essentially unchanged from last year, along with the 2009 *Instructions for Forms W-2 and W-3*, are posted on the APA website at www.americanpayroll.org/members/Forms-Pubs/#tax. Items to note include:

- **Undeliverable Forms W-2.** Keep for four years any employee copies of Forms W-2 that you tried to but could not deliver. However, if the undelivered W-2 can be produced electronically through April 15th of the fourth year after the year of issue, you do not need to keep undeliverable employee copies. Do not send undeliverable Forms W-2 to the Social Security Administration.

- **Military differential pay.** Payments made after 2008 to former employees while they are on active duty for more than 30 days in the armed forces or other uniformed services are now treated as wages for federal income tax withholding purposes. Report these payments in Box 1 of Form W-2 (see *PAYROLL CURRENTLY*, Issue No. 11, Vol. 16).

- **Reporting for nonqualified deferred compensation plans.** You are not required to complete Box 12 with Code Y (deferrals under nonqualified plans subject to §409A) (see *PAYROLL CURRENTLY*, Issue No. 23, Vol. 16).

- **Electronic payee statements.** If your employees give their consent, you may be able to furnish Copies B, C, and 2 of Forms W-2 to them electronically. See Pub. 15-A for additional information (www.americanpayroll.org/members/Forms-Pubs/#annual).

- **Online filing of Forms W-2 and W-3.** You may file Forms W-2 and W-3 electronically by visiting the Social Security Administration’s website at www.socialsecurity.gov/employer and selecting “Business Services Online (BSO).” Once registered, you can upload electronic wage files or use SSA’s “Create Forms W-2 Online” to send electronic information to the SSA. W-2 Online allows you to create “fill-in” versions of Forms W-2 for filing with the SSA and to print out copies of the forms for filing with state or local governments, distribution to your employees, and for your

records. Form W-3 will be calculated for you based on your Forms W-2.

- **Extended due date for electronic filers.** If you file your 2009 Forms W-2 with the Social Security Administration electronically, the due date is extended to March 31, 2010. For information on how to file electronically, visit the SSA website at www.socialsecurity.gov/employer.

- **Substitute forms.** If you are not using the official IRS form to furnish Form W-2 to employees or to file with the SSA, you may use an acceptable substitute that complies with the rules in Pub. 1141, *General Rules and Specifications for Substitute Forms W-2 and W-3*. Pub. 1141, which is revised annually, is a revenue procedure that explains the requirements for format and content of substitute Forms W-2 and W-3. *Note:* Your substitute forms must comply with the requirements of Pub. 1141.

- **Distributions from governmental §457(b) plans of state and local agencies.** Generally, report distributions from §457(b) plans of state and local agencies on Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, not Form W-2. See Notice 2003-20 for details (www.irs.gov/pub/irs-irbs/irb03-19.pdf).

- **Earned income credit (EIC) notice.** Employers must notify employees who have no income tax withheld that they may be able to claim an income tax refund because of the EIC. Do this by using the official IRS Form W-2 with the EIC notice on the back of Copy B or a substitute Form W-2 with the same statement. Give your employees Notice 797, *Possible Federal Tax Refund Due to the Earned Income Credit (EIC)*, or your own statement that contains the same wording if (a) you use a substitute Form W-2 that does not contain the EIC notice, (b) you are not required to furnish Form W-2, or (c) you do not furnish a timely Form W-2 to your employees.

- **Form 944.** Use the “944” checkbox in Box b of Form W-3 if you filed Form 944, *Employer’s Annual Federal Tax Return*. Also use the “944” checkbox if you filed Form 944(SP), the Spanish version of Form 944. ■

SSA Says Special Wage Payments Can Now Be Submitted Electronically

Wage payments made to employees after they retire and payments of back pay awarded by a court or government agency are considered special wage payments (SWPs). Businesses are required to submit information regarding SWPs to the Social Security Administration (SSA) for the purpose of computing an employee’s social security benefits.

Beginning January 26, 2009, employers and payroll companies will be able to upload and electronically submit SWP data using SSA’s Business Services Online [www.ssa.gov/

www.ssa.gov/bsowagenews.htm].

SSA will also continue to accept SWPs via paper Form SSA-131, computer tape, or cartridge models 3490 and 3480. However, note that diskettes and other cartridge models will not be accepted.

For more information, see IRS Publication 957, *Reporting Back Pay and Special Wage Payments to the Social Security Administration* (www.irs.gov/pub/irs-pdf/p957.pdf), or contact the Employer Services Liaison Officer (ESLO) for your region (www.ssa.gov/employer/wage_reporting_specialists.htm). ■

OCSE Issues Final Rules Implementing DRA Child Support Enforcement Provisions

The Office of Child Support Enforcement (OCSE) has issued final rules implementing applicable provisions of the Deficit Reduction Act of 2005 (DRA; Pub. L. No. 109-171; see [PAYROLL CURRENTLY, Issue No. 6, Vol. 14](#)) [73 F.R. 74898, 12-9-08; <http://edocket.access.gpo.gov/2008/pdf/E8-28660.pdf>]. The rules are effective February 9, 2009.

Annual \$25 fee. The DRA requires states to impose an annual fee of \$25 in the case of an individual who has never received assistance under a state IV-A program and for whom the state has collected at least \$500 of support. The final rules clarify that a condition for the fee requirement is that the state has “collected and” disbursed at least \$500 of support to the family. The final rules also clarify that “assistance” includes former Aid to Families With Dependent Children (AFDC) program assistance, assistance under a state Temporary Assistance for Needy Families (TANF) program, and assistance under a tribal TANF program.

Under the final rules, the IV-D (i.e., Title IV-D of the Social Security Act) agency in the *initiating* state imposes the annual \$25 fee in interstate cases. The rules prohibit collection of the \$25 annual fee from a foreign obligee in an international case receiving IV-D services, or from individuals who are required to cooperate with the IV-D program as a condition of food stamp eligibility.

Finally, the rules clarify the conditions under which the noncustodial parent may be charged the fee and the fee retained

from a child support collection. Therefore, the noncustodial parent need not have designated a portion of the support payment as the fee.

Disabled adult children. The DRA eliminates the restriction preventing access to the federal tax refund offset program to disabled adult children and allows states to collect past-due child support owed in cases where the IV-D agency is providing services, including cases where the child is not a minor. The final rules implement this provision by modifying certain definitions. For example, the definition of “qualified child” now means “a child who is a minor or who, while a minor, was determined to be disabled ... and for whom a support order is in effect.”

Disbursement of amounts collected. The DRA allows states to choose either to apply amounts collected, including amounts from federal tax refunds, toward any support owed to the family first or to pay any past-due support assigned to the state first. States elect which distribution priority in former-assistance cases to use under their IV-D programs. The final rules implement this provision by making conforming technical changes.

Review and adjustment of orders. The DRA requires states to review and, if appropriate, adjust child support orders in cases receiving TANF at least once every three years. The final rules clarify that the time frame for the review of an order begins with the establishment of the order or the most recent review of the order, whichever is later. ■

IRS Releases Form 1099-MISC for 2009

The IRS has released Form 1099-MISC, *Miscellaneous Income*, for 2009. The form is virtually unchanged from 2008. Both the form and the *2009 Instructions for Form 1099-MISC* are available for downloading on the APA website at www.americanpayroll.org/members/Forms-Pubs/#tax. This form is used by businesses to report certain payments to nonemployees (e.g., independent contractors, health care providers, attorneys). Items to note include:

- **New due date for statements sent to recipients.** The due date for furnishing statements to recipients has been changed to February 15 for statements due after 2008 if substitute payments are being reported in Box 8 or gross proceeds paid to an attorney are being reported in Box 14.

- **Military differential pay.** Payments made after 2008 to former employees while they are on active duty for more

than 30 days in the armed forces or other uniformed services are not reported on Form 1099-MISC. Report those payments on Form W-2 instead (see [PAYROLL CURRENTLY, Issue No. 11, Vol. 16](#)).

- **Death benefits.** Death benefits from qualified and nonqualified deferred compensation plans paid to the estate or beneficiary of a deceased employee are now reported on Form 1099-MISC instead of Form 1099-R.

- **Payments to individuals in medical research studies.** Payments made to individuals in medical research studies are reported in Box 3.

- **Completing Box 15a not required.** You are not required to complete Box 15a (deferrals under nonqualified plans subject to §409A) (see [PAYROLL CURRENTLY, Issue No. 23, Vol. 16](#)). ■

Wage and Hour Division Recovered Over \$185 Million in Back Wages in Fiscal Year 2008

The U.S. Department of Labor's Wage and Hour Division reports that it recovered \$185,287,827 in back wages for 228,645 workers in fiscal year 2008 (10-1-07 through 9-30-08) [www.dol.gov/esa/whd/statistics/2008FiscalYear.pdf]. The number of complaints registered with the Division decreased for the fourth year in a row to 23,845 (from 24,950), the amount collected decreased \$35 million (from \$220,613,703), and the number of workers receiving back wages was down 112,979 (from 341,624).

The Wage and Hour Division notes that the decline in the number of registered complaints reflects an emphasis on

complaint intake strategies that screen incoming calls and correspondence to ensure that an issue is properly within its enforcement jurisdiction. The percentage of Wage-Hour complaint investigations that found “no violation” remained low at 20% as a result of this strategy.

Fair Labor Standards Act

The overwhelming majority of cases handled by the Wage and Hour Division involve the FLSA. In 2008, \$140,243,801 in back wages was collected for FLSA violations, down from \$180,678,826 in 2007. Of the FLSA back wages collected in 2008, nearly \$12.8 million was

collected for violations of the white collar exemption regulations (down from \$16 million in 2007). The violation cited in the greatest number of cases was one in which the employee did not meet the duties test required for exempt executive employees. Violations of the executive duties test were cited in 524 cases and resulted in back wages of \$3.4 million for approximately 2,600 employees. Although cited in fewer cases, back wages resulting from determinations that employees failed to meet the duties test for exempt administrative employees were nearly \$4 million and affected approximately 2,900 employees.

Employers were assessed \$3.1 million in civil money penalties in 2008, down from \$3.9 million in 2007.

Family and Medical Leave Act

In 2008, the Wage and Hour Division collected \$1,532,505 in back wages for FMLA violations, down from \$1,573,501 collected in 2007. The number of violation cases decreased to 995 (from 1,087), and the number of employees affected by FMLA violations decreased to 1,082 (from 1,675).

According to the DOL, termination of employees seeking FMLA leave continues to be the primary reason that complaints are filed. Of 1,889 complaints filed in 2008, 757 alleged termination violations.

Low-wage industries

The Wage and Hour Division continues to pursue FLSA compliance in low-wage industries that employ young and immigrant workers.

- Back wages collected for restaurant workers totaled \$18,917,992 in 2008 (up from \$17,432,805 in 2007), while the number of restaurant workers receiving back wages was 23,433 (down from 27,661).

- Back wages collected for health care workers were \$11,403,813 in 2008 (up from \$9,899,417 in 2007), while the number of workers receiving back wages was 15,768 (down from 17,488).

- Back wages collected for janitorial service workers fell

to \$3,469,956 in 2008 (down from \$6,972,362 in 2007), and the number of workers receiving back wages decreased to 5,417 (from 8,420).

- Back wages collected for guard service workers totaled \$13,595,350 in 2008 (up from \$7,545,704 in 2007), and the number of workers receiving back wages increased to 13,138 (from 11,584).

Child labor

The Wage and Hour Division continues to pursue targeted enforcement of the FLSA's child labor provisions. In 2008, child labor investigations decreased slightly to 1,269 (from 1,285 in 2007) and the number of violations found decreased to 1,129 (from 1,249), while the number of minors found illegally employed increased to 4,734 (from 4,672).

Hazardous Occupation (HO) violations were found in 41% of the cases with violations. Violation of HO No. 12 (paper balers) was the most common violation, followed by violation of HO No. 11 (dough mixers).

Employers were assessed \$4.2 million in child labor civil money penalties in 2008, down from \$4.4 million in 2007.

Fiscal year 2009 initiatives

In fiscal year 2009, the Wage and Hour Division will maintain a presence in recently affected areas of the Texas Gulf Coast region as clean-up and reconstruction activities continue. In addition, the Division will continue FLSA enforcement efforts in low-wage industries such as restaurants, health care, hotels and motels, grocery stores, day care, and construction, where it is most likely to find minimum wage and overtime violations. Child labor initiatives will be concentrated in shopping malls, retail stores, and theaters, where employers are most likely to employ young workers in violation of HO No. 12. Wage-Hour investigators will continue to look for situations where employers' misclassification of employees as independent contractors results in FLSA violations. And the Division will continue to focus on increasing compliance among prior violators. ■

IRS Memo Discusses Interest-Free Adjustments to Employment Tax Underpayments

In a legal memorandum, the IRS discusses the connection between an interest-free adjustment under IRC §6205 and an accuracy-related penalty under §6662(b)(1), and concludes that there is no link between the two provisions. It addresses the question of whether application of the accuracy-related penalty to an employment tax underpayment precludes a taxpayer from receiving an interest-free adjustment for the amount of the underpayment [ILM 200846022, 10-6-08; www.irs.gov/pub/irs-wd/0846022.pdf].

On the one hand, the accuracy-related penalty imposed under §6662(b)(1) applies to various types of culpable behavior. On the other hand, neither §6205 nor the

regulations under that section define the term "error" for purposes of determining when an interest-free adjustment may be made. As a practical matter, the same facts that indicate that the penalty is warranted may also indicate that there was no error for purposes of §6205 or that the employer knowingly underreported its liability so that no interest-free adjustment is available.

Therefore, an interest-free adjustment should not be denied solely because the accuracy-related penalty is imposed. Rather, based on the facts, the examiner should determine if the employer is entitled to an interest-free adjustment under the applicable guidance. ■

IRS Issues Proposed Regulations on §409A Income and Tax Calculations: Part II

The IRS has issued proposed regulations on the calculation of amounts includible in income under IRC §409A(a) as well as the additional taxes applicable to such income [73 F.R. 74380, 12-8-08; <http://edocket.access.gpo.gov/2008/pdf/E8-28894.pdf>].

Calculating the amount deferred that is included in income: three steps

To calculate the amount includible in income upon a failure to meet the requirements of §409A(a):

- The first step is to determine the total amount deferred

under the plan for the service provider's taxable year and all preceding years. *Note:* This step was covered in **PAYROLL CURRENTLY, Issue No. 25, Vol. 16.**

- The second step is to calculate the portion of the total amount deferred for the taxable year, if any, that is either subject to a substantial risk of forfeiture (nonvested) or that has been included in income in a previous taxable year.

- The third step is to subtract the amount determined in step two from the amount determined in step one. The excess of the amount determined in step one over the amount determined in step two is the amount includible in income and subject to additional income taxes for the year as a result of the plan's failure to comply with §409A(a).

Calculation of amounts includible in income

The portion of the total amount deferred for a taxable year that was either subject to a substantial risk of forfeiture or had previously been included in income would not be includible in income under §409A.

Determining the portion of the total amount deferred for a taxable year that is subject to a substantial risk of forfeiture. In general, the proposed regulations provide that the portion of the total amount deferred for a taxable year that is subject to a substantial risk of forfeiture (nonvested) is determined as of the last day of the service provider's (employee's) taxable year. Accordingly, all amounts that vest during the taxable year in which a failure occurs would be treated as vested for purposes of §409A(a), regardless of whether the vesting event occurs before or after the failure to meet the requirements of §409A(a).

For example, if a plan fails to comply with §409A(a) due to an operational failure on July 1 of a taxable year, and the substantial risk of forfeiture applicable to an amount deferred under the plan lapses as of October 1 of the same taxable year, that amount would be treated as a vested amount for purposes of determining the amount includible in income for the taxable year.

Determining the portion of the total amount deferred for a taxable year that has been previously included in income. For a deferred amount to be treated as previously included in income, the proposed regulations would require that the service provider actually and properly have included the amount in income in accordance with the IRC. This would include amounts reflected on an original or amended return filed before expiration of the applicable statute of limitations on assessment and amounts included in income as part of an audit or closing agreement process.

In addition, a deferred amount would be treated as an amount previously included in income only until the amount is paid. Accordingly, if a deferred amount is paid in the same taxable year in which an amount is included in income under §409A, or all or a portion of an amount previously included in income is allocable to a payment made under the plan, in subsequent taxable years that amount would not be treated as an amount previously included in income. For example, if an employee includes \$100,000 in income under §409A(a), and \$10,000 of that amount consists of a payment under the plan during the taxable year, only \$90,000 would remain to be treated as a deferred amount previously included in income.

Treatment of failures continuing during more than one taxable year

Each of the service provider's taxable years would be analyzed independently to determine if amounts were

includible in income under §409A(a). Generally, this means that a service provider who includes in income under §409A(a) all amounts deferred under a plan for a taxable year would not be relieved of the requirement to include amounts in income for an earlier taxable year in which a failure also occurred.

This rule generally would prohibit a service provider from selecting from among several previous taxable years the most favorable year in which to include income. However, if an amount was actually and properly included in income under §409A(a) in a previous year, the amount would be treated as an amount previously included in income for purposes of all subsequent years. Accordingly, this rule would never make the same amount includible in income twice under §409A(a).

For example, assume an employee participates in a nonqualified deferred compensation plan and defers \$10,000 each year, is credited annually with interest at 5%, and receives no payments under the plan. The employee's total amount deferred would be \$10,500 for Year 1, \$21,525 for Year 2, and \$33,101 for Year 3. If the nonqualified deferred compensation plan fails to meet the requirements of §409A(a) in each year, the employee would be required to include \$10,500 in income under §409A(a) for Year 1, \$11,025 in income for Year 2, and \$11,576 in income for Year 3. If the employee includes \$33,101 in income under §409A(a) for Year 3, the employee would not have properly reported income for Year 1 and Year 2. However, an amount included in income for Year 3 would be treated as previously included in income for purposes of any further failures in subsequent years. In addition, if the employee subsequently properly includes amounts in income for Year 1 and Year 2 on amended returns, the employee could claim a refund of the tax paid on the excess amounts included in income for Year 3.

Similar consequences apply to the employer. If the employer fails to report and withhold on amounts includible in income under §409A(a) in Year 1 and Year 2, the employer could not avoid liability for the failure to withhold in Year 1 and Year 2 by reporting the full amount and withholding in Year 3.

Premium interest tax

If compensation is required to be included in gross income under §409A(a), the income tax imposed is increased by an amount equal to the amount of interest determined under §409A(a)(1)(B)(ii) – an additional income tax known as a “premium interest tax.” It is determined as the amount of interest at the underpayment rate plus one percentage point on the underpayments that would have occurred had the deferred compensation been includible in gross income for the taxable year in which first deferred or, if later, the first taxable year in which such deferred compensation is not subject to a substantial risk of forfeiture (i.e., vested).

Amounts to which the premium interest tax applies.

Under the proposed regulations, the amount required to be included in income under §409A(a) for the taxable year is the only deferred amount required to be allocated to previous taxable years for purposes of determining the premium interest tax. For example, assume an employee who participates in a plan has a total amount deferred in Year 1 of \$100,000 and a total amount deferred in Year 2 of \$80,000 due to deemed investment losses in Year 2. If the plan fails to meet the requirements of §409A in Year 2 (and not Year 1), the employee is required to include \$80,000 in income under §409A(a). In calculating the premium interest

tax, the employee must allocate only the \$80,000 required to be included in income under §409A(a) to the year or years the amount was first deferred or vested, even though additional amounts were deferred under the plan in previous taxable years.

Identifying amounts deferred in a particular taxable year. To calculate the premium interest tax, the taxable year(s) during which the amount required to be included in income was first deferred or first vested must be determined. Under the proposed regulations, the amount deferred during a particular taxable year generally is the excess (if any) of the vested total amount deferred for that taxable year over the vested total amount deferred for the immediately preceding taxable year.

For example, if a service provider first participated in a plan in the taxable year 2010 and has a vested total amount deferred under the plan for 2010 of \$10,000, a vested total amount deferred for 2011 of \$15,000, and a vested total amount deferred for 2012 of \$25,000, then the service provider would be treated as having first deferred \$10,000 during 2010, \$5,000 during 2011, and \$10,000 during 2012.

Identifying the initial year of deferral. Under the calculation method set forth in the proposed regulations, payments, deemed investment or other losses, and amounts included in income during taxable years before the year in which the failure occurs, generally are attributed to amounts deferred and vested in the earliest year or years in which there are amounts deferred. The proposed calculation method generally achieves this result by reducing the amount deferred for each year preceding the payment or deemed investment or other loss, and treating only the remaining deferred amounts as the source of the outstanding deferrals and payments includible in income under §409A for the year in which the failure occurs. Note that this proposed rule generally should result in the lowest possible amount of premium interest tax, because deferred amounts includible in income under §409A would be treated as first deferred and vested in the latest possible years, resulting in less premium interest on the hypothetical underpayments.

Calculating the hypothetical underpayment. The hypothetical underpayment would be calculated as if the amount were paid to the service provider as a cash payment of compensation during the taxable year. It would be calculated based on the taxpayer's taxable income, credits, filing status, and other tax information for the year, based on the original return the taxpayer filed for such year, as adjusted by an examination or amended return. The hypothetical underpayment would reflect the effect that such additional compensation would have had on the amount of federal income tax owed by the taxpayer for such year.

Other potential effects of the additional compensation payment on service provider or service recipient actions or elections would not be taken into account, including how such additional compensation could have affected participation in an employee benefit plan or other arrangement. For example, the impact such additional compensation would have had on contributions to a qualified plan – even if the additional compensation would have affected the amount the service provider would have been permitted or required to contribute – would be disregarded.

Treatment of payments or losses of deferred amounts in taxable years after they are included in income

Payments. Any amount included in gross income under §409A is not required to be included in gross income under

any other provision of the Code. Accordingly, if a service provider includes an amount in income under §409A, the proposed regulations provide for a type of deemed basis such that the amount would not be required to be included in income again (e.g., when the amount was actually paid).

Accordingly, if an amount under a plan would be includible in income if §409A were disregarded (e.g., because an amount is paid under the plan), the amount previously included in income would be immediately applied to the amount paid under the plan such that the amount paid would not be required to be included in gross income a second time.

The employee could not elect the extent to which the amount previously included in income would be applied in this context. Rather, the amount previously included in income would be required to be applied immediately to the extent an amount deferred under the same plan would otherwise become includible in income under a Code section other than §409A. Note that this rule would not affect the potential for earnings related to such amounts to be required to be included in income under §409A.

Forfeitures or losses. The application of §409A(a) may require inclusion in income of amounts that the service provider ultimately never receives. The proposed regulations provide that a service provider who is required to include an amount in income under §409A(a) with respect to a deferred amount under a nonqualified deferred compensation plan is entitled to a deduction at the time his or her right to all deferred compensation under the plan is permanently forfeited under the plan's terms, or the right to such compensation is otherwise permanently lost. The available deduction would equal the excess of the amount included in income under §409A(a) in a previous year over any amount actually or constructively received by the service provider.

A right to an amount would not be treated as permanently lost merely because the deferred amount had decreased (e.g., due to deemed investment losses), if the service provider retains a right to any amount deferred under the plan. Note, however, that the right to an amount would be treated as permanently lost if the right to the payment of the amount becomes wholly worthless. In addition, a right to an amount would not be treated as permanently forfeited or otherwise lost if the obligation to make such payment is substituted for another deferred amount or obligation to make a payment in a future year.

Effective date

The regulations are proposed to be generally applicable for taxable years beginning on or after the issuance of final regulations. Before the applicability date of the final regulations, taxpayers may rely on the proposed regulations in complying with the includible income and additional tax calculation provisions of Notice 2008-115 (see [PAYROLL CURRENTLY](#), Issue No. 26, Vol. 16).

Comments

Comments on the proposed regulations must be received by March 9, 2009. Send written comments to: CC:PA:LPD:PR, Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Or submit comments electronically at: www.regulations.gov. Be sure to reference IRS REG-148326-05. ■



STATE AND LOCAL NEWS

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EITC notice requirement: four states. Four states require employers to notify employees of the federal Earned Income Tax Credit (EITC):

California – An employer must notify *all* employees in California that they may be eligible for the EITC within one week before or after, or at the same time that the employer provides a Form W-2, *Wage and Tax Statement*, to any employee (see *The Payroll Source*®, p. 6-43). The employer must provide the notification by handing it directly to the employee or mailing it to the employee's last known address. The notification can be either: (1) instructions on how to obtain any notices available from the IRS for this purpose, including Notice 797, *Possible Federal Tax Refund Due to the Earned Income Credit (EIC)*, and Form W-5, *Earned Income Credit Advance Payment Certificate*; or (2) a notice created by the employer, so long as it contains substantially the same language as the sample notice provided in the law (download a sample notice at www.wedd.cahwnet.gov/Payroll_Taxes/pdf/EarnedIncomeTaxCredit.pdf).

Illinois – An employer that is subject to and is required to provide unemployment insurance to its employees must notify any employee whose gross wages do not exceed the maximum amount that might qualify for the EITC. The employer must give or mail any notice available from the IRS or any notice created by the employer as long as it contains substantially the same language. The notice must be furnished within one week before or after, or at the same time that the employer provides a Form W-2 to the employee.

Louisiana – A business establishment that has 20 or more employees must notify new employees, whose anticipated wages are \$35,000 or less per year, that they may be eligible for the EITC. The employer must provide written notice from the IRS or the Louisiana Workforce Commission (see www.laworks.net/Downloads/Posters/2008_Earned_Income_Credit_itr_color.pdf) at the time of hiring. This information must also be posted with other notices required by state and federal law.

New Jersey – All public and private employers must give written notice to eligible employees of the availability of both the federal and state EITC when the employer gives the employee his or her Form W-2. The notice must be distributed between January 1 and February 15 of each year to coincide with the employer's distribution of Forms W-2. The written notice must use the statement developed by the New Jersey State Treasurer (see www.state.nj.us/treasury/taxation/pdf/eitcstatement.pdf).

Alabama

Mandatory electronic W-2 filing threshold lowered. Effective 1-1-09, employers and withholding agents submitting 100 or more (was 250 or more) Forms W-2 must file electronically through the Department of Revenue's (DOR) website at www.revenue.alabama.gov/withholding/efiling.html (this updates *The Payroll Source*®, p. 8-103). Effective 1-1-10, the threshold will decrease to 50 or more Forms W-2. Employers and withholding agents that are required to file Forms W-2 electronically must also file Form A-3, *Annual Reconciliation of Alabama Income Tax Withheld*, electronically. Download the W-2 electronic filing specifications at [www.revenue.alabama.gov/Withholding/Form_10\(12-08\).pdf](http://www.revenue.alabama.gov/Withholding/Form_10(12-08).pdf) [Ala. Adm. Code §810-3-75-.03; DOR, Form 10, *Specifications for Filing W-2 Forms Electronically*, rev. 12-08].

District of Columbia

Mandatory electronic filing process for Forms W-2 implemented. Beginning January 2009, the Office of Tax and Revenue (OTR) is implementing an electronic filing W-2 process (EFW2) at www.taxpayerservicecenter.com (select "Business Tax Service Center" and register for eTSC). Employers that file more than 50 Forms W-2 must file electronically by 3-31-09. Magnetic media will no longer be accepted (this updates *The Payroll Source*®, p. 8-103). Download online W-2 filing instructions at <http://otr.cfo.dc.gov/otr/cwp/view.asp?a=1330&Q=594086>. Electronic filers that do not use OTR's website must obtain software from SSA-approved software vendors [OTR, News Release, 1-7-09].

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PAYROLL CURRENTLY NEWSLETTER

Payroll Currently (ISSN 1065-6529) is published biweekly by The American Payroll Institute Inc., in cooperation with The American Payroll Association, 30 East 33rd Street, 5th Floor, New York, NY 10016-5386; Tel: 212-686-2030; Fax: 212-686-4080. Payroll Currently is designed to provide authoritative information in regard to the subject matter covered. It is provided with the understanding that the publisher is not engaged in rendering legal, accounting or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought. © Copyright 2009 American Payroll Association. All rights reserved. Printed in the USA.