IRS REVISES §409A CORRECTIONS PROGRAM (BUT IT'S NO PANACEA)

January 22, 2009

To Our Clients and Friends:

The IRS has updated its §409A corrections program in Notice 2008-113.[1] The available corrections program applies only to "inadvertent" and "unintentional" operational failures to comply with §409A. Thus, this relief will be helpful in correcting certain administrative errors, if the several conditions for using the corrections program can be satisfied:

- The terms and conditions of the deferred compensation arrangement must comply with §409A (that is, the arrangement must be in written compliance with §409A).
- The service recipient must take commercially reasonable steps to avoid a similar operational failure from happening again.
- The service recipient must notify the IRS that it utilized the corrections program and provide the IRS with specified information about the failure and the corrective measures taken.
- Additional technical requirements must be followed to rely on the available relief. For example, there are detailed rules addressing how, when and in what amounts a service provider must repay a service recipient for deferred compensation that was paid to the service provider before it was due and requirements addressing how, when and in what amounts the deferred compensation must be paid (again) to the service provider.

Moreover, the corrections program is not available if the service recipient is experiencing "financial issues" indicating that the service recipient will not have means to pay the deferred compensation when due, and some of the corrections are not available to so-called "insiders" (*i.e.*, those persons who are, or would be if the service recipient were a registered entity under the Securities Exchange Act of 1934, as amended, executive officers, directors and 10% shareholders).

The IRS also issued a notice and proposed regulations as to how income and the additional "premium interest" tax are to be calculated for purposes of determining service providers'

[1] *The IRS originally instituted the corrections program on December 3, 2007, by way of Notice 2007-100.*

tax liabilities under §409A, as well as the reporting and withholding obligations with respect to noncompliant arrangements. Those provisions are described in a separate Client Update.

AVAILABLE RELIEF

Corrections in the year failure occurs. These rules allow service recipients and service providers to correct inadvertent and unintentional service recipient failures in the year in which the failure occurs. The failures available for these corrections include: (i) payment of deferred compensation prior to the year in which it was due, (ii) payment of deferred compensation in the correct year, but more than 30 days prior to when it should have been paid, (iii) payment of deferred compensation to a "specified employee" in violation of the "6-month delay" rule, (iv) deferring more compensation than the service provider elected to defer, and (v) granting a discounted stock option or stock appreciation right.

In general, these corrections require "reversing" the failure by the end of the year in which the failure occurred. For example, if a service recipient paid deferred compensation too early, the service provider must generally repay the compensation to the service recipient by the end of the year (special rules apply if the service provider is financially unable to repay the compensation by the end of the year). Following repayment, the service provider must have a legally binding right to receive the deferred compensation either when it was originally scheduled to be paid or thereafter on a date determined pursuant to the technical rules set forth in the Notice.

Similarly, if the service recipient deferred too much compensation, the failure must be "reversed" by the service recipient paying the improperly deferred compensation to the service provider by the end of the year. If the service recipient granted a discounted stock option or stock appreciation right, the exercise price must be increased by the end of the year to the fair market value as of the grant date.

If a failure is corrected under these rules, the deferred compensation arrangement will not be subjected to §409A's adverse tax consequences by reason of the failure.

Corrections in the following year (for non-insiders only). These rules are essentially the same as the corrections described above, except that they are not available to "insiders." For individuals who are not insiders during the year in which the failure occurs and the immediately following year, the corrective actions described above (with some technical differences) may be taken by the end of the year immediately following the year in which the failure occurs. If a failure is corrected under these rules, the deferred compensation arrangement will not be subject to §409A's adverse tax consequences.

Corrections by the end of the second succeeding year. These rules are also essentially the same as the corrections described above, although they are available to "insiders." This

relief is not available, however, for discounted stock options and stock appreciation rights. Under this rule, if the corrective actions described above (with some technical differences) are taken by the end of the second year immediately following the year in which the failure occurs, only the amount in respect of the failure must be included in income for the year in which the failure occurred (the taxpayer may need to file an amended return for that year in order to give effect to this relief); the remaining portion of the mandatorily aggregated deferred compensation arrangements are not included in income. Moreover, although the 20% penalty tax applies to the amount that is included in income under §409A, the additional "premium interest" tax will not apply.

Failures involving limited amounts. Taxpayers may apply this rule only if the amount in respect of the failure for all deferred compensation arrangements that are mandatorily aggregated under §409A during the applicable year do not exceed the limit on elective deferrals that would apply to a qualified plan under §402(g)(1)(B) (the limit was $15,500 for 2008 and is $16,500 for 2009). Unlike the other relief available under the Notice, the failure does not have to be "reversed" to rely on this rule. Under this relief, only the amount attributable to the failure must be included in income for the year of failure; the remaining portion of the mandatorily aggregated deferred compensation arrangements are not included in income. Moreover, although the 20% penalty tax applies to the amount that is included in income under §409A, the additional "premium interest" tax will not apply.

The IRS is considering whether to issue additional relief, including additional corrections for operational failures and corrections for "written document" failures, and welcomes comments from taxpayers by March 6, 2009.

This memorandum was not intended or written to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer under U.S. federal tax law.

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