OOPS, YOU DISCOVERED A §409A VIOLATION: NOW WHAT?

January 22, 2009

To Our Clients and Friends:

For the past four years, you analyzed your deferred compensation arrangements and took action to make them §409A compliant. The time for fixing plans, however, has ended. All deferred compensation plans should now be in compliance with §409A and the final regulations, both in form and operation. But Murphy's Law dictates that you will discover an arrangement that does not comply or that an error has occurred in good faith that has caused an operational failure. The IRS recently issued guidance intended to decipher the consequences of a failure for service recipients and service providers:

- Notice 2008-115 (the "Notice") explains how income is to be calculated for purposes of determining service providers' tax liabilities under §409A, as well as the reporting and withholding obligations with respect to noncompliant arrangements.[1]
- In addition to the Notice, the IRS has promulgated proposed regulations (the "Proposed Regulations") addressing how income and the additional "premium interest" tax are to be calculated for §409A purposes. Taxpayers are not required to rely on the Proposed Regulations, but taxpayers who abide by the Proposed Regulations in their entirety will be deemed to comply with the Notice.

The IRS also issued a notice providing a limited ability to correct certain inadvertent and unintentional operational violations of §409A (but not documentary violations). That notice is described in a separate Client Update.

INCOME INCLUSION GUIDANCE

Tax Liability Determined Annually. The applicability of §409A to an amount of deferred compensation is determined independently each year. If the arrangement fails to comply with §409A at any point during the year, the deferred compensation subject to the arrangement (together with any other deferred compensation which is part of the same arrangement, as determined under §409A's plan aggregation rules) is includible in income for the year, to the extent the amount is not subject to a substantial risk of forfeiture and was not included in income in a prior year.

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[1] *Notice 2008-115 generally extends the guidance provided in Notices 2006-100 and 2007-89 applicable to 2005, 2006 and 2007.*

Income Inclusion Calculation. In general, for each year in which a violation is ongoing (regardless of when during the year the violation exists), the amount includible in income under §409A is equal to (i) the "value" of the deferred compensation determined as of December 31 of that year, *minus* (A) any portion of the amount that is then subject to a substantial risk of forfeiture, *minus* (B) any portion of the amount that was included in income in any prior year, *plus* (ii) the amount of any payments made under the arrangement during the year. To the extent that amounts are paid out of the arrangement during the year, they are no longer considered as part of the arrangement in any subsequent year.

> Example: An employee has a vested account balance under a voluntary elective deferred compensation plan of $100,000 at December 31, 2009, which grows to $110,000 by December 31, 2010. Assume that the employee has a right to receive a payment of the deferred account balance upon a "change in control," which is defined to include events that are broader than those treated as a change in control under §409A (and which does not constitute a substantial risk of forfeiture). The arrangement violates §409A because the amount is payable upon an impermissible event. If the "bad" change in control provision remains in the plan during *any* part of 2009 and *any* part of 2010, then the amount includible is $100,000 for 2009 and $10,000 for 2010.

Limited ability to fix plans. No amount must be included in income under §409A for the year if the arrangement complies with §409A at all times during the year. This rule affords taxpayers a limited ability to fix plans prospectively, so as to stop the bleeding. For instance, if the definition of "change in control" in the above example is amended during 2009 to fall within the meaning of §409A, and the arrangement otherwise complies with §409A during all of 2010, no amount would be includible under §409A for 2010. This rule may be particularly beneficial for unvested arrangements because, as noted above, amounts are includible under §409A only to the extent not subject to a substantial risk of forfeiture. Thus, if the right to receive the change in control payment in the above example was not vested as of December 31, 2009, $100,000 would not have been includible in income under §409A for 2009 either, resulting in no tax liability under §409A. This should not be used as a planning tool, however, because the IRS may disregard the vesting conditions for purposes of this rule if it perceives a pattern of abuse.

Rules for specific types of plans. Specific rules apply for determining the value of deferred compensation as of December 31 of the applicable year with respect to certain types of plans:

- *Short-Term Deferrals.* If a plan provides that an amount is payable within the "short-term deferral" period but payment is actually made after the period expires, the §409A violation is deemed to occur in the year in which the short-term deferral period expires.

- *Account Balance Plans*. The value of the deferred compensation is equal to the entire account balance as of December 31 of the applicable year.

- *Stock Options and Stock Appreciation Rights*. The value of the deferred compensation is equal to the spread value as of December 31 of the applicable year.

- *Non-Account Balance Plans with "Reasonably Ascertainable" Amount*. If the amount deferred is "reasonably ascertainable" as of December 31, the value of the compensation is equal to the "present value" of *all* future payments to which the employee has a legally binding right as of December 31 of the applicable year. For this purpose, an amount is generally considered "reasonably ascertainable" if the amount, form and commencement date of the normal benefit are known, and the only unknown variables are the interest and mortality rates. If alternative times and forms of benefit that are not actuarially equivalent are available, then the amount is not "readily ascertainable" until a form of benefit and a time of commencement are selected. The "present value" of deferred compensation as of December 31 is determined by the value of the amount(s) payable thereafter, (i) multiplied by the probability that any contingencies with respect to payment will be satisfied, and (ii) discounted to reflect the time value of money, based on reasonable assumptions and methods. For this purpose, the present value cannot be discounted for the unfunded status of the arrangement, investment risk, the unwillingness or inability of the employer to pay, future plan amendments or changes in law, or similar risks or contingencies.

- *All Other Plans*. For all other plans, the Notice requires that the amount deferred as of December 31 of the applicable year be determined pursuant to "a reasonable, good faith application of a reasonable, good faith method." The Notice presumes that the use of assumptions that result in the lowest potential value does not meet this standard absent "clear and convincing evidence" to the contrary.

The Proposed Regulations provide (among other things) additional and, in some cases, alternative assumptions for calculating the value of deferred compensation as of the last day of applicable year. For example, the Proposed Regulations assume that if an amount is payable upon a trigger event (such as a change in control), the event is deemed triggered at the earliest possible point based on the facts and circumstances as they exist on December 31. Notwithstanding this general rule, if an amount is payable upon a separation from service, the service provider is deemed to have separated as of December 31 – *even if the employee has not yet terminated employment*. As another example, if more than one time and form of payment is available, the Proposed Regulations assume that the value as of December 31

is equal to the *highest* potential value that may be assigned with respect to the available times and forms of payment.

As previously mentioned, although taxpayers are not required to rely on the Proposed Regulations, if a taxpayer chooses to rely on them, he or she may not do so selectively. This presumably does not preclude a taxpayer from applying assumptions in its use of a "reasonable, good faith method" that happen to be consistent with the assumptions found in the Proposed Regulations, without using all of the proposed assumptions.

Violation of 409A(b) Funding Rules. The Notice provides income inclusion rules for arrangements that violate §409A(b) (related to funding deferred compensation outside of the United States or by employers who, or whose qualified pension plans, are experiencing financial difficulty). The amount includible in income must be determined pursuant to "a reasonable, good faith application of a reasonable, good faith method." In general, this determination is made as of the date the service recipient funds the deferred compensation. The determination for certain arrangements that were funded as of March 21, 2006, and that were not brought into compliance with §409A(b) by December 31, 2007, however, is made as of January 1, 2008.

Reporting and Withholding. Until further guidance is issued, service recipients are not required to report amounts of deferred compensation that are not subject to or that comply with §409A. Service recipients must, however, report amounts that are includible in income under §409A (because the arrangement fails to comply with §409A during the year) on a Form W-2 (for employees) or Form 1099 (for other service providers). For withholding purposes, employers must treat the amounts that are deemed included in income as "supplemental wages" earned for the year in which the violation occurs. This means that the employer must effect withholding at the 25% supplemental wage rate for amounts that are deemed included in income under §409A but do not (together with other supplemental wages) exceed $1 million, and at the 35% rate for any portion in excess of $1 million. However, employers are not obligated to withhold for the additional 20% tax and "premium interest" tax imposed by §409A. Accordingly, employees should be aware that they may owe estimated taxes with respect to amounts includible in the employee's income.

"Premium Interest" Tax. Amounts includible in income under §409A are subject to two additional Federal income taxes: (i) a 20% tax and (ii) a "premium interest" tax. The Proposed Regulations contain detailed allocation and calculation rules for determining the "premium interest" tax. In general, the "premium interest" tax is assessed on a hypothetical underpayment of tax that would have resulted had the taxpayer included the amount of deferred compensation in the year in which it was vested (or, if the arrangement was in place before January 1, 2005, in 2005). Only that portion of the deferred compensation that is deemed to have been deferred and vested as of an earlier year is taken into account for this

purpose. The "premium interest" tax is assessed on the hypothetical "underpayment" from the year of vesting through the year in which the amount is actually included in income under §409A.

Deduction for Forfeited Amounts. A service provider is entitled to a deduction if the service provider permanently forfeits an amount of deferred compensation, or the deferred compensation is otherwise completely lost, to the extent the service provider previously included the amount in income under §409A. The Proposed Regulations highlight four circumstances under which deferred compensation may become permanently forfeited or completely lost: (i) the payor becomes bankrupt or ceases to exist, (ii) forfeiture as a result of failing to meet a vesting condition, such as breaching a non-compete, (iii) the deferred compensation becomes worthless as a result of investment losses, and (iv) if the payment is based on a formula, the application of the formula to actual results gives rise to a lesser amount than the amount previously included in income.

While the right to a deduction is welcome, it does not entirely offset the adverse §409A consequences. First, the deduction is available for the year in which the compensation is forfeited or becomes worthless, possibly many years after the employee paid the §409A taxes. Second, the deduction is subject to the limitations imposed on miscellaneous itemized deductions, such as the alternative minimum tax rules and being deductible only to the extent the amount exceeds 2% the taxpayer's adjusted gross income. Third, to the extent not subject to limitation, the deduction offsets income that is subject to regular income tax rates, and therefore does not "compensate" the employee for the additional 20% and "premium interest" taxes imposed by §409A.

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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