

Correction Program for Nonqualified Deferred Compensation Plans Offers Useful But Limited Assistance

December 5, 2007

On December 3, 2007, the Treasury Department and the Internal Revenue Service (IRS) issued Notice 2007-100 (Notice), which gives taxpayers a limited ability to correct certain operational failures of a nonqualified deferred compensation plan to comply with Section 409A of the Internal Revenue Code (Code) and applicable Treasury and IRS guidance (Section 409A). Under the Notice, unintentional operational failures that are corrected in the same taxable year the failures occur generally get broad relief from the income inclusion and additional taxes triggered under Section 409A. In addition, for limited unintentional operational failures occurring in taxable years beginning prior to 2010 that are corrected within two years after the year of failure, the Notice substantially limits the income inclusion and additional taxes otherwise applicable. The Notice also requests comments on a potential expanded corrections program that would limit the income inclusion and additional taxes under Section 409A for certain operational failures not eligible for the transition relief available under the Notice, including corrections that involve larger amounts and corrections made after 2010.

Background

Section 409A generally provides that all amounts deferred under a nonqualified deferred compensation plan are currently includible in gross income to the extent they are not subject to a substantial risk of forfeiture unless the plan meets specified restrictions, including, for example, restrictions as to the timing of deferral elections and permissible distributions. Failure to comply with the requirements of Section 409A results in automatic inclusion of all amounts deferred under the affected plan; such amounts are subject to an additional 20% tax plus an interest charge on federal income taxes deferred under the plan. The costs of failure to comply with Section 409A are potentially enormous and can be very disproportionate to the magnitude of the error. Taxpayers and practitioners have petitioned Treasury and the IRS almost from the date of enactment of Section 409A to consider a corrections program to mitigate this problem.

Unintentional Operational Failures

The Notice is very clear that its relief is limited to unintentional operational failures, i.e., an unintentional failure to comply with plan provisions that satisfy Section 409A or an unintentional failure to follow the requirements of Section 409A due to errors in the operation of the plan. The Notice does not provide relief for plan terms that fail to meet the requirements of Section 409A, any

intentional failure to comply with the terms of a plan or the requirements of Section 409A, any egregious operational failure, or any operational failure that is directly or indirectly related to participation in an abusive tax avoidance transaction. Relief provided under the Notice is available only if the service recipient takes commercially reasonable steps to avoid reoccurrence of the failure. If the same or a substantially similar operational failure has occurred in the past, relief under the Notice is not available for taxable years beginning after December 31, 2008 unless the service recipient can demonstrate that it had established procedures and taken reasonable steps to avoid recurrence of the failure and the failure occurred despite the diligent efforts of the service recipient to avoid such failure.

Correction of Certain Operational Failures in the Same Taxable Year as the Failure

General Requirements

The Notice provides that if an unintentional operational failure to comply with Section 409A occurs, the service provider is not required to include any amounts in income under Section 409A as a result of the failure if the failure is corrected in accordance with the Notice and is corrected in the same taxable year as the failure occurred.

Failure to Defer Compensation Corrected in Same Taxable Year

Under the Notice, deferred compensation that should not have been paid in a taxable year but that was paid due to an operational failure (other than payments made in violation of the six-month rule as discussed in the next section) will be treated as timely deferred if the service provider repays to the service recipient the amount that was erroneously paid to the service provider on or before the last day of the service provider's taxable year in which such amount was erroneously paid. If, however, the total amount that was erroneously paid exceeds the limit on elective deferrals under Code Section 402(g) (\$15,500 for 2007) and the service provider is an "insider" (including a director, officer, or beneficial owner of more than 10% of any class of equity security of the service recipient), the service provider must also pay interest to the service recipient in order to receive relief under the Notice.

Relief is not available, however, with respect to any erroneous payment occurring during any taxable year of the service provider in which the service recipient experienced a substantial financial downturn or otherwise experienced financial or other issues that indicated a significant risk that the service recipient would not be able to pay the amount deferred when the payment became due.

Failure to Delay Payment in Violation of Six-Month Rule Corrected in Same Taxable Year

Under Section 409A, deferred compensation payable to or on behalf of a key employee of a public company due to the employee's separation from service may not be paid until after the end of the six-month period following the date of such separation. Under the Notice, amounts paid prior to the expiration of such six-month period due to an unintentional operational failure will not be treated as violating Section 409A if, on or before the last day of the service provider's taxable year in which the amount was paid, (i) the service provider repays to the service recipient the amount that was erroneously paid, and (ii) immediately after such repayment, the service provider has a legally binding right to receive such amount from the service recipient on the date determined by adding the number of days, from the date of the early erroneous payment to the date of repayment of the amount to the service recipient, to the later of (a) the date the amount would otherwise have been payable under the

terms of the plan and the applicable deferral election or (b) the date the service provider repaid the erroneous payment to the service recipient.

Relief is not available, however, with respect to any erroneous payment occurring during any taxable year of the service provider in which the service recipient experienced a substantial financial downturn or otherwise experienced financial or other issues that indicated a significant risk that the service recipient would not be able to pay the amount deferred when the payment became due.

Excess Deferred Compensation Corrected in Same Taxable Year

Under the Notice, if an amount that should not have been deferred under a plan is credited to a service provider's account as a result of an unintentional operational failure and such amount otherwise would have been paid to the service provider, the excess amount will not be treated as deferred under the plan if it is paid to the service provider on or before the last day of the service provider's taxable year in which the excess amount was incorrectly treated as deferred compensation. Additionally, if the service provider is an insider (as described previously), the remaining account balance must be reduced by positive earnings related to the excess amount incorrectly deferred. In other cases, such adjustment may be (but is not required to be) made.

Correction of Exercise Price of Stock Award in Same Taxable Year

Under Section 409A, nonqualified stock options and stock appreciation rights are exempt from Section 409A if (among other requirements) the exercise price of such stock award is not less than the fair market value of the underlying stock on the date of grant. Under the Notice, if the exercise price is less than the fair market value of the underlying stock on the date of grant as a result of an unintentional administrative error in determining the exercise price, the stock award will not be treated as nonqualified deferred compensation if, prior to the stock award being exercised and not later than the last day of the service provider's taxable year in which the service recipient was granted the stock award, the exercise price is reset to an amount equal to or exceeding the fair market value of the underlying stock on the date of grant.

Limited Transition Relief for Certain Operational Failures Not Corrected in Same Taxable Year

As discussed earlier in this LawFlash, Section 409A operational failures corrected in the taxable year in which the failure occurred will result in little if any economic cost to the parties. In cases in which the correction is made after the taxable year of the failure, the Notice provides transition relief through 2010 by limiting the amount of income inclusion and additional taxes for certain operational failures to a specified amount. In such cases, the amount includible in income under Section 409A is limited to the amount that should have been treated as deferred compensation under the plan but was instead paid to the service recipient (or, as applicable, is limited to the excess deferred amount paid to the service provider) and does not include any other amounts deferred under the plan. Additionally, although the service provider is required to pay the additional 20% excise tax on such includible income, the service provider is not required to pay the interest tax. Relief is available under this provision only if all requirements under the Notice are satisfied no later than the end of the service provider's second taxable year following the taxable year in which the failure occurred.

If deferred compensation under a plan should have been paid to a service provider during a taxable year beginning before January 1, 2010 but was not paid due to an unintentional operational failure, the

Notice provides the transition relief described previously if (i) the amount involved does not exceed the limit on elective deferrals under Code Section 402(g), (ii) the service recipient pays to the service provider the amount that should have been paid by the later of the end of the service provider's taxable year in which the failure is discovered or the fifteenth day of the third month following the date on which the failure is discovered (provided that such payment shall be paid no later than the end of the second taxable year of the service provider following the taxable year in which the failure occurred), and (iii) any earnings received on such amounts are forfeited or added to the payment to the service provider and any losses are permanently disregarded or subtracted from the payment to the service provider. If the service recipient properly reports the payment, it will not be subject to penalties for the failure to properly withhold under the Code.

Information and Reporting Requirements

The service recipient must attach to its original federal income tax return for the applicable taxable year (i.e., the year in which the failure occurred for corrections made within the same taxable year as the failure and the year in which the service recipient discovers the failure for corrections not made in the same taxable year) a statement that contains certain information set forth in the Notice, which includes a description of the operational failure, the name of the service providers affected by the failures, and the amounts involved. The service recipient also must provide certain of this information to each service provider affected by an operational failure that is entitled to relief under the Notice, except that a service recipient is not required to provide such notice to a service provider affected by a correction to the exercise price of a stock award. A service provider seeking relief under the transition relief for corrections not made in the same taxable year as the operational failure must attach to its income tax return a copy of the statement received from the service recipient with respect to each failure.

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