



IRS Issues Guidance on Correction of Certain Unintentional Section 409A Operational Failures Under Nonqualified Deferred Compensation Plans

On December 3, 2007, the Internal Revenue Service (the "IRS") issued Notice 2007-100 (the "Notice"), which sets forth guidance as to how certain unintentional failures of nonqualified deferred compensation plans to operate in full compliance with Section 409A of the Internal Revenue Code ("Section 409A") may be corrected. The relief provided by the Notice extends only to certain nonnegligious (and which are not part of an abusive tax-avoidance transaction), unintentional operational failures, and does not extend to any failures of the written plan terms to comply with Section 409A. Finally, the relief generally applies only if the failure and its correction is timely reported to the IRS by both the service provider and the service recipient, and the service recipient takes commercially reasonable steps to prevent a recurrence of the operational failure. Generally, the Notice provides relief for operational failures which are corrected within the same taxable year and limited transition relief for operational failures occurring prior to 2010 and corrected in different taxable years. Because the procedures are detailed and include specific reporting requirements, employers should consult with qualified counsel should any such operational failures occur.

1. Complete Relief from All Section 409A Penalty Provisions Where the Operational Failure and Its Correction Occur within the Same Taxable Year

Erroneous Payments. If an amount was erroneously paid or made available to a service provider in a taxable year due to an unintentional operational failure, by December 31 of that year either the service provider must repay that amount to the service recipient, or the

service recipient must reduce the service provider's compensation by that amount. (If the erroneously paid amount exceeds the limit on elective deferrals that applies to a qualified plan for that year (e.g., \$15,500 for 2007 and 2008) and the service provider is an "insider" of the service recipient (i.e., a director or officer of the service recipient or a beneficial owner (directly or indirectly) of more than 10 percent of any class of stock of the service recipient), the service provider must also pay an interest charge (computed using the short-term applicable Federal rate) to the service recipient at the time of repayment.)

Erroneous Deferrals. Conversely, if an amount is erroneously treated as deferred compensation due to an unintentional operational failure, and the amount would have been paid to the service provider during the taxable year but for the error, such amount must be paid to the service provider by December 31 of that year and the service provider's account balance must be adjusted accordingly. If the service provider is an "insider" of the service recipient (as defined above), by December 31 of such year the remaining account balance (or other deferred compensation under the plan) must be adjusted for positive earnings, retroactive to the date the excess amount was incorrectly credited to the insider's account.

Correction of Violation of Six-Month Delay Rule. A special rule applies where the operational failure con-

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sists of a violation of the requirement that six months must pass before certain payments can be made to certain "specified" (public company) employees upon separation from service. In that case, the plan will remain compliant provided that the employee repays the erroneously paid amount and, immediately after the repayment, has a legally binding right to receive the amount from the employer on the date that is the same number of days after the later of (i) the date the amount would otherwise have been payable under the plan, or (ii) the date of the repayment, as the number of days from the date the service recipient made the erroneous payment to the service provider through the date the service provider repaid the erroneous payment to the service recipient, and the repaid amount is not paid to the service provider before such date.

Correction of Exercise Price of Stock Right.

Where, due to an unintentional administrative error in determining the exercise price under a stock option or stock appreciation right (collectively, a "stock right"), the exercise price under a stock right is less than the fair market value of the underlying stock on the date of grant, (thereby running afoul of Section 409A), if, before the stock right is exercised but no later than December 31 of the calendar year in which the service recipient granted the stock right, the exercise price is reset to an amount at least equal to the fair market value of the underlying stock on the date of grant, the stock right will be treated as not providing nonqualified deferred compensation under Section 409A.

2. Limited Transition Relief through 2010 Where the Operational Failure and Its Correction Occur in Different Taxable Years

Unlike the scenarios described above, where the operational failure occurs before 2010 but is not corrected within the same year, complete relief is provided from the Section 409A interest charge penalty, and partial relief is provided from the income inclusion penalty. However, under those circumstances, the Section 409A excise tax penalty will apply.

Erroneous Payments. If an amount that should have been treated as deferred compensation (or deferred) under a plan is not credited to the service provider's

account or otherwise is not treated as deferred compensation during that year, or does not remain as deferred compensation after the end of that year, in all cases due to an unintended operational failure, and was therefore paid or made available to the service provider during his or her taxable year, and the amount paid or made available to the service provider (in the aggregate, under the plan and any arrangements treated as a single plan under Section 409A), does not exceed the limit on elective deferrals that applies to a qualified plan for that year (e.g., \$15,500 for 2007 and 2008), the service provider must include in income under Section 409A the amount that should have been treated as deferred compensation (or been deferred) under the plan. The 20% excise tax will apply, but not the Section 409A interest charge penalty.

Erroneous Deferrals. If deferred compensation should have been paid or made available to the service provider during the service provider's taxable year, but is instead erroneously deferred due to an unintended operational failure, provided that the amount that should have been paid or made available does not exceed the limit on elective deferrals that applies to a qualified plan for that year (e.g., \$15,500 for 2007 and 2008), and the service recipient pays 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, then the amount includible in income under Section 409A's income inclusion penalty is limited to the excess amount paid to the service provider, and does not include any other deferred compensation under the plan. In addition, any earnings or losses that are allocable to the erroneously deferred amounts through the date of payment to the service provider must be either forfeited or added to the payment of the service provider, or permanently disregarded or subtracted from the payment of the service provider, as the case may be.

Correction of Violation of Six-Month Delay Rule.

Unintended operational violations of the six-month

delay rule may be treated similarly to other erroneous payments, as described above.

No Relief Provided to Correct Exercise Price under a Stock Right. No special relief is currently available for operational failures relating to the use of a below fair market value exercise price under a stock right where the corrective action is taken in a different year than in which the grant of the stock right occurred.

3. Related Information and Reporting Requirements

To obtain relief under the Notice, both the service recipient and the service provider are required to comply with certain information and reporting requirements. In general (not for stock rights exercise price corrections), the service recipient is required to attach a special statement to its federal income tax return for its taxable year in which the failure occurred and must provide a copy of the statement to the affected service provider by the Form W-2/1099 deadline for that year (by January 31 if no such Form is required with respect to the service provider), who must also attach a copy of the statement to his or her federal income

tax return for the taxable year in which the failure was discovered.

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