Employee Benefits Alert

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IRS Announces Limited 409A Correction Program

Notice 2007-100
(Section 409A Correction Procedures)

On December 3, 2007, the IRS released Notice 2007-100 (the “Notice”), which provides new, limited procedures whereby certain operational failures of a nonqualified deferred compensation (“NQDC”) plan may be corrected, resulting in either no or a limited violation under Section 409A. The Notice also announces a broader correction program that the IRS and Treasury have under consideration whereby certain operational failures may be remedied (including correction in subsequent taxable years) to comply with Section 409A. The IRS and Treasury Department have set a deadline of March 3, 2008, for submission of any comments on aspects of this potential program.

Sponsors of deferred compensation plans are likely to be disappointed in the relief provided by the new Notice, particularly if they are comparing it to the type of relief granted to qualified retirement plans in the EPCRS program. While there may be certain instances in which the new relief will be useful, it is very narrow in scope, is subject to a variety of conditions, and will require sponsors of such plans to notify the IRS that they have self-corrected under the program, all of which may reduce the attractiveness of this relief to sponsors.

Correction of Certain Operational Failures

The Notice establishes procedures whereby certain unintentional operational failures under Section 409A may be remedied (1) within the same taxable year as the failure, resulting in no amount being includible in gross income under Section 409A; or (2) in a subsequent taxable year, resulting in a limited amount being includible in gross income under Section 409A. Failures eligible for these correctional procedures are limited to certain unintentional failures to comply with plan provisions that satisfy the requirements of Section 409A or unintentional failures to follow the requirements of Section 409A due to inadvertent operational errors. Other types of failures -- such as intentional failures to operationally comply with Section 409A, plan design failures, or failures attributable to the exercises of stock rights that otherwise would result in a violation of Section 409A -- are specifically excluded from the scope of the Notice.

The type of relief available under the Notice depends on the type of operational failure and the timing of the correction.

Correction Within the Same Taxable Year

Failure to Defer Amount or Incorrect Payment in the Same Taxable Year

Amounts (other than a payment to a specified employee that is required to be delayed for six months following his/her separation from service) that, under the terms of the plan and Section 409A, were incorrectly paid or made available to a service provider in a taxable year due to an
unintentional operation failure are eligible to be remedied under the Notice if the following requirements are met:

- During the same taxable year in which the amounts are erroneously paid or made available to the employee, the employee repays to the employer the amount that was erroneously paid or made available to the employee; and

- Immediately after repayment, the employee has a legally binding right under the plan to be paid the amount that would have been due if such amount had not been erroneously paid or made available to the employee during such taxable year, at the same time and in the same form of payment that the amount would have been payable if such erroneous payment had not occurred.

In addition, if (1) the total amount erroneously paid or made available under a plan within the employee’s same taxable year exceeds the limit on elective deferrals that would apply to a qualified plan under Section 402(g)(1)(B) (for 2007, $15,500) for the year in which the erroneous payment was made and (2) the employee is considered an “insider” under the Notice, the employee is required to pay both the amount erroneously paid and interest on such amount. (The Notice provides a formula for calculating the interest due.)

If the amount is properly repaid, which under the Notice may be by direct payment or reduction in the employee’s compensation, the erroneous payment is not includible in gross income or reported on a Form W-2 or 1099.

This relief is further limited by two additional conditions which sponsors of plans may find somewhat surprising. If, in connection with the repayment, the employee receives a benefit that is intended as a substitution for all or part of the amount that is required to be repaid, the amount will not be treated under the Notice as having been repaid. Furthermore, no relief is available in any year that the employer experienced a substantial financial downturn or financial or other issues that indicated a significant risk that the employer would not be able to pay the deferred amounts when originally due (even where the employee has restored the deferral to the employer).

**Incorrect Payment in Violation of the Required Six-Month Delay in Payment for Specified Employees**

With respect to amounts the payment of which was required to delayed for six months following a specified employee’s separation from service, if such amounts are instead paid before the expiration of the six-month period due to an unintentional operational failure, the Notice provides that such early payment will not be treated as having failed to comply with Section 409A(a)(2)(B)(i) if, within the same taxable year in which the early payment was made, the following steps are taken:

- The employee repays to the employer the amount that was erroneously paid or made available to the employee; and

- Immediately after such repayment, the employee has a legally binding right under the plan to receive such amount -- but not until a date determined in accordance with the Notice (and the repaid amount is not paid or made available to the employee before such date). In general, the Notice requires in such case that the payment of the restored amounts be further delayed for a period equal to the period of time the employee had the use of the amount.

Repayment of such amounts by the employee occurs by payment from the employee to the employer, in which case,
the erroneous payment is not includible in gross income or reported as income on a Form W-2 or Form 1099; however, subsequent payment of the amount in accordance with the Notice is required to be report on a Form W-2 or Form 1099.

**Excess Deferred Amount That Is Corrected in the Same Taxable Year**

If an amount that should not have been deferred under the plan is treated as deferred compensation (e.g., credited to the employee’s account under the plan) as a result of an unintentional operational failure and such amount otherwise would have been paid to the employee in that same taxable year, such excess amount is not treated as a deferred amount if (1) the excess amount is paid to the employee on or before the last day of the employee’s same taxable year in which the amount was incorrectly treated as deferred compensation, and (2) the amount to which the employee has a legally binding right under the plan at the end of the year must be adjusted to reflect the payment. Furthermore, if the employee is an “insider,” the remaining account balance is required to be adjusted for positive earnings retroactive to the date the excess amount was incorrectly credited to the employee’s account. (Adjustment of the employee’s account for negative earnings is optional.) Note that this relief is not available with respect to an employer’s failure to timely pay out amounts deferred in one or more previous years -- although in such case there may be limited relief under Treas. Reg. § 1.409A-3(d).

**Correction of Exercise Price of Otherwise Excluded Stock Rights**

The Notice provides for a special correction procedure with regard to a stock right (i.e., stock option or stock appreciation right) whose terms would not be NQDC under Section 409A except that, due to an unintentional administrative error in determining the exercise price, the exercise price of the stock right is less than the fair market value of the underlying stock on the date of grant. To the extent not previously exercised, if the exercise price of such stock right is increased to equal or exceed the fair market value of the underlying stock on the date of grant, and such increase occurs during the employee’s same taxable year in which the stock right was granted, the stock right will not be treated as deferred compensation under Section 409A.

**No Correction Within the Same Taxable Year**

**Failure to Defer Small Amount Not Corrected in the Same Taxable Year and Certain Erroneous Payments**

For taxable years of an employee beginning before January 1, 2010, the Notice provides transitional relief for failures that meet the following criteria in addition to certain other requirements:

- An amount that should have been treated as deferred compensation under Section 409A was not treated as such (e.g., was not credited to the employee’s account) or did not remain deferred compensation after the end of such year;
- The amount was paid or made available to the employee during his/her taxable year;
- The failure is not corrected within the employee’s same taxable year that the failure occurred but is corrected not later than the end of the second taxable year after the year the failure occurred; and
• The amount paid or made available does not exceed the limit on elective deferrals that would apply to a qualified plan under Section 402(g)(1)(B) for the year of the operational failure (for 2007, $15,500).

If the above requirements are met, a violation under Section 409A will be deemed to have occurred only with respect to the amount that should have been treated as deferred compensation under the plan (or should have continued to be deferred under the plan) but was instead paid or made available to the employee. Under the Notice, any other amounts deferred under the plan will not be treated as an amount includible in income under Section 409A. Although the amount includible in income under Section 409A will be subject to the additional 20% tax, the premium interest tax under Section 409A(a)(1)(B)(i)(I) will not apply to such amounts.

**Limited Excess Deferred Amount not Corrected in the Same Taxable Year**

For taxable years of an employee beginning before January 1, 2010, the Notice provides transitional relief for failures that meet the following criteria in addition to certain other requirements:

• An amount of deferred compensation should have been paid or made available to the employee during his/her taxable year (or an amount that should have been paid or made available to the employee is treated as deferred compensation and not paid or made available to the employee) due to an unintentional operational failure;

• The failure is not corrected within the employee’s same taxable year that the failure occurred but is corrected not later than the end of the second taxable year after the year the failure occurred;

• The amount that should have been paid or made available does not exceed the limit on elective deferrals that would apply to a qualified plan under Section 402(g)(1)(B) for the year of the operational failure (for 2007, $15,500); and

• By the later of (1) the end of the employee’s taxable year in which the failure is discovered or (2) the 15th day of the third month following the date upon which the failure is discovered, the employer pays the employee the amount that should have been paid or made available; and

• The employee includes such amount in income and pays the additional taxes under Section 409A.

If the above requirements are met, the amount includible in income under Section 409A is limited to the excess amount paid to the employee and does not include other deferred compensation amounts under the plan. Although the amount includible in income under Section 409A will be subject to the additional 20% tax, the premium interest tax under Section 409A(a)(1)(B)(i)(I) will not apply to such amounts.

**IRS and Employee Notification**

If a payment is remedied in accordance with any of these relief provisions, the employer must provide notification to the IRS and affected employees of the unintentional operational failure and the correctional procedures undertaken. (The Notice contains a listing of the information required to be included in each of these notices.)
Potential Program to Correct Certain Failures

The IRS and Treasury Department are requesting comments regarding the potential establishment of a correction program under which taxpayers could correct certain operational failures of Section 409A, including correction after the end of the employee's taxable year in which the failure occurs. The Notice proposes a limited scope for this program and requests comments regarding a variety of topics, including program eligibility, and permissible correction procedures.

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