



The Washington Report **BENEFITnews**

BULLETIN NO: 09-09

JANUARY 23, 2009

Additional Analysis of IRS Notice 2008-113 - Updated and Expanded 409A Correction Procedures

In December 2008, the Internal Revenue Service issued Notice 2008-113, which updates and expands the initial section 409A correction guidance issued in December 2007. Although this new notice significantly expands the types of operational violations that can be corrected and the relief available, it does not permit plan documents or form defects to be corrected. However, Notice 2008-113 explains that the Revenue Service is considering expansion of the correction procedures to cover certain plan document failures. The Service further requests specific comments regarding the potential terms and conditions of such a program. As promised, this *Washington Report* provides a more detailed analysis of the Notice 2008-113 new correction procedures.

Background

Nonqualified deferred compensation arrangements that are subject to section 409A must satisfy specific requirements in order to avoid adverse tax consequences to the service providers (e.g., employees/participants covered by the arrangements). (See our Bulletin No. 08-80.) There are potentially three significant adverse tax consequences to an employee if the requirements are not satisfied: (i) all deferred compensation must be included in income in the current taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in income (including deferrals in prior years), (ii) an additional tax is imposed equal to 20 percent of the deferred compensation, and (iii) an additional tax is imposed equal to the interest, using the IRS' underpayment rate plus 1 percent, that would have been imposed during the deferral period if the deferred compensation had been includible in income when first deferred (or not subject to a substantial risk of forfeiture). In addition, under the plan aggregation rules, all plans of a similar type are aggregated and treated as violating the requirements if one of the plans of the same type violates such requirements.

Recognizing these potentially significant adverse tax consequences, even if they result from minor, inadvertent violations, the IRS issued Notice 2007-100 (see our Bulletin No. 2007-111), which permits limited corrections of certain operational failures under Section 409A(a). Notice 2007-100 included two categories of corrections - (i) specific operational violations corrected in the same year in which the failure occurred, and (ii) specific operational violations involving amounts that do not exceed the qualified plan deferral limit (i.e., \$16,500 for 2009).

Expanded Relief

Notice 2008-113 expands the relief available for certain 409A violations. The notice prescribes a number of general eligibility requirements that must be satisfied before a failure can be corrected, including, but not limited to:

- The service recipient (e.g., employer) must take commercially reasonable steps to avoid the recurrence of the operational failure;
- The correction procedures are not available to employees whose federal income tax returns are under examination by the IRS for the year in which the operational failure occurred;
- The correction procedures only apply to operational failures that are inadvertent and unintentional;
- The correction procedures are not available with respect to any erroneous payment made during any taxable year

of the employee in which the employer experiences a substantial financial downturn, or otherwise experiences financial or other issues, if such downturn or other issue indicates a significant risk that the employer will not be able to pay the amount deferred when the payment becomes due; and

- The correction procedures are not available if the failure is directly or indirectly related to participation in any listed transaction under Treasury Regulations section 1.6011-4(b)(2).

Notice 2008-113 includes four categories of relief for certain 409A failures, which are discussed separately below.

(1) Same Year Corrections: The first category is essentially a continuation of the corrections permitted under Notice 2007-100 for certain failures corrected in the same year. Under this category, the following four types of operational failures can be corrected without any adverse tax consequences if the failures are corrected by the end of the calendar year in which the failure occurred (and other requirements specified in the notice are satisfied):

(A) Failure to Defer Amount or Incorrect Payment of Amount Payable in a Subsequent Taxable Year: Amounts that should not have been paid or made available to the employee (e.g., a failure to defer an amount or an incorrect payment) due to an operational failure can be corrected in the same taxable year by having the participant repay the amount to the employer on or before the last day of the taxable year in which the amount was erroneously paid or made available. This permitted correction does not, however, apply to amounts that were paid in violation of the six-month delay rule, which provides that amounts payable to a specified employee of a publicly-traded company on account of his or her separation from service cannot be paid any earlier than six months following the date of the separation from service. Violations of the six-month delay rule can be corrected under a separate rule (discussed below).

(B) Incorrect Payment of Amount Payable in Same Taxable Year or Incorrect Payment in Violation of Six-Month Delay Rule: Amounts that were paid to specified employees before the expiration of the six-month delay period or that should have been paid more than thirty days later in the same taxable year can be corrected by having the employee repay the amount that was erroneously paid and having the plan hold such repayments until the later of: (i) the date the amount would otherwise have been payable under the terms of the plan, or (ii) the end of the period measured from the day of repayment that equals the number of days from the date the amount was originally paid through the date the participant repaid the amount (or, if earlier, the date the amount would otherwise have been payable under the terms of the plan). For example, if an amount should have been paid on July 1, 2009, but was paid on April 1, 2009 and repaid to the plan on August 1, 2009, the plan would have to hold the repayment for 91 days, or until November 1, 2009 (i.e., for the three months from the date originally paid to the date the amount would have otherwise been payable). In addition, the repayment by the employee to the plan must be made on or before the last day of the taxable year in which the amount was erroneously paid.

(C) Excess Deferred Amounts: Amounts that should not have been deferred or treated as deferred compensation in a particular year (e.g., an excess deferral) can be corrected by having the plan pay the excess amount to the employee by the end of the calendar year in which the excess deferral was made.

(D) Correction of Exercise Price of Otherwise Excluded Stock Rights: Stock rights (i.e., stock options and stock appreciation rights) are generally excepted from the requirements of 409A if, among other requirements, the stock rights are granted with an exercise price that is not less than the fair market value of the underlying stock on the date of grant. If a stock right otherwise would not be subject to 409A, except that the exercise price was erroneously established at less than the fair market value of the stock on the grant date, the exercise price can be reset under Notice 2008-113. Such a stock right will not be subject to 409A if, before the stock is exercised and not later than the last day of the calendar year in which the stock right was granted, 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.

As noted above, Notice 2008-113 prescribes other requirements and special rules that must be satisfied in order to obtain the relief for this category of corrections. For example, if an employee is required to repay an amount erroneously distributed, the employee may either pay the employer the amount directly or, in lieu of such repayment, the employer may reduce the employee's compensation that would otherwise have been paid on or before the required deadline by an equivalent amount. The amount of any compensation reduced is includible in income by the employee. The notice also provides that an amount will not be treated as repaid by the employee if, in connection with such repayment, the employer

pays the employee, or otherwise provides a benefit (including an obligation to pay an amount or provide a benefit in the future), intended as a substitute for all or part of the amount the employee is required to repay the employer.

In addition, the notice provides that if the employee is not an "insider" (defined below) and the repayment of an amount would cause an immediate and heavy financial need (as defined for purposes of the Code section 401(k) regulations), in lieu of immediate repayment, the employer and the employee may enter into a legally binding agreement to have such amounts repaid over a specified period that ends not later than 24 months from the due date (without extensions) for the federal income tax return for the employee's taxable year during which the amount was erroneously paid, provided the employee must also pay interest on the amount repaid to the employer (at a interest rate that is no less than the short-term applicable Federal rate under Code section 1274(d)(1) ("AFR")). For this purpose (and other purposes under the notice), an employee is considered an insider if he or she is a director or officer or is directly or indirectly the beneficial owner of more than ten percent of any class of equity security of the employer, generally determined in accordance with the rules of Section 16 of the Securities Exchange Act of 1934, as amended, but without regard to whether the employer has any securities registered under such Act (and by applying analogous rules if the employer is not a corporation).

As another example, the notice provides that if the amount required to be repaid exceeds the qualified plan deferral limit (i.e., \$16,500 in 2009) and the employee is an insider, the employee must pay interest to the employer for the period during the year in which the erroneous payment was held by the employee (at an interest rate no less than the AFR). The employer generally must treat this interest payment as income to the employer.

There are a number of other special rules and requirements that may apply to each type of correction. The notice provides that all such rules and requirements must be fully complied with in order to obtain the relief provided under the notice.

(2) Next Year Corrections: The second category of permitted corrections includes the same four failures described above (i.e., (1)(A), (B), (C) and (D)), but the corrections must be made by the last day of the taxable year immediately following the taxable year in which the failure occurred (i.e., corrected by the end of the next year). In addition, this category of permitted corrections is only available to employees who are not insiders (as defined above).

Any amounts distributed, whether made erroneously or to correct an error, generally are included in income, but are not subject to the additional 20% tax or premium interest tax. There are no other adverse tax consequences. For example, no other amounts deferred under the arrangement or any other arrangement required to be aggregated with it under 409A are taxed. In addition, any corrective repayments by the employee can be deducted by the employee in the year of repayment. Notice 2008-113 also prescribes other requirements and special rules that must be satisfied in order to obtain the relief for this category of corrections, which can be different from those prescribed for the same year corrections referenced in subsection (1) above.

(3) Second Year Corrections: The third category of permitted corrections includes the first three failures described in subsection (1) above (i.e., (1)(A), (B) and (C), but not (D)), but the corrections must be made by the last day of the second taxable year following the taxable year in which the failure occurred (i.e., corrected by the end of the second taxable year following the taxable year of the failure). This category of permitted corrections is available to all employees, whether or not they are insiders.

Any amounts distributed, whether made erroneously or to correct an error, generally are included in income and are subject to the additional 20% tax under 409A. However, there are no other adverse tax consequences. For example, the additional premium interest tax does not apply and no other amounts deferred under the arrangement or any other arrangement required to be aggregated with it under 409A are taxed. In addition, any amounts included in income and subject to the additional 20% tax under 409A are treated as previously included in income for 409A purposes (i.e., not subject to tax when subsequently distributed from the plan). Notice 2008-113 also prescribes other requirements and special rules that must be satisfied in order to obtain the relief for this category of corrections, which can be different from those prescribed for the same-year and next year corrections referenced in subsections (1) and (2) above. This category of permitted corrections is also available to all employees, whether or not they are insiders.

(4) Limited Amount Corrections: Notice 2008-113 also provides limited relief for certain corrections that involve amounts that do not exceed the qualified plan deferral limit (i.e., \$16,500 for 2009). The corrections must be made no later than the end of the second taxable year following the taxable year in which the failure occurred.

If the requirements of the notice are met, the amount includible in income under 409A is limited to the amount involved and does not include any other amounts deferred under the plan (or any other plan required to be aggregated with the plan). In addition, although the employee is required to pay the additional 20% tax on the amounts includible in income, the employee is not required to pay the additional premium interest tax. This relief generally applies to the following two types of unintentional operational violations:

(A) An amount that should have been deferred, but was paid or made available to the employee. This would include amounts that were paid in violation of the six-month delay rule for specified employees.

(B) An amount that should have been paid, but was not. To qualify for the relief, this amount must be paid no later than the second taxable year following the taxable year in which the failure occurred.

This category of permitted corrections is available to all employees, whether or not they are insiders.

Special Transition Rules for Pre-2008 Operational Failures

Notice 2008-113 also includes special transition rules for certain operational failures that occurred prior to 2008. Under these special rules, an employee may use the next year correction procedures described in subsection (2) above (except for correcting the exercise price of stock rights) for such pre-2008 failures, but may treat the employee's 2009 taxable year as the next taxable year following the taxable year during which the failure occurred. This effectively gives employees a one-year transition period (i.e., 2009) to take advantage of the relief provided for next year corrections for eligible failures that may have occurred before 2008.

Information and Reporting Requirements

Notice 2008-113 also provides guidance regarding the information and reporting requirements that must be satisfied by both the employee and employer to fully correct and obtain the relief provided under the notice. A correction will not be completed unless the information and reporting requirements are fully satisfied.

A number of the specific corrections include reporting requirements that may apply (e.g., filing amended returns). In addition, the notice prescribes general information and reporting requirements that have to be satisfied. For example, with respect to same year corrections, the notice provides that the employer generally must attach to its timely-filed (including extensions) original federal income tax return for its taxable year in which the failure occurred a statement entitled "Section 409A Relief under Section IV of Notice 2008-113" setting forth the specific information prescribed in the notice. In addition, the employer must provide to each affected employee a similar statement no later than the date (with extensions) on which it is required to provide a W-2 (which is generally January 31st of the immediately following year). The notice specifies other specific information and reporting requirements that may need to be satisfied for certain types of corrections permitted under the notice.

Effective Date

Notice 2008-113 supersedes and replaces Notice 2007-100 for taxable years beginning on or after January 1, 2009. However, taxpayers may rely on Notice 2008-113 for taxable years beginning before January 1, 2009. Because Notice 2008-113 generally expands the relief provided by Notice 2007-100, Notice 2008-113 is essentially effective for all applicable years.

Plan Document Failures

Notice 2008-113 also indicates that the IRS is considering a program to provide relief for plan document failures. The notice includes an express request for comments on such a program and includes a number of specific questions on which the IRS would like comments, including (but not limited to):

(1) What types of failures would be eligible for the relief?

(2) Should relief be limited to minor or nonmaterial errors and if so how would the materiality of a failure be determined?

(3) To the extent eligibility for the relief is contingent upon whether a noncompliant plan provision has been put into effect, or whether a noncompliant plan provision is applicable to or affects an amount deferred, what standards would apply to determine whether such a noncompliant plan provision has been put into effect or otherwise applies to or affects an amount deferred?

(4) What rules would govern the appropriate correction for the noncompliant plan provision and how would such rules avoid granting an impermissible late subsequent deferral election or election to accelerate a payment?

(5) How would the correction and relief apply if the correction were made during the employee's taxable year and would there be any distinction between amounts deferred before the correction and amounts deferred in the same year but after the correction?

(6) What information would employees and employers be required to file with the IRS to make use of such correction procedure?

(7) What procedures would employers be required to implement to prevent a recurrence of the same or a substantially similar plan document failure?

The IRS has requested that comments be submitted by March 6, 2009.

Conclusion

Notice 2008-113 represents a significant expansion of the initial correction guidance issued in 2007. In addition, because it provides a series of increasing consequences depending on the year of correction - same year, next year and second year - the notice encourages compliance reviews and quick corrective actions by employees and employers. Although plan document failures cannot be corrected, the notice indicates that the IRS is considering such a program and has expressly requested comments on specific aspects of such a program. Finally, as the full compliance period continues, it would seem likely that other corrections will have to be permitted, and therefore, it is hoped that the correction program will continue to evolve in the same manner as the Employee Plans Compliance Resolution System (EPCRS) for qualified retirement plans.

THE ABOVE ADVICE WAS NOT INTENDED OR WRITTEN TO BE USED, AND IT CANNOT BE USED BY YOU FOR THE PURPOSES OF AVOIDING ANY PENALTY THAT MAY BE IMPOSED BY THE INTERNAL REVENUE SERVICE.

In the event that this *Washington Report* is also considered to be a "marketed opinion" within the meaning of the IRS guidance, then, as required by the IRS, please be further advised of the following:

THE ABOVE ADVICE WAS WRITTEN TO SUPPORT THE PROMOTIONS OR MARKETING OF THE TRANSACTIONS OR MATTERS ADDRESSED BY THE WRITTEN ADVICE, AND, BASED ON THE PARTICULAR CIRCUMSTANCES, YOU SHOULD SEEK ADVICE FROM AN INDEPENDENT TAX ADVISOR.

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