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CLIENT UPDATE

IRS Issues Correction and Income Inclusion Guidance for Failed Section 409A Deferred Compensation Arrangements

In December 2008, the Treasury and the IRS issued guidance under §409A of the Internal Revenue Code that (i) permits certain violations of §409A to be corrected where the documents implementing the deferred compensation arrangement comply with §409A, but the arrangement is not operated in compliance with the plan documents and §409A (an "operational failure"), and (ii) describes how to calculate the deferred amounts to be included into an employee's income (even before actual payment), as well as the 20% excise tax and interest charge imposed by §409A.

Correction of Operational Failures

Under the new guidance, relief is available from §409A's income inclusion, excise tax and interest charge for the following operational failures if commercially reasonable steps are taken to avoid a recurrence and the failure was inadvertent:

Amounts intended to be deferred that are mistakenly paid. These amounts will be treated as timely deferred if an employee repays the amount (on a pre-tax basis) by the end of the year following the year in which it was paid. Special rules apply where repayment would cause undue financial hardship. If the employee does not qualify or if the payment is improperly corrected, the employee will only be required to include the defective deferral into income; no 20% excise tax or interest charge will be imposed. However, if the employee is a "Section 16 insider" (determined without regard to whether he or she is employed by a public company) and he or she corrects in the subsequent year, additional requirements are imposed, including the 20% excise tax.

Accelerated payment of amounts that should have been paid in the future (including failures to delay payment for six months to key employees). These amounts will be treated as having been paid on schedule if (*i*) an employee repays the amount (on a pre-tax basis) by the end of the year following the year in which it was paid, and (*ii*) the employee has the right to receive the repaid amount within a certain number of days after the originally scheduled payment date. If the employee does not qualify or if the payment is improperly corrected, he or she will only be required to include the accelerated payment into income; no 20% excise tax or interest charge will be imposed. However, if the employee is an insider and he or she corrects in the subsequent year, additional requirements are imposed, including the 20% excise tax.

Amounts deferred that should have been paid currently. These amounts will not be treated as deferred compensation if the amount is paid to an employee by the end of the year following the year in which it should have been paid and the employee's deferral account is adjusted to reflect that such payment was made. Depending on whether the employee is an insider or not, adjustments for investment gains and losses may be required. If the employee does not qualify

or if the payment is improperly corrected, the employee will be required to include the improper deferral into income (regardless of whether actually paid) and will be subject to the 20% excise tax; no interest charge will be imposed, however.

Stock rights granted at less than fair market value. Discounted options or stock appreciation rights will not be treated as providing deferred compensation if such stock right would otherwise have been excluded from §409A but for the below market strike price and the strike price is reset to the fair market value on the grant date (or greater) before exercise (and no later than the end of the taxable year in which it was granted). If the employee does not qualify or if the strike price is improperly corrected, he or she will only be required to include the discount into income (once vested and regardless of whether the stock right is exercised) and will be subject to the 20% excise tax; no interest charge will be imposed.

The guidance also requires an employer to withhold upon any income to be included, but does not require withholding for the 20% excise tax or interest charge (at least not yet). It also requires an employer to report such amounts to the IRS. Finally, the correction guidance also contains other programs, which are more limited.

Calculation of Income Inclusion, 20% Excise Tax and Interest Charge

Once there is a plan failure requiring an employee to include deferred amounts into income and pay the 20% excise tax or interest charge, the new income inclusion proposed regulations provide guidance on how to calculate the amount in question.

Income Inclusion. Once a failure occurs that is not or cannot be corrected, an employee is required to include into income all amounts deferred under a plan for the current year and all prior years. (Subsequent compliance with §409A will generally eliminate the need to include future deferrals into income.) The proposed regulations provide that this calculation is performed on a year by year basis as of the end of each year, so that the amount included into income is equal to the excess of:

(i) The amounts deferred for the current year and all prior years (including any payments of deferred amounts made during an applicable year); over

(ii) The portion of such amount (if any) that was either subject to vesting or was previously included into income during the applicable year.

For each of the calculation's prongs, there are complex conventions to which you must adhere. For example, under the first prong, the present value of any future payments must be calculated using reasonable actuarial assumptions and methods, as well as the probability of whether any particular payment event will occur. In addition, where alternative times and forms of payment are available (e.g., in cases where payment will be triggered upon a change in control or a separation from service), the one with the highest present value must be used. There are also calculations for specific types of deferred compensation arrangements, such as account balance plans, severance arrangements, stock options and stock appreciation rights.

Under the second prong, among other things, the amounts must have been actually and properly included into income (including on an original or amended return). If it turns out that the employee is not actually paid the amounts included in income as a result of a §409A failure, he

or she will be entitled to a deduction for the taxable year in which the right to such amount was permanently forfeited or lost.

20% Excise Tax. Once the amount to be included into income is determined, the employee must pay an additional 20% on that amount.

Interest Charge. In addition, the amount to be included into income is subject to an interest charge (unless otherwise determined under the new correction guidance). This interest charge is designed to compensate the government for the underpayment of taxes in prior years. To determine the interest charge, the amount that is to be included into income for a given year is allocated to the year in which such amount was first deferred or, if later, when such amount becomes vested, creating a hypothetical underpayment for such earlier year (because the amount should have been included in income at that time). The hypothetical underpayment is treated as additional cash compensation to the employee for the year(s) in which it was first deferred or vested, taking into account certain adjustments that would have been made to the employee's tax returns had such amount been included in income in the earlier years. The premium interest rate (the IRS underpayment rate plus one percentage) is then applied to this hypothetical underpayment to calculate the interest charge.

If you have any questions relating to the new guidance or §409A, please contact your primary attorney at Morrison Cohen LLP or any of the following:

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