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IRS Issues Proposed Regulations on Section 409A Income Inclusion

The Treasury Department and the Internal Revenue Service (IRS) recently released the much-anticipated guidance on the calculation of amounts includible in income under Section 409A(a) of the Internal Revenue Code (Section 409A) (Proposed Regulation §1.409A-4) and interim guidance on the reporting and withholding requirements for deferred compensation under Section 409A (Notice 2008-115). While much of the guidance met expectations formed from prior transitional guidance, the guidance contained a few key surprises that should relieve the burden on taxpayers trying to comply with the complex requirements of Section 409A.

Key Highlights of Proposed Regulations and Notice

- **Adverse tax consequences occur only in the year of the Section 409A violation.** Amounts deferred under a plan which does not comply with Section 409A are included in income and are subject to the additional 20 percent tax only in the year in which the Section 409A violation occurs. These deferred amounts will not be subject to adverse tax consequences in years following the year of the violation provided the plan does not continue to violate Section 409A. In addition, amounts are not included in income or subject to the additional 20 percent tax in years prior to the year in which the Section 409A violation occurs.

- **Regardless of when during the year the Section 409A violation occurs, income inclusion and the additional 20 percent tax apply to amounts deferred and vested as of the end of the taxable year in which a Section 409A violation occurs.** If a Section 409A violation occurs at any time during the year, the amount includible in income is tested as of the last day of the taxable year. This rule eliminates the administrative burden of recalculating included income throughout the year based on deemed earnings and losses.

- **Additional latitude is given for amounts subject to a substantial risk of forfeiture.** Amounts subject to a substantial risk of forfeiture during the entire year in which a Section 409A violation occurs are generally not included in income or subject to an additional 20 percent tax. Therefore, operational and documentary violations that occur only in years prior to the year in which the substantial risk of forfeiture lapses will generally not result in adverse Section 409A tax consequences. This provides an ongoing opportunity to fix, without penalty, Section 409A violations for unvested amounts.

- **Detailed technical guidance is provided on the calculation of amounts deferred and the premium interest tax owed**. The Proposed Regulations outline rules for determining the present value of amounts deferred where the amounts that ultimately will be paid and the payment dates are unknown at the time of the calculation. In addition, the Proposed Regulations provide guidelines for calculating the amount deferred under specific types of compensation arrangements (including account balance plans, severance agreements and stock options) and calculating the premium interest tax owed with respect to such amounts.

- **Service provider may be able to recover taxes paid on amounts included in income which are not ultimately received.** Taxes paid on deferred amounts not ultimately received may be deducted on future tax returns when the right to the deferred amount is permanently forfeited.

- **Compliant deferred compensation arrangements do not need to be reported**. Until the Treasury Department and IRS issue further guidance, employers are not required to report amounts deferred under deferred compensation arrangements compliant with Section 409A.

- **Additional taxes and penalties are not subject to employer withholding**. Under the interim guidance, employers must treat amounts included in income as wages for income tax withholding purposes; however, employers are not required to increase the amount withheld on account of the additional 20 percent tax imposed by Section 409A or the premium interest tax.

- **Comments requested and more guidance to come**. The Treasury Department and IRS have requested comments to the Proposed Regulations by March 9, 2009. Specifically, they have requested comments on whether interest on amounts improperly excluded from income can be calculated in a simpler way (including a possible safe harbor method). In addition, the Treasury Department and IRS have indicated that more guidance will be forthcoming on the interaction between Section 409A and Section 457A, and on Section 409A(b).

The summary below discusses certain aspects of the Proposed Regulations and Notice 2008-115. More information on Notice 2008-113 (regarding relief for operational violations under Section 409A) is provided in a separate memorandum.

Calculation of Amounts Includible in Income Under Section 409A and Additional Taxes

Proposed Regulation §1.409A-4 describes the method for determining the amount includible in income under Section 409A(a), the additional 20 percent tax, and the premium interest payment applicable to such amount in the event that a plan document fails to comply with Section 409A or a plan is operated in a manner that fails to comply with Section 409A.

The Timing of Income Inclusion

A service provider is required to include in income (and pay an additional 20 percent tax on) amounts that are deferred under an arrangement that violates Section 409A — either in form or operation — in the year in which a violation occurs. The service provider will not, however, be required to include income or pay additional taxes in any prior or subsequent years in which the failure does not occur. The preamble to the Proposed Regulations states that the Treasury Department and IRS specifically considered, but rejected, the notion that a Section 409A violation in one year would be treated as continuing during taxable years beyond the year in which the initial violation occurred. Therefore, an operational failure that is not repeated in a subsequent year will not result in additional adverse tax consequences in future years (*e.g.*, an amount deferred pursuant an untimely deferral election in an earlier year will not be subject to adverse tax consequences in subsequent years). Similarly, a plan document provision which violates Section 409A will not result in additional adverse tax consequences in years following the year in which the plan is amended to comply with Section 409A.

In addition, the service provider is not required to include in income (or pay an additional 20 percent tax on) deferred amounts that are subject to a substantial risk of forfeiture at the end of the taxable year in which a violation occurs. As a result, if the Section 409A violation does not continue, either because the documentary plan failure is corrected or an operational failure is not repeated, amounts that are subject to a substantial risk of forfeiture at the end of the taxable year in which the Section 409A violation occurs will not be subject to adverse tax consequences under Section 409A.

The preamble to the Proposed Regulations explicitly recognizes that these rules could provide the means for taxpayers to disregard the requirements of Section 409A by permitting repeated operational violations with respect to unvested deferred amounts. To prevent this abuse, the Proposed Regulations provide that the substantial risk of forfeiture will be disregarded if the facts and circumstances indicate that the service recipient has a practice of permitting Section 409A violations with respect to unvested amounts. Accordingly, the liberal approach adopted in the Proposed Regulations should in no event be used as a planning technique.

The following examples illustrate the principles discussed above:

- In 2010, a service provider defers a bonus under a Section 409A compliant deferral plan. Fifty percent of the bonus is fully vested at all times and 50 percent vests in 2012. The plan provides that the full bonus, to the extent vested, is paid on separation from service. In 2011, the service provider makes an impermissible re-deferral election to have the bonus paid one year following separation from service. No other Section 409A violations occur. The 50 percent of the bonus that is vested in 2011 is included in income in 2011 and is subject to the additional 20 percent tax. The 50 percent of the bonus that was not vested in 2011 will be paid in accordance with the impermissible election and will not be subject to adverse tax consequences under Section 409A.
- In 2010, a company discovers that its executive change in control severance plan adopted in 2009 does not contain the required provision for a six-month delay for the payment of severance to specified employees. The company amends the severance plan in 2010 to provide for a six-month delay. Provided that the company does not undergo a change in control on or before Dec. 31, 2010, participants will not suffer adverse tax consequences as a result of this corrected documentary failure.

Determining Amounts Included in Income and the Additional 20 Percent Tax

In any year in which a Section 409A violation occurs, the amount included in income under Section 409A is determined under the following formula:

(A) Determine the amount deferred as of the end of the applicable tax year;

(B) Subtract amounts previously taken into income; and

(C) Subtract amounts subject to a substantial risk of forfeiture as of the end of the applicable tax year.

Each year in which a Section 409A violation occurs is evaluated independently. The calculation of amounts included in income for any year in which a Section 409A violation occurs are not affected by calculations done with respect to prior years in which a Section 409A violation also occurred, except to the extent that amounts taken into income in prior years are deducted from the amount deferred as of the end of the applicable year.

The Proposed Regulations include detailed guidelines for calculating the amount deferred at year-end under a noncompliant arrangement. In general, the amount deferred for purposes of the formula above equals (i) the present value as of the end of the taxable year of the amounts ultimately payable under the plan (taking into account the plan aggregation rules) plus (ii) amounts paid to the service provider under the plan during the applicable year.

To determine the present value of an amount deferred as of the end of the year in which the violation occurs, both the total amount ultimately payable and the payment date must be determined. At the time that the present value is being determined, it may not be possible to determine the amount ultimately payable (*e.g.*, because the amount payable is based on the employee's salary or bonus at the time of payment) or the date the amount will be paid (*e.g.*, because the amount is payable on the occurrence of an event such as separation from service or a change in control). To address this uncertainty, the Proposed Regulations provide that taxpayers should generally use good faith assumptions based on facts and circumstances as of the end of the applicable taxable year and, subject to certain detailed rules, the probability that a payment will be made on a particular date. Generally, where the plan provides for alternative times or forms of payment, deferred amounts will be treated as payable at the time and in the form which results in the highest present value.

Additional tax liabilities may not be assessed when, at the time the Section 409A violation is discovered, the tax year is closed. However, where the violation continues in open plan years, the service provider is not permitted to deduct from the amounts deferred the income that would have otherwise been included.

The Proposed Regulations also set forth specific rules for determining the present value of amounts deferred for common types of compensation arrangements.

- **Account balance plan** The present value of the amounts deferred under an account balance plan (*e.g.*, a standard nonqualified deferred compensation plan) is generally the account balance under the plan as of the last day of the applicable year.
- **Severance** If payment is triggered by a separation from service, the present value of the deferred amount is calculated assuming the separation from service occurred on the last day of the taxable year in which Section 409A was violated. For example, assume that a specified employee is a party to an employment agreement providing for a vested separation payment equal to three times the sum of the employee's base salary and target bonus as of the termination date and that the plan does not provide that the separation payment is subject to the required six-month delay. In 2009, the employee will be required to include in income (and pay an additional 20 percent tax on) an amount equal to three times the sum of the employee's base salary and target bonus determined assuming separation from service on Dec. 31, 2009. If the required six month delay provision is not added to the agreement by the end of 2009, the amount deferred under the employment agreement will be recalculated in 2010 assuming separation from service on Dec. 31, 2010. The excess of the 2010 amount over the amount taken into income in 2009 will be included in income in 2010 and will be subject to an additional 20 percent tax.

- **Stock Options** The present value of amounts deferred under a stock option that violates Section 409A and has not been exercised prior to year-end equals the excess, if any, of the fair market value of the underlying stock on the last day of the taxable year over the exercise price of the stock option. If the noncompliant stock option was exercised during the year, the present value of the amounts deferred equals the excess of the fair market value of the underlying stock on the date of exercise over the exercise price of the stock option.

- **Short-Term Deferrals** Amounts that, based on the facts and circumstances on the last day of the taxable year, may be short-term deferrals are not included in the amount deferred. Amounts that are not in fact paid in the applicable short-term deferral period, and therefore constitute deferred compensation, are included in the amounts deferred in the year in which the applicable short-term deferral period expires.

The additional tax imposed in the year in which Section 409A is violated is equal to 20 percent of the amount included in income in that year under Section 409A.

Determining the Premium Interest Tax Owed While deferred amounts that do not comply with Section 409A are included in income and are subject to an additional 20 percent tax only in the year in which the Section 409A violation occurs, Section 409A penalizes service providers for not including the amounts in income in the year in which they would have been included had they not been deferred. As a penalty for this earlier underpayment, service providers must pay, in the year of the Section 409A violation, interest at the underpayment rate plus 1 percent on any amounts that, absent the deferral, would have been included in income in the taxable year first deferred or, if later, the first taxable year in which the deferred compensation was not subject to a substantial risk of forfeiture. The Proposed Regulations provide intricate rules for calculating the premium interest tax owed. Generally, the income included in the year in which the violation occurred must be allocated among the earlier years that amounts would have been included in income absent the deferral, taking into account certain adjustments that would have been made to the service provider's tax returns had the income been included in the earlier years (*e.g.*, itemized deductions may have been further limited or additional carryovers such as carryover losses may have been used). In the preamble to the Proposed Regulations, the Treasury Department and IRS acknowledge that the method for calculating interest tax owed is cumbersome and request comments on an appropriate safe harbor method.

Determining Future Adjustments to Income Taxes Owed Amounts that are included in income in tax years in which a Section 409A violation occurs are not required to be included in income when ultimately paid (although, in practice, amounts included in income in accordance with the Proposed Regulations will often be paid to the plan participants in the year of the violation since continuing the deferral does not benefit the participants). If a service provider does not ultimately receive payment of deferred compensation amounts that were included in income in prior years in accordance with the Proposed Regulations (because, for example, the amounts were ultimately forfeited pursuant to a restriction, such as a noncompetition covenant, that did not constitute a substantial risk of forfeiture), the service provider may deduct the previously included but unpaid income in the year in which the service provider permanently forfeits the right to all deferred compensation under the plan (applying the plan aggregation rules). For this purpose, a decrease in an amount deferred under a plan as a result of a deemed investment loss is not treated as permanently forfeited if the service provider retains the right to an amount deferred under the plan (unless the right becomes wholly worthless during the taxable year).

Interim Guidance on Withholding and Reporting of Deferred Compensation

Notice 2008-115 waives all reporting of Section 409A compliant deferred compensation plan amounts until further guidance is issued. Service recipients are, however, required to report deferred compensation amounts that violate Section 409A and are therefore includible in income. The amounts includible in income (but not the additional 20 percent tax) are also subject to income tax withholding. The methods outlined for calculating amounts includible in income under Notice 2008-115 are consistent with the prior guidance applicable to calendar years 2005, 2006 and 2007. In addition, taxpayers may rely on the more detailed guidance set forth in the Proposed Regulations provided that the taxpayer complies with all of the provisions of the Proposed Regulations.

Notice 2008-115 is effective until further guidance is published. The Treasury Department and IRS have indicated they do not expect to issue further guidance until the Proposed Regulations are finalized and further guidance, once issued, will not be effective earlier than the calendar year following the year in which the regulations are finalized. Taxpayers that comply with Notice 2008-115 will not be liable for additional income tax withholding or penalties, or be required to file corrected returns, as a result of future published guidance.

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December 15, 2008

IRS Expands Relief for Operational Violations Under Section 409A

On December 5, 2008, the Internal Revenue Service issued guidance under Section 409A of the Internal Revenue Code that provides relief from the full application of Section 409A for certain operational (but not documentary) failures. Notice 2008-113 expands upon and supersedes a program initially announced in Notice 2007-100. The IRS also solicited comments as to whether the program should be expanded to provide relief for documentary failures.

The relief applies to the following types of operational failures, provided those failures are inadvertent and unintentional (Listed Violations):

- erroneous payment of amounts that should have been deferred;
- erroneous deferral of amounts that should have been paid;
- premature payment of amounts that should have been paid later in the same year; and
- erroneous establishment of an option price at less than the stock's fair market value on the grant date.

As a condition to the relief, the service recipient must take commercially reasonable steps to avoid a recurrence of the operational failure. Relief is not available after 2009 if the same or a substantially similar operational failure had previously occurred unless the service recipient can demonstrate that it had established and followed practices reasonably designed to ensure that the failure would not recur.

In some cases, all taxes under Section 409A can be avoided, while in other cases the amount of the tax is merely reduced, as follows:

- Section IV of the Notice eliminates all taxes under Section 409A for the Listed Violations if they are corrected during the same year;
- Section V of the Notice eliminates all taxes under Section 409A for the Listed Violations if they are corrected during the following year, but only where the affected service provider has not been an "insider" under Section 16 of the Securities Exchange Act of 1934 at any time during the years in which the failure and correction occurred (or would not have been an insider during either of those years if the service recipient were a public company subject to Section 16);
- Section VI of the Notice reduces the tax payable where the Listed Violations involve amounts not in excess of the applicable dollar limit in effect under Code Section 402(g) (*e.g.*, $16,500 for 2009);
- Section VII of the Notice limits the amount to be included in income under Section 409A and waives the "premium interest tax" (but not the additional 20 percent tax) for certain of the Listed Violations if they are

corrected before the end of the second year following the year in which the failure occurred; and

- No taxes are assessed under Section 409A in respect of options mistakenly granted with an exercise price at less than fair market value provided that, before the end of the year following the year of grant, the exercise price is reset at not less than the original grant date fair market value.

Limited transitional relief also is available under Section VIII of the Notice for certain pre-2008 operational failures involving non-insiders. No relief is available under Sections V, VI or VII where a service provider is under IRS audit for the year in which the operational failure occurred.

The program provides relief only where the operational failure is corrected as provided in the Notice. In some cases, as a condition to relief, the service provider must repay amounts erroneously paid or made available by the service recipient, together with interest in some cases. Any required repayment must be of the entire pre-tax amount (*i.e.*, without regard to tax withholdings, though future tax withholdings may be offset), and the service recipient is prohibited from making a “gross-up” or other payment to the service provider in respect of the repayment amount. In addition, the Notice requires service recipients and, in some cases, service providers, to file an attachment with their federal income tax returns for specified years to identify the circumstances of the failure and highlight reliance upon the Notice’s relief provisions.

The relief under the Notice is subject to many other exceptions and special rules that are beyond the scope of this memorandum.

The matrix on the following pages summarizes most of the relief available under the Notice. Because the matrix — like the Notice — assumes considerable familiarity with the existing guidance under Section 409A, it is designed to be of use mostly to those with operational responsibility for Section 409A compliance as a means to identify the provisions of the Notice with the most relevance to any particular violation of the Section 409A requirements.

(continued on next page)

Summary of Certain Assumptions and Terms Used

- "Year X" refers to the year of failure (with corresponding meanings for "Year X + 1" and "Year X + 2")
- "SP" refers to service provider
- "SR" refers to service recipient
- References to Sections are references to the applicable section of the Notice
- A repayment requirement generally contemplates either direct repayment or the reduction of amounts otherwise payable to the service provider later in the same year

	Amounts that Should have been Paid in Subsequent Year are Paid in Current Year (Insufficient Deferral)	**Payment Made Too Early in Scheduled Year of Payment (including failure to delay for six months)**	**Excess Deferral**
If corrected in Year X	<u>§ IV.A. - Treated as Timely Deferral If</u>: • SP repays gross amount by year end of Year X or compensation for remainder of Year X is reduced (non-insiders can make repayment (with interest) over period up to 24 months from due date of SP's tax return for Year X if repayment would cause immediate and heavy financial need) • If an insider and amount exceeds 402(g) limit (*e.g.*, $16,500 for 2009), repayment must include interest • SP has a legally binding right to amount that would have been due (but for the erroneous payment), in accordance with plan • Erroneous payment does not involve failure to meet six-month delay requirement	<u>§ IV.B. - Treated as Correctly Paid If</u>: • SP repays gross amount by end of Year X • SP has a legally binding right to payment of repaid amount on the date corresponding to the scheduled payment date plus number of days from date of erroneous payment to date of repayment (or, if repayment is made after scheduled payment date, number of days from date of erroneous payment to scheduled payment date)	<u>§ IV.C. - Not Treated as an Amount Deferred If</u>: • SR pays excess amount to SP by end of Year X • Plan account of SP is adjusted to reflect payment (if SP is an insider, adjustment must also be made to reverse positive earnings on excess deferral)
If corrected in or by end of Year X+1 (Only Applicable to SPs Who Were Not Insiders At Any Time During Year X and Year X+1) The § VIII special transition rule provides that, if the SP not an insider at any time during Year X, and if Year X is pre-2008, the relief in §§ V.B., C. and D. is available through 2009 (*i.e.*, 2009 is treated as Year X+1)	<u>§ V.B. - Treated as Timely Deferred If</u>: • Erroneous payment does not involve failure to meet six-month delay requirement • SP repays gross amount (plus interest) in Year X+1 (or over period of up to 24 months, as described in IV.A. above) *(continued)*	<u>§ V.C. - Treated as Correctly Paid If</u>: • SP repays gross amount by end of Year X+1 • SP has a legally binding right to receive payment of repaid amount on date corresponding to date of repayment plus number of days from erroneous payment to originally scheduled payment date *(continued)*	<u>§ V.D. - Not Treated as an Amount Deferred If</u>: • SR pays excess amount to SP in Year X+1 • Plan account of SP is adjusted to reflect payment (including reversal of positive earnings on excess deferral) *(continued)*

	Amounts that Should have been Paid in Subsequent Year are Paid in Current Year (Insufficient Deferral)	**Payment Made Too Early in Scheduled Year of Payment (including failure to delay for six months)**	**Excess Deferral**
	• SP has a legally binding right to amount that would have been due (but for the erroneous payment), in accordance with plan • Erroneous payment includible in SP's income for Year X; SP is entitled to deduction for repayment (excluding interest) in determining AGI for Year X+1; subsequent payment included in SP's income for year of payment	• Erroneous payment includible in SP's income for Year X; if repayment and subsequent payment occur in same year, no deduction or income inclusion for SP in Year X+1; if repayment and subsequent payment do not occur in same year, SP entitled to deduction for repayment in determining AGI for Year X+1 and subsequent payment included in SP's income for year of payment	• SR does not pay interest or otherwise compensate SP to reflect time value of money
If corrected by end of Year X+2 and the requirements set forth in the applicable column are satisfied, SP's income inclusion is limited to payment amount (and does not include any other plan-related amounts): 20 percent tax required, but premium interest tax is not payable	<u>§ VI.B. requirements</u>: • Amount involved does not exceed the 402(g) limit (*e.g.*, \$16,500 for 2009) • SR must report payment as 409A income for year of payment <u>§ VII.B. requirements</u>: • Erroneous payment does not involve failure to meet six-month delay requirement • No other relief applicable under the Notice • SP repays gross amount (plus interest, if SP is an insider) • SP has a legally binding right to the amount that would have been due (but for the erroneous payment), in accordance with plan • SR must report 409A inclusion for Year X (per amended W-2 or 1099) and SP must include erroneous payment and 20 percent tax in income for Year X (per amended return)	<u>§ VI.B. requirements</u>: • Amount involved does not exceed the 402(g) limit (*e.g.*, \$16,500 for 2009) • SR must report payment as 409A income for year of payment <u>§ VII.C. requirements</u>: • No other relief applicable under the Notice • SP repays gross amount • SP has a legally binding right to receive payment of repaid amount on date corresponding to the date of repayment plus the number of days from erroneous payment to originally scheduled payment date • SR must report 409A inclusion for Year X (per amended W-2 or 1099) and SP must include erroneous payment and 20 percent tax in income for Year X (per amended return)	<u>§ VI.C. requirements</u>: • Amount involved does not exceed the 402(g) limit (*e.g.*, \$16,500 for 2009) • SR pays excess amount to SP by end of Year X+2 • SR must report payment as 409A income for year of payment; if so reported, no penalties for failure to withhold <u>§ VII.D. requirements</u>: • No other relief applicable under the Notice • SR pays excess amount to SP • SR must report payment as 409A income for Year X (per amended W-2 or 1099); if so reported, no penalties for failure to withhold