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LEGAL ALERT



## Legal Alert: Section 409A Update - New Guidance from the IRS

12/9/2008

On December 5, 2008, the Internal Revenue Service (IRS) issued new guidance under Internal Revenue Code (Code) Section 409A. The new guidance consists of: (1) proposed regulations dealing with the calculation of amounts includible in income under, and the additional taxes imposed by, Section 409A(a) when nonqualified deferred compensation fails to comply with Section 409A, and (2) a Notice providing relief for, and methods of correcting, certain operational failures to comply with Section 409A.

### Guidance on Calculations

The proposed 409A regulations provide detailed guidance on the proper method of calculating the amounts that are includible in a service provider's income as a result of a violation of Section 409A, as well as the "premium interest tax," i.e., the additional income tax equal to the interest on underpayments that would have occurred if the deferred compensation at issue had been included in the taxpayer's income when deferred (or when vested, if later). These computations, along with the 20% additional income tax, are necessary in order to comply with the sanctions imposed by Section 409A.

Because all deferred compensation arrangements are not the same, the proposed regulations also provide specific rules that apply to various types of nonqualified deferred compensation arrangements, e.g., "account balance" and "nonaccount balance" plans, stock rights, separation pay arrangements, reimbursement arrangements, split dollar life insurance, and others. Another way in which the proposed regulations will be helpful is that they provide methods of correcting violations for nonvested deferrals, and provide that compliance generally is tested on a year-by-year basis, i.e., failure to comply in one year generally may be corrected for a later taxable year. In addition, determinations under the proposed regulations are made as of the end of the taxable year, regardless of the actual date a failure occurs; this, for example, prevents the possibility of being charged with paying tax on deferred amounts that by the end of the year have "disappeared" due to market factors. Guidance is also provided that enables a service provider to deduct amounts that have already been included in income but are never actually received, such as where a service recipient has become insolvent, or is unable to pay for other reasons.

Finally, the proposed regulations delay the requirement that 409A deferrals be reported, on Form W-2 or 1099-Misc., until the regulations are finalized. Similarly, the reporting under the regulations of amounts includible in income pursuant to Section 409A is delayed until the regulations are finalized; the

preamble states that further interim guidance is anticipated concerning 2008 reporting requirements.

#### **409A Correction Program**

In addition to the proposed regulations, the IRS issued Notice 2008-113 which prescribes a correction program for certain operational violations of Section 409A requirements, expanding on the existing correction program that was announced in Notice 2007-100. Among other changes, the new program expands upon the ability to correct operational failures after the close of the year in which the failure occurs, including special transitional relief for certain failures that occurred prior to January 1, 2008.

Similar to the IRS' Employee Plans Compliance Resolution System (EPCRS), in order to encourage voluntary correction, the Notice limits the amount of 409A taxes that will be assessed due to certain operational failures, regardless of the amounts involved in the violation. Furthermore, like the EPCRS, the Notice prescribes specific correction methods for specific types of failures. In many cases, it must be demonstrated that "commercially reasonable" steps have been taken by the end of 2009 so as to avoid the recurrence of an operational failure.

The Notice, however, still requires an IRS filing by both the service provider and the service recipient, and limits the ability (in some cases, eliminates the ability) of both public companies and private entities to effect corrections with respect to so-called "insiders," e.g., officers, directors or ten percent (or more) shareholders.

In addition, the new program makes no provision for correction of "plan document" failures (though the Notice does request comments on the advisability of such a procedure). This omission – even if temporary – emphasizes the need for employers to ensure that all of their compensatory arrangements are reviewed for 409A compliance, and amended as necessary, prior to December 31, 2008.

If you have any questions regarding the deferred compensation provisions of Section 409A of the Code or other compensation or benefits issues, please contact Jeffrey Ashendorf, 212-453-5926, [jashendorf@fordharrison.com](mailto:jashendorf@fordharrison.com), or Stephen Zweig 212-453-5906, [szweig@fordharrison.com](mailto:szweig@fordharrison.com), or any member of Ford & Harrison's Employee Benefits practice group.