

News from our Compensation & Benefits Group

IRS Guidance and Transition Relief for Correction of Section 409A Operational Errors

Recently issued IRS Notice 2008-113 outlines correction procedures to be followed for certain inadvertent operational violations of Section 409A of the Internal Revenue Code and offers the possibility of obtaining either complete or partial relief from its adverse tax consequences. The relief provided and the correction procedures required depend upon when the operational failure is corrected and whether the affected individual is a Section 16 insider. Adverse Section 409A tax consequences can be completely avoided for certain operational errors that are corrected in the same taxable year. In addition, for non-Section 16 insiders, adverse Section 409A tax consequences can also be completely avoided for operational errors that are corrected in the following taxable year, but interest payments by the individual may be required. For operational errors that are not corrected until the second year following the year of the failure, some Section 409A taxes will apply to the individual, but not to the maximum extent authorized. The Notice also provides transition relief for operational errors corrected on or before December 31, 2009 for non-Section 16 insiders.

To qualify for relief, the employer must report the operational violation to the IRS as part of its federal tax return and in most cases must also provide a related notice to the affected individual. In addition, the employer must take commercially reasonable steps to prevent similar operational errors from recurring. Only the following types of inadvertent operational errors are eligible for correction under the Notice:

- ▶ Grants of discounted stock options and stock appreciation rights
- ▶ Failure to delay separation payments to specified employees for at least six months
- ▶ Premature payments
- ▶ Deferrals greater or less than the correct amount

The earlier that an eligible operational error is discovered and corrected, the more likely that the error will be eligible for correction and that additional Section 409A taxes and interest payments can be avoided. Therefore, employers should consider scheduling and implementing an annual audit of the operation of those arrangements that provide for deferred compensation in order to allow sufficient time to discover and correct operational errors prior to each year-end. Moreover, employers that are designing and implementing new deferred compensation arrangements may want to consider scheduling payments under such arrangements to occur early in the calendar year, so that there will be time to discover and correct any operational errors in processing payments or deferrals prior to year-end.

As discussed in our prior *Cooley Alerts* [www.cooley.com/news/alerts.aspx?ID=000040906820], operational compliance with Section 409A has been required since January 1, 2005. With the issuance of IRS Notice 2008-113, employers should now consider whether there have been any operational failures since January 1, 2005 that may need to be corrected. The broad categories

of arrangements (those entered into on or after January 1, 2005, and in some cases prior to that date due to limited “grandfathering”) that may be subject to Section 409A include:

- ▶ Certain stock rights (e.g., deferred compensation settled in shares, restricted stock units, phantom stock, discounted

KEY ATTORNEY CONTACTS

Wendy Davis	650/843-5157 wdavis@cooley.com
Renee Deming	650/843-5115 rdeming@cooley.com
Soo Kim	212/479-6760 skim@cooley.com
Michelle Lara	858/550-6011 mlara@cooley.com
Dan Meehan	720/566-4061 dmeehan@cooley.com
Buff Miller	650/843-5351 bmiller@cooley.com
Tom Reicher	415/693-2381 treicher@cooley.com
David Walsh	703/456-8021 dwalsh@cooley.com
Thomas Welk	858/550-6016 twelk@cooley.com

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stock options and discounted stock appreciation rights).

- ▶ Separation pay arrangements (plans and individual agreements providing severance benefits, including those payable upon or after a change in control).
- ▶ Account balance plans (deferred compensation arrangements expressed in the form of individual account balances, including supplemental executive retirement plans utilizing individual account balances).
- ▶ Non-account balance plans (individual arrangements and supplemental executive retirement plans expressing a benefit in terms of a defined benefit formula).
- ▶ Reimbursement plans (plans and individual agreements providing for taxable expense reimbursements).
- ▶ Bonus plans.

The Notice does not provide relief for correcting document errors, including failures to have timely (*i.e.*, by the end of 2008) amended plans and agreements to comply with Section 409A. However, the IRS is soliciting comments as to whether such

a program should be implemented, and it seems to us that some form of relief likely will be provided.

The Compensation & Benefits Group at Cooley is prepared to work with you to identify Section 409A operational errors and correction procedures that may provide full or partial relief from adverse Section 409A tax consequences. If you would like our assistance, please contact one of the attorneys listed above. ■

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