

December 12, 2008

## New Program to Correct Certain 409A Operational Failures

The Treasury Department and Internal Revenue Service have announced a new program to correct certain Internal Revenue Code Section 409A operational failures under nonqualified deferred compensation plans. The new program is set forth in [Notice 2008-113](#). The new program expands on and replaces the Section 409A correction program announced last December in Notice 2007-100. Here are some of the key points of the new program.

**No Relief for Documentary Compliance.** The new program applies only to *operational* failures to comply with Section 409A. The new program does *not* extend the deadline for amending plan documents to comply with Section 409A. That deadline remains December 31, 2008. Nor does the new program offer relief for any required amendment that is not adopted by the December 31, 2008 deadline.

**Limited Relief for Insiders.** Relief is limited (and in certain cases unavailable altogether) for “insiders.” For purposes of the new program, insiders include directors, officers and more than 10% beneficial owners of an employer, as determined under Section 16 of the Securities Exchange Act. The limits on insiders apply regardless of whether the employer is publicly or privately held and regardless of whether the employer is a corporation.

**Eligibility.** To be eligible for the program:

- the operational failure must be inadvertent and unintentional;
- the employer must have taken steps to avoid the recurrence of operational failures;
- the employee’s tax return must not be under audit with respect to the plan for the year in which the operational failure occurred;
- the operational failure must be fully corrected;
- the employer must not have experienced a substantial financial downturn or “financial or other issues” in the year in which an erroneous payment was made to an employee, if the downturn or other issue would pose a significant risk that the employer will not be able to pay the amount when due; and
- all of the requirements for the particular correction method and the notice requirements described below are met.

**Corrections Made in Same Year as Failure.** An early or late payment that is not made in accordance with the plan terms or deferral election may be corrected in the same tax year.

- To correct early payments (including, for example, payments resulting from failures to process deferrals and payments made at least 30 days early within a year), the employee must repay the employer.
- To correct a late payment (including, for example, an excess or improper deferral), the employer must repay the employee.
- For non-insider employees who would otherwise incur an immediate and heavy financial need if repayment is made in the same year, the repayment period may be extended for up to 24 months following the due date for the non-insider employee’s tax return for the year in which the failure occurred.

- If correction is made within the same tax year, certain adverse tax consequences of Section 409A may be avoided, including inclusion in income on vesting, 20% penalty tax, premium interest rate and certain additional reporting and withholding requirements.
- In certain cases, the employee must repay to the employer interest on the repaid amount and the employee's plan account balance may be adjusted for earnings (or losses).

**Corrections for Non-Insiders in Year Following Year of Failure.** An early or late payment to a **non-insider** employee that is not made in accordance with plan terms or a deferral election may be corrected in the year immediately following the year in which the failure occurred.

- Early and late payments must generally be corrected in the same manner as described under "Corrections Made in Same Year as Failure" above.
- In certain cases, the employee must repay the employer interest on the repaid amount and the employee's account balance may be adjusted for earnings or losses.
- If correction to a non-insider employee is made in the year following the year in which the failure occurred, certain adverse tax consequences under Section 409A may be avoided, such as the 20% penalty tax, the premium interest rate and certain additional reporting and disclosure requirements.

**Correction of Stock Rights.** Under Section 409A, certain stock rights (including stock options and stock appreciation rights) are generally exempt from Section 409A if the exercise price is not less than the fair market value of the underlying shares on the date of grant and certain other requirements are met. The new program permits employers to reset the exercise price of a

discounted stock right to an amount that is not less than the fair market value of the underlying stock on the date of grant. The stock right will be treated as exempt from Section 409A if the exercise price adjustment is made:

- before the stock right is exercised;
- for insiders, by the end of the year in which the stock right is granted; and
- for non-insiders, by the end of the year following the year in which the stock right is granted.

**Other Corrections.** The new program also permits the correction of (1) certain operational failures involving limited amounts (\$16,500 for 2009) and (2) certain early and late payments not corrected within two years, to the extent these corrections cannot be made in the same year or the year following the year in which the operational failure occurred. These corrections are subject to the 20% penalty tax but not the premium interest rate under Section 409A. The new program also provides special relief for operational violations occurring before 2008.

**Notice Requirements.** An employer relying upon the new correction program must attach a statement to its tax return and furnish a similar statement to affected employees that it is relying on the relief under the program. The guidance sets forth specific information that must be included in the statements. No statements are required to be filed or furnished for corrections of the exercise price of otherwise exempt stock rights.

**Comments Requested.** Treasury and the IRS have requested comments on the new program and comments on whether a program to correct plan document failures would be feasible and advisable. Comments must be submitted by March 6, 2009. For more information on the IRS's Notice 2008-113 and our prior client alerts on 409A, please visit <http://www.chadbourne.com/409A/>.

**Our client alerts are for general informational purposes and should not be regarded as legal advice. If you would like additional information or have any questions, please contact:**

William G. Cavanagh  
+1 (212) 408-5388  
[wcavanagh@chadbourne.com](mailto:wcavanagh@chadbourne.com)

Lauren D. Kelly  
+1 (212) 408-5520  
[lkelly@chadbourne.com](mailto:lkelly@chadbourne.com)

David Gallai  
+1 (212) 408-1033  
[dgallai@chadbourne.com](mailto:dgallai@chadbourne.com)

Edward P. Smith  
+1 (212) 408-5371  
[esmith@chadbourne.com](mailto:esmith@chadbourne.com)

Marjorie M. Glover  
+1 (212) 408-1016  
[mglover@chadbourne.com](mailto:mglover@chadbourne.com)

[www.chadbourne.com](http://www.chadbourne.com)

New York Washington Los Angeles Houston Mexico City  
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