



Cooley
LLP

Morgan Lewis

**Section 409A Correction:
It's Never Too Late**

Daniel Hogans, Morgan, Lewis & Bockius LLP
Michelle Lara, Cooley LLP

January 12, 2011

© 2011 Cooley LLP. Firm: Palo Alto Square, 9000 El Camino Real, Palo Alto, CA 94306.
The content of this packet is an introduction to Cooley LLP's capabilities and is not intended, by itself, to provide legal advice or create an attorney-client relationship. Prior results do not guarantee future outcome.

attorney advertisement

Overview

- ▶ **Methods of Correction**
 - ▶ Unvested Amounts
 - ▶ Operational Errors
 - ▶ Plan Document Errors
- ▶ **Other Correction Issues**
- ▶ **Common 409A Compliance Errors**
- ▶ **Case Studies**

2

Correction of Errors – Unvested Amounts

- ▶ Proposed income inclusion regulations: 1.409A-4
 - ▶ Will be effective upon issuance of final regulations, but may be relied upon in the interim period
 - ▶ Address the determination and timing of inclusion of amounts in income that are subject to Section 409A and non-compliant
 - ▶ Amounts are includible in income and subject to 409A additional taxes in first year in which:
 - ▶ Amount vests or is no longer subject to a “substantial risk of forfeiture” (SRF), and
 - ▶ The deferred amount is subject to a 409A operational or plan document error

3

Correction of Errors – Unvested Amounts

- ▶ May self-correct while amount is still unvested and the SRF does not lapse before the end of the year in which the correction occurs
 - ▶ SRF does not mean the same thing as “payment event”
 - ▶ Possible to correct on an earlier date in same taxable year that the SRF expires?
- ▶ Works for both operational and documentary compliance errors
 - ▶ Discounted unvested options
- ▶ No tax return filing or IRS notification required
- ▶ IRS will not respect SRF related corrections where there is a history or pattern of abuse
 - ▶ Can be used to correct inadvertent errors only
 - ▶ No pattern of permitting impermissible deferral election/payment timing changes on non-vested amounts

4

Correction of Errors – Unvested Amounts

- ▶ What if the SRF has not yet lapsed, but will lapse on a later date in the current year?
- ▶ Possible to add a new SRF so that SRF won't lapse at later date in current year, then self-correct?
- ▶ Generally, addition of a new SRF is not respected under the 409A rules, except where:
 - ▶ Amounts would otherwise vest upon "change of control"
 - ▶ Materially greater benefits are provided as consideration for the addition of a new SRF

5

Correcting Errors in Plan Operation – Vested Amounts

- ▶ IRS Notice 2008-113: Correction Program for 409A Operational Compliance Errors
- ▶ Possible significant reduction or elimination of 409A tax exposure due to operational errors
 - ▶ Amounts subject to operational errors are "aggregated" with other deferred amounts under the "plan" by the same service provider
- ▶ Available for unintentional operational failures:
 - ▶ Premature payments of amounts that otherwise should have been deferred
 - ▶ Failures to delay payments to specified employees for six months
 - ▶ Deferrals of amounts that should not have been deferred
 - ▶ Discounted options

6

Correcting Operational Errors – IRS Notice 2008-113 (cont.)

- ▶ IRS notification/filing requirements
 - ▶ For corrections of errors completed in same taxable year as the failure, must generally file IRS notification with the service recipient's tax return
 - ▶ Relief under IRS Notice 2010-80 from requirement to notify the service provider or file notice with the service provider's tax return
 - ▶ Correction in a year following the year of failure generally requires
 - ▶ Notification to participant
 - ▶ IRS notice filings with corporate and individual returns

7

Correcting Operational Errors – IRS Notice 2008-113 (cont.)

- ▶ Does not cover correction of plan document errors
- ▶ Plan document must be 409A compliant
- ▶ Service provider's taxable year must not be under IRS examination
- ▶ Must take reasonable steps to avoid recurrence of the failure
- ▶ Relief for early payment errors may not be available where service recipient is subject to a substantial financial downturn
- ▶ Different correction rules apply for "insiders," as determined under the Section 16 Securities Exchange Act Rules (regardless of whether the service recipient is publicly traded)
 - ▶ Directors
 - ▶ Senior Management

8

Correcting Operational Errors – IRS Notice 2008-113 (cont.)

- ▶ Timing Issues
 - ▶ Corrected within the same taxable year as the failure:
 - ▶ Available for insiders
 - ▶ Avoid income inclusion and additional taxes under Section 409A completely
 - ▶ Not available to correct 6-month delay violations
 - ▶ Extended repayment periods (up to 24 months, but with interest) possibly permitted for non-insiders
 - ▶ For insiders, if amounts exceed 402(g) limit, interest must be added to repayment amounts

9

Correcting Operational Errors – IRS Notice 2008-113 (cont.)

- ▶ Timing Issues
 - ▶ Corrected in following taxable year:
 - ▶ Not available for insiders
 - ▶ Interest must be added to all repayment amounts required from service providers
 - ▶ Otherwise avoid 409A tax exposure

10

Correcting Operational Mistakes – IRS Notice 2008-113 (cont.)

- ▶ Corrected in second year following year of operational failure:
 - ▶ Available for insiders
 - ▶ Not available for options
 - ▶ 409A additional 20% tax applies:
 - ▶ Box 12 Code Z reporting on Form W-2
 - ▶ No premium interest tax applies
 - ▶ No taint on other deferred amounts
 - ▶ If under the 402(g) limit:
 - ▶ no requirement that service provider must repay amounts
 - ▶ earnings on erroneous deferrals may be paid to the service provider
 - ▶ May require amended tax returns for prior years

11

Correcting Operational Mistakes – IRS Notice 2008-113 (cont.)

- ▶ Operational error discovered after end of second year following year of failure?
 - ▶ No correction opportunity under IRS Notice 2008-113
 - ▶ Amend prior tax returns?
 - ▶ Statute of limitations?

12

Correction of Plan Document Errors

- ▶ IRS Notice 2010-6: the types of plan document errors that are eligible for correction include:
 - ▶ ambiguous payment terms
 - ▶ impermissible payout triggers and payout schedules,
 - ▶ violations of deferral election rules,
 - ▶ certain impermissible discretion to delay payments,
 - ▶ certain impermissible discretion to accelerate payments
- ▶ Not available for correction of discounted stock options or stock appreciation rights
- ▶ IRS Notice 2010-80:
 - ▶ May correct certain “linked” non-qualified plan errors
 - ▶ May correct stock rights that were intended to be 409A compliant (rather than exempt)

13

Correction of Plan Document Errors (cont.)

- ▶ The particular plan document error must be described in IRS Notice 2010-6 to be eligible for correction
 - ▶ Each specified error has its own particular correction methodology
 - ▶ No general correction “principles” apply
 - ▶ No opportunity to correct if the error is not described in IRS Notice 2010-6
- ▶ Neither the service provider nor the service recipient may be under examination
 - ▶ Problematic for entities that are under continuous examination
- ▶ Must also correct any interim operational failures under Notice 2008-113
- ▶ Must also correct any other “similar” plan document errors

14

Correction of Plan Document Errors (cont.)

- ▶ Not all plan document errors are viewed as equally “evil” and deserving of 409A tax “punishment”
 - ▶ Wide range of categories of plan document errors, correction methods, and severity of consequences
 - ▶ Certain “ambiguous” plan terms may be self-corrected at any time, with no IRS filing or adverse 409A tax consequences
 - ▶ Payment will be made “as soon as practicable”
 - ▶ Ambiguous definition of permitted 409A payment event
 - ▶ E.g., “termination of employment” vs. “separation from service”

15

Correction of Plan Document Errors (cont.)

- ▶ Adverse tax consequences may be triggered, even after correction, depending upon the timing of subsequent events
- ▶ For most plan document corrections, if payments are triggered within the 12 month period following the date of correction, 50% of the deferred amount will be subject to Section 409A taxes
- ▶ Transition relief was available for errors that were corrected by December 31, 2010 without any adverse 409A tax consequences
 - ▶ Treated as retroactively corrected effective on January 1, 2009
- ▶ Special relief from adverse tax consequences available for initial adoption of a “new plan” if corrected by the end of calendar year or 15th day of third month following adoption
 - ▶ Plan aggregation rules apply

16

Correction of Plan Document Errors (cont.)

- ▶ Plan document correction procedures generally require filings of notices of correction to the IRS with both the individual and the corporate tax return
 - ▶ Flag to IRS auditors?
- ▶ Notice 2010-80 provides a limited exemption to service provider notification and tax return filing for certain errors
 - ▶ Service recipient tax return notification filing is still required
 - ▶ Generally available for any plan document errors:
 - ▶ If corrected no later than December 31, 2010 (under transition relief), or
 - ▶ Arrangements already in effect as of December 31, 2010 that potentially give service providers discretion to influence timing of payments (e.g., release of claims)

17

Correction of Plan Document Errors (cont.)

- ▶ Special relief under Notice 2010-80 for “release of claims” related plan document errors for arrangements that were in place on or before December 31, 2010
 - ▶ No plan document failure for payments made by March 31, 2011
 - ▶ For payments made after March 31, 2011, no plan document failure if:
 - ▶ Payments are made in the second taxable year (where the potential payment period spans multiple years), or
 - ▶ If erroneously paid in first taxable year, the early payment is corrected under Notice 2008-113
 - ▶ Permitted to use operational error correction even though a plan document error exists
 - ▶ If amounts are “deferred” after December 31, 2012, the plan document must be corrected no later than December 31, 2012

18

Correction of Plan Document Errors (cont.)

- ▶ Unclear whether plan document errors are “aggregated together” under the 409A rules
 - ▶ Example: 409A-compliant “top-hat” deferred compensation plan permits annual elections to defer base compensation earned in the following year, and executives elected during 2009 to defer receipt of their 2010 base salary amounts under the plan. In 2011, the plan is amended to permit such deferral elections to be made no later than the January 31st of the same year in which the base salary is earned. Are previously 409A-compliant 2010 base salary deferrals elected in 2009 tainted by the subsequent plan document violation, so that prior 2010 base salary deferrals are also subject to 409A taxes?
- ▶ In October 2010, Keith Ranta (the author of IRS Notice 2010-6) indicated that the IRS has not yet taken a position on this issue

19

Other Correction Considerations

- ▶ If not corrected per the IRS procedures, what are the consequences?
 - ▶ Service recipient obligation to report amounts immediately recognized in income and subject to additional 409A taxes on Form W-2 and 1099-MISC
 - ▶ Service recipient obligation to collect withholding on amounts that are recognized in income
 - ▶ When does the statute of limitations on the error begin to run?
 - ▶ At the time of deferral?
 - ▶ At the time of self-correction without following the IRS procedures?
 - ▶ When the deferred amount is paid?
 - ▶ At the time of vesting?
 - ▶ 3 year or 6 year statute of limitations?

20

Other Correction Considerations

- ▶ Is correction under IRS Notices and other guidance sufficient to avoid California parallel 409A taxes?
- ▶ California Franchise Tax Board (FTB) April 2010 Tax News Issue
 - ▶ “On January 19, 2010, the Internal Revenue Service (IRS) released Notice 2010-6... Because the California Revenue and Taxation Code (R&TC) Sections 17501 and 24601 conformed to IRC Section 409A, we follow IRS Notice 2010-6.... For California income tax purposes, however, service recipients or providers that rely upon the Notice for relief are not required to attach additional statements to their California income tax returns.”
- ▶ Maria Brosterhous, Tax Counsel at the FTB:
 - ▶ California also follows IRS Notice 2008-113
 - ▶ California will generally follow all IRS corrective guidance on 409A, unless the FTB puts out a notice to the contrary

21

Common 409A Compliance Errors

- ▶ Severance Pay
 - ▶ Release of claims timing issues
 - ▶ Defective definition of “termination” or “separation”
 - ▶ Failure to include 6 month delay provision in non-exempt severance benefit arrangements for specified employees
- ▶ Lack of specificity or ambiguous provisions governing payment timing
 - ▶ (e.g., “you will be paid one year annual salary in the event of your termination of employment”)
- ▶ Impermissible discretion to elect to accelerate or delay the scheduled timing for payment of benefits
 - ▶ (e.g., benefit payments may be accelerated and paid in a lump sum at the employer’s discretion)

22

Common 409A Compliance Errors (cont.)

- ▶ Definitions of change of control in bonus plans that do not conform to Section 409A requirements
 - ▶ (e.g., including an initial public offering as a “change of control” event that will trigger bonus payments) where other 409A exemptions are not available
- ▶ Expense reimbursement provisions with a maximum cap that covers moving expenses or other taxable expenses that may be incurred during more than one taxable year
- ▶ Alternative payments schedules for the same payment event that do not comply with the 409A requirements
 - ▶ (e.g., severance payments will be made in installments if a termination is due to resignation, but will be made in a single lump sum if due to an involuntary termination)

23

Correction Case Study #1 (Release of Claims)

- ▶ Executive employment agreement provides for a lump sum \$100,000 payment upon a separation from service.
- ▶ Payment of severance subject to requirement that executive must provide an effective release of claims no later than 60 days following the separation.

24

Correction Case Study #2 (Discounted Option)

- ▶ Stock option for 100 shares is granted to an executive on February 1, 2011, with an exercise price mistakenly set at less than fair market value on the grant date.
- ▶ Option is 25% fully vested on the grant date, and vests with respect to 25% of shares on next 3 anniversaries of grant date.
- ▶ Option is exercised for 50 vested shares on January 1, 2012.

25

Correction Case Study #3 (Severance Agreement)

- ▶ Agreement provides for \$200,000 in cash severance benefits that are subject to Section 409A (non-exempt)
- ▶ Severance will be paid out in a single lump sum upon an involuntary termination and in 12 monthly installments upon any other termination or resignation.
- ▶ A separation from service occurs on June 15, 2012.

26

Correction Case Study #4 (Bonus Arrangement)

- ▶ Agreement provides for a \$100,000 bonus payment upon the Compensation Committee's determination of achievement of certain corporate performance goals.
- ▶ Bonus to be paid out in 24 monthly installments, unless the Compensation Committee otherwise determines to pay out the bonus in a single lump sum.
- ▶ Compensation Committee determines that the applicable performance goals are met on January 18, 2012.

27

Circular 230 Disclosure

Morgan Lewis
Cooley
LLP

- ▶ The following disclosure is provided in accordance with the Internal Revenue Service's Circular 230 (21 CFR Part 10). Any tax advice contained herein is intended to be preliminary, for discussion purposes only, and not final. Any such advice is not intended to be used for marketing, promoting or recommending any transaction or for the use of any person in connection with the preparation of any tax return. Accordingly, this advice is not intended or written to be used, and it cannot be used, by any person for the purpose of avoiding tax penalties that may be imposed on such person.

28

www.cooley.com