Employee Benefits Alert

February 10, 2009

Income Inclusion and Correction under Section 409A

If an arrangement fails to meet the requirements of Section 409A, all accumulated amounts deferred under the plan and no longer subject to substantial risk of forfeiture become includible in the service provider's income to the extent not previously included. Section 409A imposes an additional tax on these included amounts — 20% of the included amount, plus interest running from the date of deferral. There is limited relief available for operational failures that would otherwise give rise to income inclusion but are timely corrected. Special reporting requirements apply.

Income Inclusion

Section 409A, which was passed as part of the American Jobs Creation Act of 2004, provides rules governing the taxation of nonqualified deferred compensation and is effective with respect to deferred compensation granted, or still subject to a substantial risk of forfeiture, on or after January 1, 2005. Compliance must be both documentary and operational — that is, the governing plan document must conform to the requirements of the statute, and the plan must be operated in compliance with both its governing document and Section 409A and accompanying regulations.

In December 2008, the IRS issued guidance on income inclusion of deferred compensation under Section 409A. Notice 2008-115. For the most part, these rules extended the guidance provided regarding tax year 2007 in Notice 2007-89. The Treasury also issued proposed regulations regarding the calculation of includible income and applicable taxes. Subject to a consistency requirement, taxpayers may rely on these proposed regulations.

Interim Guidance. Notice 2005-1 and subsequent guidance provided that an employee's income includible under Section 409A should be reported in box 12 of Form W-2 using Code Z. A non-employee's income includible under Section 409A should be reported by the payer as non-employee compensation in box 15b of Form 1099-MISC. For the most part, Notice 2008-115 provides that these and other income-inclusion rules continue to apply.

Proposed Regulations. The proposed regulations provide additional guidance regarding the calculation of amounts includible in income and the tax imposed under Section 409A.

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In general, the proposed regulations provide new assumptions that would govern (1) the calculation of the present value of deferred compensation, and (2) identification of the tax year in which compensation is "first deferred or vested." In general, the present-value assumptions maximize the present value includible in income and hence the tax consequences of plan failure. In contrast, the rules governing when amounts were "first deferred or vested" and the character of distributions impose a first-in-first-out ("FIFO") rule; distributions are treated as paid out of the earliest deferrals and previously taxed income (if applicable). These rules minimize the premium interest payable, maximize deferral and hence reduce the tax consequences of plan failure.

An Anti-Abuse Rule. The taxes applicable under Section 409A are calculated as a percentage of *vested* deferred compensation. There is no additional tax if a plan failure occurs and is corrected while the service provider's entire deferred amount is unvested. However, if the taxpayer routinely violates Section 409A while his account is unvested, the IRS reserves the right to require the taxpayer to include in income his entire deferred-contribution account, including amounts still subject to the substantial risk of forfeiture.

Correcting Operational Failures

Notice 2008-113 provides limited correction for operational failures that would otherwise give rise to income inclusion and additional taxation under Section 409A. Applicable procedures and available relief depend on the status of the service provider, the amount of the failure, and the timeliness of correction.

In order to correct failures under Notice 2008-113, certain conditions must be met:

- The affected parties must have no pattern of similar violations and must take steps to prevent any recurrence.

- The failure must be inadvertent and unintentional, must not be related to participation in a "listed transaction," and must be an operational one (no relief is available for documentary failures).

- In general, amounts inappropriately deferred or paid must be repaid.

Exceptions do apply. For example, an erroneous payment is not eligible for correction if the service recipient experienced a financial downturn in the year of the payment. Special restrictions also apply to "insiders." An insider is a director, officer, or the beneficial owner (directly or indirectly) of more than ten percent of any class of stock, determined in accordance with the rules of the SEC under section 16 of the Securities Exchange Act of 1934. Analogous rules apply to non-corporate entities.

Operational failures that are corrected in the same taxable year as the failure may be completely corrected without cost. The relief available becomes progressively more limited for later corrections. Operational failures that are not corrected until after the close of the second taxable year following the failure may not be eligible for correction at all. However, a special transition rule extends the availability of relief for failures that occurred before December 31, 2007. (Transition relief is only available to non-insiders.)

For correction to be effective, the affected employer and service provider must both disclose relevant information in an attachment to their income-tax returns.

Please contact employeebenefits@capdale.com if you have any questions.

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