

MEMORANDUM

DATE: December 5, 2007

RE: IRS Notice 2007-100 – Self-Correction Procedures for 409A Violations

The IRS has published limited self-correction procedures that can reduce or eliminate penalties under Section 409A for certain operational failures. The correctable failures as they relate to tax-exempt employers¹ are:

1. Paying amounts that should have been (or remained) deferred, and
2. Deferring amounts that should have been paid.

Whether the 409A penalties are reduced or eliminated depends on whether the failure is corrected within the same taxable year.

I. General Requirements

To qualify for relief:

1. The failure must have been operational. Failure of plan documents to contain correct provisions is not correctable under the guidance;
2. The failure must have been unintentional;
3. The correction must be timely reported to the IRS;
4. The employer² must take “commercially reasonable steps to avoid a recurrence of the operational failure.” Commencing in 2009 a failure that is the same or substantially similar to a failure previously corrected under these procedures will only avoid penalties if the employer shows that after the first failure it had taken commercially reasonable steps and established practices and procedures to insure the failure would not recur, and the failure recurred notwithstanding the employer’s “diligent efforts”; and
5. In the case of failures involving excess or early payments, the payments are not in a year in which the employer experienced a substantial financial downturn or otherwise experienced issues that created a significant risk the employer would not be able to pay the deferred amounts when due.

¹ Additional failures that can be corrected in taxable employers are failure to defer payments for six months following a specified employee’s separation from a public company, and failure to determine the correct exercise price on certain stock rights.

² In this memorandum we refer to employer and employee. However, the same rules apply to independent contractor relationships.

II. Corrections within Same Year as Failure

If the failure is corrected within the same taxable year, the 409A penalties are waived. Correction requires the following:

A. Correcting payments that should have been deferred (e.g., the employer pays deferred compensation earlier than it should have been paid, or the employer fails to withhold amounts the employee had elected to defer)

- The employee must repay the amounts on or before the last day of the year. Repayment may be through cash payment or after-tax payroll deduction.
- If the employee is an “insider” (i.e., a member of the board or an officer³), and if the amount of the failure exceeds the annual salary reduction qualified plan deferral limit (\$15,500 in 2007 and 2008), the employee must also pay interest to the employer based on the number of days between the payment and the repayment. The interest rate is the IRS short-term applicable federal rate for the month in which the failure occurred (3.88% in December 2007).
- The employer *may* adjust the account for earnings/losses during the period the employee held the money. Any such adjustment must be made on or before the last day of the year.⁴

B. Correcting deferrals that should have been paid (e.g., the employer withholds amounts the employee elected to defer, or fails to pay plan benefits when due)

- The employer must pay the excess deferral on or before the last day of the year.
- If the employee is an insider, any earnings generated in the deferral account on the excess deferrals must also be distributed on or before the last day of the year. For non-insiders, the employer may distribute or retain in the plan any earnings.
- The employer may adjust the account for any losses on the excess deferrals.
- The employer may pay interest on the excess deferrals, provided it pays such amounts on or before the last day of the year.

III. Corrections After the Year of Failure

If the failure is corrected after the year of failure, the 409A penalties are limited. However, unlike the remedies for corrections made in the same year as the failure, corrections for prior year failures are limited – the remedy is only available for errors no greater than the qualified plan deferral limit for the year of the failure (\$15,500 in 2007 and 2008), the failure must have occurred before January 1, 2010, and the correction must be made no later than the end of the second year after the year of the failure.

³ “Officer” refers to actual bylaw officers, such as CEO, CFO and possibly COO. This varies depending on the governing documents of each organization.

⁴ Or, if it is impracticable to make the adjustment on or before the end of the year, the employee must have a legally-binding right to the adjustment.

Correction requires the following:

A. Correcting payments that should have been deferred (e.g., the employer pays deferred compensation earlier than it should have been paid, or the employer fails to withhold amounts the employee had elected to defer)

- The employer must report the excess distribution as a payment in violation of 409A. The reporting is on the Form W-2 (original or amended) for the year in which the payment was made. The excess is reported in Box 12, Code Z.
- The employee must pay the additional 20% tax on the excess distribution, but not the penalty interest.

B. Correcting deferrals that should have been paid (e.g., the employer withholds amounts the employee elected to defer, or fails to pay plan benefits when due)

- The employer must pay the excess deferral on or before the last day of the year (or no later than the 15th day of the third month after the date of the discovery, if later).
- The employer must also distribute (or cause the employee to forfeit) any earnings in the plan on the excess deferral.
- The employer must report the distribution on the employee's W-2 for the year of the payment, including reporting such amount in Box 12 using Code Z.
- The employee must pay the 20% penalty on the excess deferral, but not the penalty interest.

IV. Reporting

The relief noted above is conditioned on the proper reporting of the failure and correction, as follows:

A. Corrections within Same Taxable Year (Failures described in Section II, above)

- The employer attaches to its return for the year in which the failure occurred a statement containing:
 - The name and SSN of each employee affected by the failure,
 - The name of the plan under which the failure occurred,
 - A brief description of the failure and the circumstances under which it occurred, including the amounts involved and the date on which the failure occurred,
 - A brief description of the steps taken to correct the failure and the date such correction was completed, and
 - A statement that the failure is eligible for correction and that the employer has taken all actions required for the correction.

- The employer must provide to each affected employee the statement described above excluding the name and SSN of each affected employee. The employee retains the statement and uses it only if audited.

B. Corrections After Year of Failure (Failures described in Section III, above)

The reporting procedures are the same as noted above, except the employee must also attach a copy of the statement to the employee's return for the year in which the failure was discovered and corrected.

V. Potential for Additional Guidance/Relief

The IRS has asked for public comments regarding whether the limited guidance noted above should be made permanent, whether additional procedures should be added for failures involving amounts in excess of the qualified plan deferral limits, and what such procedures might be.

Please contact us if you have any questions regarding the new self-correction procedures.

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KDS:cdp