

# IRS Program Permits Avoiding Section 409A's 20% Penalty Tax for Certain Unintentional, Operational Violations Under Certain Compensation Arrangements

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Fenwick  
FENWICK & WEST LLP

## OVERVIEW OF LATEST DEVELOPMENT

On Dec. 5 the IRS announced Notice 2008-113, providing correction methods for certain unintentional, operational failures in relation to non-qualified deferred compensation arrangements and certain equity awards that would otherwise invoke the 20% penalty tax under Section 409A ("Section 409A") of the Internal Revenue Code of 1986, as amended (the "Code"). California, which has enacted a parallel 20% penalty tax may, in light of this Notice, announce their own correction program or provide that corrections made under this program will be effective to prevent imposition of California's parallel penalty tax. Prior corrections guidance in Notice 2007-100 is superseded by Notice 2008-113.

Notice 2008-113 covers steps for correcting other violations in addition to those discussed below. In this alert we will only cover the correction programs for separation payments to "specified employees" of public companies and the correction programs for mispriced stock options, areas that are of greatest relevance to our clients.

### Correction Program for Payments to "Specified Employees" (Public Companies Only)

Section 409A requires that payments of non-qualified deferred compensation that are to be made on termination of employment to a "specified employee" of a publicly traded company can not be made for 6 months; otherwise, the penalty tax of Section 409A applies. If payment of deferred compensation is made prior to the end of the 6-month period, the payment becomes subject to the penalty tax under Section 409A. A "specified employee" is generally any "key employee" under Section 416(i) of the Code. This classification is limited to no more than 50 "officers" (potentially including "officers" of subsidiaries) with the highest annual compensation in excess of an annually-adjusted threshold (\$160,000 for 2009).

### Eligibility Requirements for the Self-Correction Program for "Specified Employees"

1. The employer must implement "commercially reasonable" steps to avoid recurrence of the failure.
2. The employee must not already be under examination by the IRS.
3. The documentation providing for the payment must incorporate a 6-month delay provision (*i.e.*, there must be documentary compliance with Section 409A).
4. Correction is not available unless the payment was made inadvertently and unintentionally.
5. Relief is not available if in the year the payment is made the employer "experiences a substantial financial downturn, or ... other issues, if such ... indicates a significant risk" that the payment will not be paid when due.

### Manner of Self-Correction When Payment and Correction Occur in Same Tax Year

Self-correction requires: (i) by the end of the employee's tax year (December 31) the employee must repay the employer the *gross* value (the entire amount including the amount withheld for taxes; for example, if the gross amount is \$10,000, then that is the amount that must be repaid notwithstanding that federal and state taxes were withheld on the amount that was erroneously paid early), and (ii) the repaid amount is not returned to the employee until (as applicable): (a) if repayment occurs **prior** to the original correct date for payment (the "6-Month Date"), then the new correct date for payment is the 6-Month Date plus the number of days that have passed *from* the date of mispayment *through* the date

of repayment to the employer, or (b) if repayment occurs **after** the 6-Month Date, then the new payment date is delayed for a number of days equal to the the number of days from the date of mispayment to the 6-Month Date. Appropriate adjustments in the timing of withholding for employment taxes can be made under Section 6143 of the Code. If the amount is one on which earnings or losses were possible until paid by the employer, then no adjustment for gains is permitted that occur from the date of mispayment to the date of repayment (though the employer may exercise discretion to adjust the amount repaid to the employee to take into account any losses).

For the tax year of the mispayment, the employer must timely-file its federal tax return with a statement entitled “§ 409A Relief under § IV of Notice 2008-113” and provide a similar statement to the employee. The statement attached to the tax return must disclose: (i) the name and taxpayer identification number of the affected employee, (ii) identifying information of the plan or arrangement from which mispayment occurred, (iii) a description of the circumstances (including amount and date) surrounding the mispayment, (iv) the steps taken for correction and the date(s) taken, and (v) a statement that the mispayment is eligible for correction and that all required actions for correction have been taken.

#### **Manner of Self-Correction When Correction is Made in Tax Year Immediately Following Tax Year of Payment**

Self-correction is available only for mispayments made to “specified employees” who are not also “insiders” under Section 16 of the Securities Exchange Act of 1934 at any time during the tax year in which the mispayment occurs. Self-correction requires: (i) by the end of the employee’s tax year (December 31) following the year of mispayment, the employee must repay the *gross* value of the amount that should have been paid on the 6-Month Date, and (ii) the repaid amount is not returned to the employee until the number of days after the date of repayment as the number of days that passed *from* the date of mispayment *through* the 6-Month Date. The mispayment is reported as income on the W-2 for the year of mispayment. If repayment by the employee is in a different year from the year in which the repayment is returned to the employee,

then the employee can reduce, by the amount of the repayment, the employee’s taxable gross income for the year of the repayment (in the year the repayment is returned, the employee’s gross income is increased and the employer reports the returned amount on the employee’s W-2 for the year in which the repayment is returned to the employee). If the amount is one on which earnings or losses were possible until paid by the employer, then no adjustment for gains is permitted that occur from the date of mispayment to the date of repayment (though the employer may exercise discretion to adjust the amount repaid to the employee to take into account any losses).

For the employer’s tax year in which the fact of mispayment is discovered by the employer, the employer must timely-file its federal tax return with a statement entitled “§ 409A Relief under § V of Notice 2008-113” and provide a similar statement to the employee (who must also be informed to attach a copy of the statement to the employee’s tax return for the year of repayment). The statement attached to the tax return must disclose: (i) the name and taxpayer identification number of the affected employee, (ii) identifying information of the plan or arrangement from which mispayment occurred, (iii) a description of the circumstances (including amount and date) surrounding the mispayment, (iv) the steps taken for correction and the date(s) taken, and (v) a statement that the mispayment is eligible for correction and that all required actions for correction have been taken.

If the failure is discovered in a tax year later than the tax year immediately following the year of mispayment, other self-correction programs are available.

#### **CORRECTION PROGRAM FOR DISCOUNTED STOCK OPTIONS**

##### **The Issue for Discounted Stock Options**

Nonstatutory stock options granted at an exercise price per share of not less than 100% of the fair market value per share on the date of grant are exempt from Section 409A. Nonstatutory stock options granted at less than 100% of fair market value are subject to Section 409A.

## Eligibility Requirements for Correction Program for Discounted Stock Options

1. Must implement “commercially reasonable” steps to avoid recurrence of the failure.
2. The employee must not already be under examination by the IRS.
3. The documentation indicates the exercise price is to be at least 100% of fair market value.
4. Only the unexercised portion of the stock option qualifies for relief.

## Manner of Self-Correction When Correction Occurs in Same Tax Year as Date of Grant

The exercise price must be corrected by not later than the earlier of: (i) December 31 of the year of grant, and (ii) the date immediately prior to the date on which the option is exercised.

For the tax year in which the discounted stock option was granted and corrected, the employer must timely-file its federal tax return with a statement entitled “§ 409A Relief under § IV of Notice 2008-113” (and in its discretion may provide a similar statement to the employee). The statement attached to the tax return must disclose: (i) the name and taxpayer identification number of the affected employee, (ii) identifying information of the plan or arrangement under which the grant was made, (iii) a description of the circumstances surrounding the misstatement of the exercise price, (iv) the steps taken for correction and the date(s) taken, and (v) a statement that the mispricing is eligible for correction and that all required actions for correction have been taken.

## Manner of Self-Correction When Correction is Made in Tax Year Immediately Following Tax Year of Date of Grant

Self-correction is available only for grants to persons who are not also “insiders” under Section 16 of the Securities Exchange Act of 1934 at any time during the tax year in which falls the date of grant. The exercise price must be corrected by not later than the earlier of: (i) December 31 of the year immediately following the year in which the grant was made, and (ii) the date immediately prior to the date on which the option is exercised.

For the tax year of the correction, the employer must timely-file its federal tax return with a statement entitled “§ 409A Relief under § V of Notice 2008-113” and provide a similar statement to the employee (who must also be informed to attach a copy of the statement to the employee’s tax return for the employee’s corresponding tax year of correction). The statement attached to the tax return must disclose: (i) the name and taxpayer identification number of the affected employee, (ii) identifying information of the plan or arrangement under which the grant was made, (iii) a description of the circumstances surrounding the misstatement of the exercise price, (iv) the steps taken for correction and the date(s) taken, and (v) a statement that the mispricing is eligible for correction and that all required actions for correction have been taken.

Notice 2008-113 is attached as a link, click here:  
<http://www.irs.gov/pub/irs-drop/n-08-113.pdf>.

For more information on this, or related matters, you may wish to contact any attorney in the Executive Compensation and Employee Benefits Group:

[Scott P. Spector](mailto:sspector@fenwick.com) (650.335.7251 – [sspector@fenwick.com](mailto:sspector@fenwick.com))  
[Blake W. Martell](mailto:bmartell@fenwick.com) (650.335.7606 – [bmartell@fenwick.com](mailto:bmartell@fenwick.com))  
[Tahir J. Naim](mailto:tnaim@fenwick.com) (650.335.7326 – [tnaim@fenwick.com](mailto:tnaim@fenwick.com))  
[Liza Wells Morgan](mailto:lmorgan@fenwick.com) (650.335.7230 – [lmorgan@fenwick.com](mailto:lmorgan@fenwick.com))  
[Andrea Vachss](mailto:avachss@fenwick.com) (650.335.7895 – [avachss@fenwick.com](mailto:avachss@fenwick.com))  
[John E. Ludlum](mailto:jludlum@fenwick.com) (650.335.7872 – [jludlum@fenwick.com](mailto:jludlum@fenwick.com))  
[Nicholas Frey](mailto:nfrey@fenwick.com) (650.335.7882 – [nfrey@fenwick.com](mailto:nfrey@fenwick.com))

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