

MEMORANDUM TO CLIENTS

December 10, 2007

**RE: IRS ESTABLISHES LIMITED CORRECTION PROGRAM
UNDER CODE SECTION 409A**

On December 3, 2007, the IRS issued Notice 2007-100 (the "Notice"), which sets forth a limited correction program for unintentional operational failures under Code section 409A and solicits comments on a more expansive correction program. If the requirements of the Notice are met:

- Certain operational failures that are corrected during the year the failure occurs will not result in section 409A violations.
- Certain operational failures that occur in years before 2010 and involve only limited amounts (e.g., \$15,500 or less in 2007/2008) may be corrected within two years. Only the amounts involved in such a failure will be subject to adverse treatment under section 409A.

I. Background on Section 409A Violations and Penalties

Section 409A provides specific rules for deferral elections and distributions under covered plans. If a violation of these rules occurs with respect to an executive's benefits under a plan, generally all the executive's vested benefits that are subject to 409A under the plan (and any plans that are required to be aggregated with it) are subject to adverse treatment. Specifically, these amounts are taxed to the executive immediately, and a 20% additional tax is also imposed on the amounts plus interest.

There is no exception for de minimis violations under section 409A. Thus, a violation involving a very small amount (e.g., \$50 too much paid one year) can result in the value of an executive's entire plan benefit being subject to these harsh penalties. Given this dramatic result, employers began requesting some time ago that the IRS establish a correction program similar to its qualified retirement plan correction program (the "EPCRS"). The Notice is the first response to these requests.

II. General Requirements for Correction

Relief under the Notice applies only to the correction of unintentional operational failures under a plan with provisions that satisfy the requirements of section 409A. The Notice does not provide any correction mechanism for plan document provisions that do not comply with section 409A. Among other requirements, the following rules apply for corrections under the new program:

- The employer must take commercially reasonable steps to avoid a recurrence of the failure.
- Correction is not available for intentional or egregious failures, or failures related to an abusive tax avoidance transaction.
- The program is not available for a correction that is not made in the year of the failure if the employee is under audit for the year of the failure.
- The employer satisfies the information and reporting requirements described in section V below.

III. Correction During Same Year

The following unintentional operational failures (regardless of the amount involved) will not be treated as resulting in a section 409A violation if they are corrected during the year in which they occur and certain other requirements are met.

- **Mistake in Carrying Out Deferral Elections.** An employer defers more or less of an employee's compensation than was elected.
- **Erroneous Payments.** Payment of amounts prior to the year they are scheduled to be paid.
- **Erroneous Payments to Key Employees.** Amounts are mistakenly paid to a key employee during the six-month "waiting period" following the employee's separation from service.
- **Erroneous Deferrals.** Amounts that should have been paid to an employee during a certain year are not paid.
- **Correction of Exercise Price of Stock Option.** An unintentional administrative error results in the exercise price of a stock option (or SAR) being less than the fair market value of the underlying stock on the date of grant.

Correction of these errors typically requires repayment of the amount involved (either by the employee or the employer, as applicable). In some circumstances where corporate "insiders" are involved, additional requirements apply, including the calculation and payment of interest. Correction for early payment or payment during the key employee waiting period is not available if the failure occurs during a year the employer experiences a "substantial financial downturn." A stock option exercise price failure may be corrected before exercise by resetting the exercise price in accordance with the terms of the Notice.

IV. Correction of Limited Amounts After Year of Failure

Certain unintentional operational failures may be corrected after the year of the failure, if the failure occurs before 2010, does not involve amounts in excess of the Code section 402(g) limit (\$15,500 for 2007/2008), correction is made by the end of the second year following the

year the failure occurred, and certain other requirements in the Notice are met. In these cases, the failure will result in only the amount involved in the failure being subject to immediate taxation and the 20% penalty (rather than all amounts the employee has deferred under the plan and other similar aggregated plans). The failures eligible for such correction include:

- **Failure to Defer/Erroneous Payments.** The accelerated payment of amounts that should have been paid in a later year. No repayment by the employee is required to correct in this case.
- **Erroneous Deferrals.** Failure to pay amounts that should have been paid to an employee during a certain year. Prompt payment by the employer is required.

V. Information and Reporting Requirements

If correcting a failure during the same year, the employer must provide a statement to the IRS in its federal tax return for the year the failure occurs and to each affected employee regarding entitlement to section 409A relief. This statement must include the identification of each affected employee (including his or her "insider" status), the amount and plan involved, a description of the failure, a description of corrective actions taken, and an affirmative statement that such failure is eligible for correction and all requirements have been met.

For failures not corrected in the same year, both the employer and employee must attach a statement prepared by the employer to their federal tax returns for the year the failure is discovered. This statement must contain the same types of information set forth above for same year corrections. In addition, the employer's statement to each affected employee must include an instruction to attach a copy of the statement to the employee's federal tax return.

These requirements are considerably more rigorous than self-correction of qualified plans under EPCRS where, in general, there is no requirement for the employer or the employee to report the correction to the IRS. And the Notice makes clear that any use of the relief under the Notice will be subject to IRS audit, and the taxpayer will have the burden of demonstrating that the requirements for relief were met.

VI. Future Correction Program

The IRS is considering a corrections program for certain operational failures discovered after the year of failure beyond the limited relief provided in the Notice. Generally, this program would be limited to failures corrected promptly after discovery (and no later than two years after the date of such failure), and would limit the amount subject to adverse treatment under section 409A to the amount involved in the operational failure, rather than all amounts deferred under the plan and similar plans. This program will not likely provide rulings, closing agreements, or other formal approvals. The Notice provides the basic framework of limitations and requirements for such a program, which are similar to those for the limited program announced in the Notice, other than the \$15,500 limit on the size of the violation and the 2010 deadline.

The Notice requests comments on the design of this future program by March 3, 2008.

Please call one of the following, or the Groom attorney you regularly contact, if you have any questions about this IRS Notice or its impact on your executive compensation arrangements.

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