

Section 409A – Review Your Compliance, Now

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As we head toward the end of 2009, employers need to review their compliance with the nonqualified deferred compensation requirements of Section 409A of the Internal Revenue Code. As explained below, there is more flexibility for correcting errors if correction is made in the same year as the violation. There is also leniency for fixing errors in the year after the year in which they occur. The end of 2009 also marks the end of a transition period during which all Section 409A violations back to 2005 may be rolled up and corrected by December 31, 2009 under the most favorable correction method available. Action is required immediately, though, in order to make sure compliance can be achieved by year-end.

Background — What is Section 409A Compliance

All About? Section 409A, which was effective January 1, 2005, mandates that deferred compensation plans comply with strict rules governing the selection, form and timing of payment of plan benefits. If a plan violates Section 409A, all vested post-2004 deferred amounts under the plan (and all similar plans) become taxable to the affected employees. There is also an interest penalty and a 20% tax penalty based on the amounts otherwise included in income. For this purpose, there are two types of potential violations — plan document errors (where the words are wrong) and operational failures (where administration does not conform to the document).

These penalties fall on the individual employees affected. Besides reporting obligations, employers are not subject to direct penalties for Section 409A violations. However, employees are likely to seek to be made whole for penalties if the errors are due to employer mistakes.

Note also that deferred compensation covered by Section 409A includes not just traditional deferred compensation plans. It also could include things like severance agreements, employment agreements, bonus payment plans and

the like. Even informal agreements could be swept into Section 409A's reach.

One year ago, employee benefits and executive compensation lawyers were feverishly working to beat the December 31, 2008 deadline for Section 409A plan document compliance mandated by final IRS regulations. Notwithstanding everyone's best intentions, mistakes were made. In some cases, plan documents did not say what they should have said. In other cases, the documents might have been perfectly drafted, yet the operational aspects of the plan were not in compliance with the actual documents (or even with the legal requirements). In still other cases, some plans were missed altogether and remain unamended for Section 409A.

The current state of affairs is reminiscent of the old saying: "To err is human, to forgive, divine." When it comes to Section 409A compliance, though, employers and their advisors tend to be more human than the IRS is divine. Admittedly, the IRS has issued a limited voluntary correction program to deal with Section 409A operational violations (as opposed to document failures). In addition, based on some proposed IRS regulations under Section 409A, there is a limited correction opportunity for plans with non-vested deferrals to correct plan language.

Yet, the generally available voluntary correction program is limited to only certain types of operational errors. There is no formal program for correcting plan document errors (although there is one under IRS consideration). Moreover, the IRS has launched an audit initiative to identify Section 409A violations and attempt to collect the stiff Section 409A penalties. Copies of the specific questions that the IRS will raise on audit have been circulating among benefits practitioners and they reveal that the IRS will seek detailed documentation concerning all of an employer's nonqualified deferred compensation plans and Section 409A compliance for prior years.

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That is why employers need to look carefully at their deferred compensation arrangements and operational compliance. If mistakes are identified, now is the time to decide whether and how to fix them and mitigate the exposure to IRS-imposed sanctions.

IRS Section 409A Correction Program. To find and correct errors, the first place to look is at the documents and actual plan operation. If everything is written correctly and administered properly, that's great. If not, you need to review and understand IRS Notice 2008-113. This notice explains the correction program for Section 409A operational compliance. Covered failures that are identified in a given year can generally be corrected by the end of that year with no financial penalty. The guidance also provides leniencies for covered errors that are corrected in the year after which they occur and, in some instances, even two years after the year in which the errors occur. To take advantage of the later year correction, however, the individuals involved have to be non-insiders and there are still limited penalties that can apply. (Insiders are defined as directors, officers, or more than 10% owners.) That is why the best approach is to fix an error in the year of the failure or, at the latest, the year after the year of the failure.

Special Transition Rule for 2009. Before explaining some of the types of failures that are correctible, it is important to recognize a special IRS transition rule. Given the gap between the statutory effective date (January 1, 2005) and final compliance date, the IRS allows all operational errors for non-insiders that occurred since January 1, 2005 to be treated as if they occurred in 2008. That way, the correction is treated as having been made in the year after the year of the violation and the correction for non-insiders is penalty-free. Therefore, there is a premium on finding and fixing errors that may have occurred since Section 409A's effective date and fixing those errors before December 31, 2009.

Types of Fixable Errors. The types of errors that are correctable under the IRS notice include the failure to honor a deferral election even if it was validly made. For example, if an employee had elected to defer 25% of compensation and, operationally, that deduction wasn't taken out of the employee's pay, that error would be correctable under the IRS guidance. Other errors that are correctable include a failure to pay a distribution at the time that it was required to be paid, deferring more than what the individual employee had elected to defer, payment of a lump sum instead of installments (or vice versa), and errors in valuing certain stock rights.

Note that errors can even occur when you least expect it. For example, suppose an executive deferred \$10,000, representing 50% of her bonus but none of her salary. Mid-year,

the company decides not to pay bonuses but to increase salary somewhat. The failure to defer the \$10,000 (because no bonus was paid), combined with an increase in salary could be a Section 409A violation because the increased salary could be a substitution for the otherwise deferred bonus amount. That's why you really need to look at the facts very closely with the help of a Section 409A expert to see where "stealth" violations might occur.

To take advantage of the IRS correction program, an employer must take commercially reasonable steps to make sure the errors do not recur. Also, there are notice requirements associated with the IRS correction program and errors generally have to have been unintentional and inadvertent. Importantly, relief under the IRS program is not available if the error occurs during a year when the employer experiences a substantial financial downturn, if the downturn creates a significant risk that the employer will not be able to pay the deferred amounts when due.

Special Limited Opportunity to Fix Document Errors. Separately from the formal IRS correction program, the IRS has issued proposed regulations governing the penalties and income inclusion rules for Section 409A violations. Under this guidance, the IRS indicated that there is an opportunity to correct plan document failures under very limited circumstances. This could occur where deferred compensation amounts under the plan are not otherwise vested at all during the calendar year. As long as an employer does not abuse the use of this rule, the IRS indicated that document correction could be made without penalty by the end of the year. Once again, this emphasizes the importance of finding errors before the end of the year and taking advantage of correction possibilities.

Where Do You Go From Here? Now is the time to review your compliance. Are you sure your documents are all properly amended? Have you confirmed that your operational compliance is consistent with your plan documents? Have you encouraged administrators to find and identify mistakes in administration? Given the availability of correction alternatives, it is counter-productive to discourage people from bringing mistakes forward or focus on fixing blame for the errors. Early identification of errors and careful consideration of correction alternatives is the best way to mitigate or avoid the harsh Section 409A penalties.

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