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409A Operational Compliance and Corrections: Special Opportunities Available During 2009

Section 409A of the Internal Revenue Code ("Section 409A") imposes strict rules on deferred compensation plans and a wide range of compensation arrangements (such as severance plans and employment agreements) that are not traditionally considered deferred compensation. There are significant tax penalties if these rules are not followed precisely. A seemingly innocuous mistake can have dire consequence, and an error that affects one plan or program can "taint" others.

Steps to Improve Operational Compliance. Section 409A and the numerous new requirements it imposes on deferred compensation arrangements are very complex. To help minimize errors, many companies are:

- Preparing Section 409A operational manuals to assist their personnel and their outside service providers in properly administering these programs; and
- Establishing checks and balances to regularly ensure that these processes are working.

For example, Section 409A establishes a specific definition of "separation from service." Under some circumstances, an individual who is treated as continuing to be employed will have a Section 409A separation from service. Likewise, an individual who is treated as terminated may not yet have experienced a Section 409A separation from service. A thorough administrative manual can assist in determining when a true Section 409A separation has occurred and thereby in avoiding the tax penalties that would be associated with misclassifying an individual's termination.

Correcting Operational Errors. Though it is helpful to have an administrative process that is designed to catch as many administrative errors as possible, the IRS has established a new program that permits certain inadvertent and unintentional operational errors to be corrected ***within 2 years of the failure*** with varying degrees of reduced penalties.

The types of errors that may be corrected include:

- Distributing amounts too early or too late;
- Contributing too much or too little; and
- Pricing stock options improperly.

The available correction depends on the amount involved, the year of correction, and whether the affected participant is an "insider" (an officer, director or 10% owner). Relief from Section 409A penalties is generally better the sooner the error is discovered and corrected. Usually, it will be much less costly to correct an error that has recently occurred than to wait until the end of the 2-year correction period.

Importance of Auditing Arrangements and Correcting Errors Quickly

If Section 409A is violated, deferred amounts become subject to immediate taxation and two separate penalty taxes. The IRS recently proposed regulations on the calculation of the amounts includible in income and the penalty taxes.

Under these proposed regulations, income inclusion and penalties are based on the amount of vested deferred compensation at the end of the year of failure. This means that it may be possible to correct errors (including errors in a plan document or written agreement) without income inclusion or penalties if the corrections are made before the year in which the deferred compensation becomes vested.

Consider, for example, a Section 409A severance benefit that does not become vested until the individual is involuntarily terminated. If there is an error in the documentation of this benefit, it may be possible to correct this error during 2009 without early taxation or penalties if the individual is not involuntarily terminated (and, therefore, becomes vested) until a later year.

Of course, to take advantage of this correction opportunity, it is important to take action now. Once benefits become vested, correction without early taxation and penalties will not be possible.

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Additional Correction Opportunities in 2009. Though the IRS's correction program is generally only available to correct errors that occurred during the previous 2 years, the IRS has extended the correction deadline for any individuals who are not insiders through the end of 2009. This means that ***2009 is the last time to correct errors that occurred during 2005, 2006 and 2007***.

To take advantage of this limited correction window, now is the time to schedule Section 409A audits of the past operation of all deferred compensation plans and programs. A thorough compliance audit can help identify errors before it becomes too late to correct them.

Plan Document Errors. The correction program described above only applies to ***operational*** errors. It does not apply to errors in a Section 409A plan document or to failures to amend a plan document to comply with the final Section 409A regulations by the December 31, 2008 deadline. However, please see the sidebar for a possible way to correct document errors that affect unvested benefits.

Contact Information. For additional assistance with reviewing your Section 409A plans, updating your administrative processes and/or correcting errors, please contact Don Mazursky (404.888.8840), David Putnal (404.888.8836), Glenn Infinger (404.888.8845), Toby Walls (404.888.8870) or Teri King (404.888.8847).