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IRS Launches Targeted Section 409A Audits

The IRS has announced a new targeted audit program to confirm that deferred compensation plans are in compliance with Section 409A of the Internal Revenue Code ("Section 409A"). Previously, the IRS has only examined Section 409A issues as part of a more general taxpayer audit.

Focus of Section 409A Audits. The IRS is conducting these targeted Section 409A audits by sending Information Document Requests ("IDRs") to companies that the IRS believes are likely to have deferred compensation plans. The IRS audits will generally focus on the top 10 most highly compensated individuals at the company and the following three issues:

- Initial deferral elections;
- Subsequent deferral elections; and
- Payouts under Section 409A, including the six-month delay for specified employees.

However, it is important to remember that Section 409A applies to a wide range of compensation arrangements (such as severance plans and employment agreements) that are not traditionally considered deferred compensation.

Potential Penalties. These targeted Section 409A audits should be taken very seriously. The failure to precisely follow the strict Section 409A rules results in immediate taxation of vested deferred amounts and significant penalties (including a 20% excise tax) imposed on the individual executives.

Next Steps. We advise that companies act now to self-audit and review compliance with Section 409A because, once a company or executive is under IRS audit, the IRS's Section 409A correction programs for operational and documentary errors may not be available.

Contact Information. For more information, please contact Don Mazursky (404.888.8840), Glenn Infinger (404.888.8845), David Putnal (404.888.8836), Toby Walls (404.888.8870), Teri King (404.888.8847) or Andrew Overway (404.888.8858).