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Penalty-Free IRS Section 409A Correction Program Expires this Year

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Section 409A is one of the most insidious provisions ever placed into the Tax Code. Section 409A is the section in the Internal Revenue Code that was added in 2004 to govern the taxation of deferred compensation plans. The problem is that Section 409A's reach extends far beyond what the business world normally considers to be deferred compensation. Basically, Section 409A sweeps in any arrangement, by whatever name it's called, that has the effect of giving someone a payment in a year later than the year in which the person delivered the services that are being paid for. As a result, Section 409A's scope includes arrangements such as severance agreements, employment agreements, change-in-control agreements and expense reimbursement arrangements.

The problem is that even a slight violation of Section 409A can result in massive tax penalties. A Section 409A violation can result in the immediate taxation to the employee involved of all vested amounts payable under the "deferred compensation" arrangement even if they are not payable until years in the future. In addition to the accelerated income tax, there is also a 20 percent penalty tax. Plus, a penalty interest rate is charged from when the benefits first became vested. And for those employees who are unlucky enough to be residing in a state, such as California, that has adopted its own state tax version of Section 409A, they will also have to pay state income tax and penalties as well.

Section 409A violations come in two varieties: (1) operational failures and (2) (the one we're concerned about in this Alert) document failures. An operational failure occurs when the terms of the plan aren't followed correctly. For example, the executive was paid out too much, or too little, or too early or too late. A document failure occurs when the terms and conditions of the

"deferred compensation" plan/agreement/arrangement do not follow the requirements of, or the definitions used in, Section 409A. And it's important to realize that a Section 409A violation occurs as soon as a document has an offending provision, even if that offending provision never gets used. (The IRS does not believe in the "No Harm/No Foul" Rule.)

Common document failures that are considered to be Section 409A violations include:

- Allowing for payment upon termination of employment, if that termination does not meet the Section 409A definition of "separation from service."
- Using a definition of "change-in-control" in a "single trigger" plan that doesn't track the definition used in Section 409A.
- Defining "disability" more liberally than what's allowed under Section 409A.
- Allowing payments to be delayed longer than 90 days after the payment date.
- Conditioning severance payments upon the delivery of a signed release but failing to place a time limit on the delivery of the release that precludes the employee from controlling the tax year in which the severance payment is received (assuming the severance arrangement isn't structured to be exempt from Section 409A).
- Allowing for payment events that are not permitted under Section 409A.
- Giving the employer the discretion to accelerate payments.
- Letting the employee decide the form of payment or the payment schedule at the time the benefits become payable.
- Giving the employer or the employee the discretion to change the time or schedule of payments.
- Allowing employees to defer salary or bonuses outside of the deadlines set by Section 409A.
- Not providing for the six-month delay in payment upon termination of employment by a "specified employee" (applies to publicly traded companies only).

The IRS currently has a correction program in place that allows document failures to be corrected without any tax penalties. The correction involves amending the document to remove or modify the offending provision, attaching a statement regarding the correction to the employer's tax return and providing the employees involved with a statement regarding the correction for them to attach to their federal tax returns.

But to come under this correction program, the corrective amendment has to be adopted no later than December 31, 2010. Keep in mind that an amendment may need to be adopted or approved by the employer's Compensation Committee or Board of Directors and may also need the written consent of the participants involved. So, make sure to take Board meeting dates and holiday vacation schedules into account if you're trying to meet the December 31 deadline.

It is unlikely that the IRS will extend this correction program or that similar penalty-free relief will be offered in the future. To make sure this correction opportunity doesn't go to waste, employers should confirm that all of their compensation arrangements have been reviewed for Section 409A compliance. Any arrangements that haven't should be immediately reviewed by someone familiar with the subtleties of Section 409A to determine if any corrective amendments need to be adopted by year-end.

Questions?

For additional information, please contact Vince Cacciottoli in our Portland office.