

IRS provides relief for Section 409A document failures

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The Internal Revenue Service (IRS) recently released a document correction program allowing employers to voluntarily correct nonqualified deferred compensation plans that violate IRS Section 409A¹. The advantage of this correction program is that employers may reduce or possibly avoid accelerated income tax inclusion and penalties and interest that would otherwise be imposed on employees as a result of a Section 409A violation.

Background

Section 409A was enacted in October 2004. While employers were required to operate their deferred compensation plans in compliance with Section 409A beginning Jan. 1, 2005, their plan documents were not required to be in compliance with Section 409A until Jan. 1, 2009.

Section 409A imposes restrictions on arrangements that provide for deferred compensation. Generally speaking, an arrangement provides for deferred compensation if the employee has a legally binding right to receive compensation in a future tax year that he or she earned in a prior tax year. The restrictions imposed by Section 409A include restrictions on the timing of elections to defer compensation, restrictions on when payments may be received from deferred compensation plans and restrictions on the form of the payments.

If a deferred compensation plan violates Section 409A, either in form or operation, the amount deferred becomes includable in the employee's income in the current tax year and the employee is subject to a 20 percent penalty on the amount deferred, plus interest.

Document failures that may be corrected The document correction program may be used to correct deferred compensation plans that violate Section 409A for any of the following reasons:

- restructure of troubled bond transactions

- ambiguous language in the plan document;
- plan document does not include required definitions for permissible payment events or includes impermissible definitions of such terms;
- plan document allows payments to be made over impermissible payment periods;
- plan document includes impermissible payment schedules or payment events;
- plan document does not include six-month waiting period for certain employees; and
- plan document permits initial deferral elections that violate Section 409A.

Eligibility

In order to utilize the document correction program the following requirements must be met:

- document failure must be inadvertent and unintentional;
- employer must fully correct the document failure in a manner specified by the program;
- employer must make reasonable efforts to fully correct any failures that are substantially similar;

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- neither the employer nor the employee may be the subject of a federal tax audit involving the deferred compensation plan (certain exceptions apply); and
- employer and employee must comply with the program's information reporting requirements.

There is no requirement that the employer show proof that it reviewed its deferred compensation plan and made a good faith attempt to bring the plan into compliance prior to the Jan. 1, 2009, compliance deadline imposed by the IRS.

Recommendation

Employers should carefully review any arrangements that allow employees to defer compensation to ensure the plan document is in compliance with Section 409A. Deferred compensation can occur in many types of agreements, including traditional deferred compensation plans, bonus, incentive and equity-based arrangements, employment agreements, and severance and retention agreements. Therefore, it is important that employers review all arrangements that may be impacted by Section 409A. If document compliance issues are discovered and corrected pursuant to the document correction program prior to Dec. 31, 2010, the employer can take advantage of the temporary relief from current income taxation of deferred amounts and penalties and interest imposed under Section 409A.

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¹ The document correction program is set forth in IRS Notice 2010-6 published on January 5, 2010.

² This client alert is intended only as a general discussion of IRS Notice 2010-6 and is not intended as, nor may it be relied upon as, legal advice.