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Section 409A: End of Transition Relief for Documentary Compliance – Time to Focus on Operational Compliance

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2009 not only signaled the end of the "transition period" toward full Code Section 409A documentary compliance, it also left employers with a new program to correct "operational" failures under Section 409A. In December, the IRS issued Notice 2008-113, which meaningfully expanded the remedies available to correct certain Section 409A violations. Although the corrections program announced in Notice 2008-113 has no expiration date, companies are encouraged to monitor their compliance carefully, as errors are correctible only for a limited time following their occurrence.

Background

Section 409A imposes requirements on a broad range of nonqualified deferred compensation plans and arrangements, and subjects plan participants to stringent penalties for noncompliance (notably, early inclusion in income, an extra 20% tax, and an additional interest premium). IRS guidance provided an extended transition period during which written plans and arrangements that did not meet the documentary requirements of Section 409A could be brought into compliance. When the final regulations became effective on January 1, 2009, that transition period expired. However, in December, the IRS announced a program allowing certain "operational" failures under Section 409A to be corrected while avoiding penalties under Section 409A. This corrections program is described in IRS Notice 2008-113.

Eligibility under the Corrections Program

Relief under the corrections program is available only for "unintentional operational failures," which are failures to comply with the provisions of a plan that otherwise satisfy Section 409A, or unintentional failures to follow the requirements of Section 409A in practice. To qualify for the corrections program, in addition to correcting the failure as provided under the program, an employer must take commercially reasonable steps to avoid a recurrence of the operational failure. For taxable years beginning after December 31, 2009, if a similar failure had occurred previously, the employer must also demonstrate that it had established reasonable procedures to prevent recurrence of the failure, and that the failure occurred despite the employer's diligent efforts.

Relief is not currently available for plan provisions that fail to meet the requirements of Section 409A, for any exercise of a stock option or stock appreciation right that would result in a violation of Section 409A, or for taxable years with respect to which an employee's income tax returns are under examination.

Failures Eligible for Correction without Penalty

The corrections program provides that Section 409A penalties may be avoided with respect to certain unintentional operational failures if they are corrected prior to the end of the taxable year in which the failure occurred, or during the following taxable year. Correctable failures include:

- Early payment of an amount that should have been deferred until either a subsequent year, or a later date within the same year
- Early payment of an amount in violation of the six-month delay requirement applicable to "specified employees" of public companies
- Improper or excess deferral of a currently payable amount
- Grant of a discounted stock option

Notice 2008-113 describes the specific corrections procedures that must be followed to successfully correct such failures, some of which include IRS reporting. If an eligible failure is corrected in the same year as its occurrence, no early income inclusion is required with respect to early payments, and both the 20% penalty and the additional interest premium imposed by Section 409A are avoided. If correction is made in the year *following* the year of the failure, the 20% penalty is avoided. However, in that case, early payments must be included in income in the year in which paid, and incorrectly deferred payments must be included in income in the year in which actually paid. Correction during the year following the year in which the failure occurred is available only with respect to payments to individuals that are not "insiders" of the employer. Insiders include officers, directors, and owners of more than 10% of any class of the employer's stock.

Limited Relief for Other Failures

The corrections program provides additional limited relief for errors involving (i) amounts less than an inflation-index IRS limit ($16,500 for 2009) or (ii) early payments or improper deferrals not corrected within the first two taxable years as described above. Relief is available in such cases only to the extent the applicable corrections procedures are fully complied with no later than the second taxable year following the year in which the failure occurred. However, while this limited relief does permit taxpayers to avoid the interest premium with respect to such failures, the 20% penalty under Section 409A is not avoided.

Conclusion

Although the corrections program does provide significant relief for what may be common operational failures under plans and arrangements subject to Section 409A, full benefits of the relief can be realized only if the failures are timely identified and corrected. In addition, the corrections program applies only to operational failures of plans and arrangements otherwise in compliance with Section 409A, but offers no remedy for documentary failures. The IRS and Treasury Department are considering whether to offer an ongoing corrections program for documentary noncompliance.

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