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Window Closing this Year for Most Favorable 409A Correction Relief for Operational Errors Made Before 2009

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Background

Section 409A of the Internal Revenue Code of 1986 ("Section 409A") continues to complicate the design and operation of many types of compensatory arrangements including not just traditional deferred compensation, but also severance, retention, expense reimbursement, and many other types of programs that may pay compensation in a later year. Even though Section 409A became effective in January 2005, the guidance remains confusing and sporadic, and many employers have had operational errors over the last few years. Section 409A violations can result in premature taxation of all of the employee's vested deferred compensation under the arrangement (as well as under other similar arrangements), a 20% additional tax on those amounts (increased by another 20% for California residents), and a requirement to pay interest on unpaid taxes at a premium rate. Under the expiring transition relief discussed below, 2009 provides the last chance to correct errors made before 2008 and avoid most of the adverse effects of Section 409A on the corrected arrangements.

IRS Notice 2008-113 (the "Notice," available here) provides correction procedures for certain inadvertent and unintentional operational errors under Section 409A. Errors for which relief is available include:

(1) failures to properly defer amounts or early payment of deferred amounts;

(2) payments made in violation of the six-month rule for specified employees of public companies, which requires delayed post-termination payments in some situations;

(3) excess deferrals; and

(4) failures with respect to the exercise price of stock compensation that would otherwise be exempt from Section 409A.

As explained below, corrections made after 2009 for errors that occurred in 2008 and 2009 will face more onerous requirements and higher expense. *More importantly, errors made before 2008 will not be correctable at all once the special transition relief provided under the Notice expires at the end of this year.* Please note that the corrections process will not necessarily avoid the California extra 20% tax—California approved the prior set of corrections guidelines under an approach that would also apply to this Notice, but the Franchise Tax Board has not issued any announcements that it will follow the Notice.

Correction Methods

The type of correction procedure and the relief available largely depend on how quickly companies identify and correct the operational errors. The key benefit of using the Notice is that an error is not treated as a violation of Section 409A, removing the risk of premature taxation. However, the procedure requires taking corrective steps that vary with the type of error and the time elapsed before correction—*the key difficulty in almost all corrections of early payment or overpayment errors lies in the requirement that the recipient must repay the amounts, even in situations in which they will eventually be paid the amounts again.* Some corrections can still trigger the Section 409A additional tax as described below, but all correction methods under the Notice avoid the payment of interest at a premium rate (as well as the premature overall taxation mentioned above). The categories of corrections under the Notice include the following:

<u>Same-Year Corrections.</u> Generally, errors corrected in the same taxable year can avoid the 20% additional Federal tax and the premium interest.

<u>Next-Year Corrections.</u> Employees who are non-insiders (i.e., employees who are not officers, directors, or 10% owners of any class of the employer's equity) may correct errors in the year immediately following the error year and avoid both the 20% additional tax and the premium interest.

<u>Corrections Within Two Years.</u> Errors corrected by the end of the second taxable year following the error year can avoid the premium interest but are still subject to the 20% additional tax.

<u>Small Amount Corrections.</u> As an alternative to the above corrections, an employee may correct errors that do not exceed the amount a person can contribute for himself or herself to a 401(k) plan (the "Section 402(g) limit") by the end of the second taxable year following the error year, and only pay the 20% additional tax, without having to take some of the correction steps (such as repayment for early payments) and without application of the premium interest. The applicable Section 402(g) limit depends upon the year in which the error occurred and ranges from $14,000 in 2005 to $16,500 in 2009.

No Correction After Two Years. There is no correction procedure available for errors that are corrected after the end of the second taxable year following the error year. Such errors are subject to the full penalties imposed by Section 409A including early income inclusion, application of the 20% additional tax, and application of the premium interest.

Expiring 2009 Transition Relief. Section VIII of the Notice provides limited transitional relief that allows non-insiders to treat errors from 2005 through 2007 as qualifying for the "Next-Year Corrections" procedure, but only if the errors are corrected in 2009. Thus, taxpayers may correct errors that either would be subject to a correction procedure that imposes the 20% additional tax or for which there would be no available correction procedure using the more favorable Next-Year Corrections procedure through the end of this year. After this year, errors from 2005 through 2007 will no longer be correctable under the Notice.

Our Recommendations

We have recently learned from other practitioners that the IRS has begun conducting audits of companies' compliance with the requirements of Section 409A, looking back even to 2006. Accordingly, we recommend that employers conduct audits of any arrangements potentially covered by Section 409A as soon as possible to identify any operational errors that may have occurred and take corrective action under Notice 2008-113 where possible. In addition, particular attention should be paid to any operational errors that may have occurred on or before December 31, 2008 in order to take advantage of the Next-Year Corrections procedure and the 2009 Transitional Relief for non-insiders before its expiration at year end. This looks to be the last opportunity for such transition relief, as the IRS has informally indicated that no additional guidance (or, presumably, transition relief) is expected.

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