

News from our Compensation & Benefits Group

## Will You Be Ready For Section 409A Compliance Audits?

IRS audits that cover compliance with Section 409A of the Internal Revenue Code seem a near term certainty.<sup>1</sup> As a result, employers should take steps now to ensure that their deferred compensation arrangements are in compliance with the documentary and operational requirements of Section 409A. Adverse tax consequences under Section 409A may include premature taxation, an additional 20% federal income tax (and possibly an additional state tax equivalent, as is the case in California), and an interest-charge tax.

Although the final Section 409A regulations are already effective and the December 31, 2008 deadline for documentary compliance has already passed, employers still have an opportunity to act quickly to amend, in certain respects, documents that do not comply with Section 409A and to correct Section 409A operational errors, thereby reducing or completely avoiding adverse Section 409A tax consequences. The earlier that a non-compliant document or operational error is discovered and corrected, the more likely that adverse Section 409A tax consequences can be avoided. Also, certain transition relief for correction of Section 409A operational errors involving non-Section 16 insiders will expire on December 31, 2009. Therefore, commencing this year, employers may want to consider implementing annual 409A compliance audits for their compensation arrangements.

### Fixing Section 409A document errors

On October 26, an IRS representative indicated that the Service soon will issue

formal guidance on correction of Section 409A errors in plan documents, and such guidance, when issued, will be the subject of a later *Cooley Alert*. However, even in advance of an IRS document correction program, the proposed 409A income inclusion regulations provide a window of opportunity to correct plan document errors. The proposed regulations provide that Section 409A taxes are not imposed for any taxable year with respect to benefits that are subject to a substantial risk of forfeiture. Accordingly, as long as a document that does not comply with Section 409A is amended to bring it into compliance prior to the year in which the benefits are no longer subject to a risk of forfeiture (*i.e.*, vest), there are no adverse Section 409A tax consequences related to the documentary failure.<sup>2</sup> Therefore, employers have an opportunity to amend any non-compliant documents by December 31, 2009 with respect to benefits that will not vest until 2010 (or any later year).<sup>3</sup>

It is notable that the IRS had indicated that the foregoing method of correcting document errors is intended to be used sparingly and will not be considered effective if the facts and circumstances indicate that an employer has engaged in a pattern or practice of allowing otherwise impermissible changes in the time and form of payment with respect to nonvested deferred amounts. Accordingly, this method of correcting unintended errors and is not a substitute for care in the design, drafting and operation of deferred compensation arrangements. Employers that may have

not yet audited and amended their benefit programs for compliance with Section 409A are encouraged to contact a member of the Compensation & Benefits Group.

### Fixing Section 409A operational errors

As mentioned in our prior *Cooley Alert* at [www.cooley.com/58917](http://www.cooley.com/58917), IRS Notice 2008-113 outlines correction procedures to be followed for certain inadvertent

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operational violations of Section 409A and offers the possibility of obtaining either complete or partial relief from its adverse tax consequences. The relief provided and the correction procedures required depend upon when the operational failure is corrected and whether the affected individual is a Section 16 insider. The earlier that an eligible operational error is discovered and corrected, the more likely that the error will be eligible for correction and that additional Section 409A taxes and interest payments can be avoided or at least minimized.

Relief generally is not available under the Notice if an operational error is corrected any later than the second taxable year following the taxable year of the failure. However, the Notice provides special transition relief for the following types of operational errors involving non-Section 16 insiders that are corrected on or before December 31, 2009, regardless of the taxable year of the failure:

- ▶ Failure to delay separation payments to specified employees for at least six months.
- ▶ Premature or late payments.
- ▶ Deferrals of more or less than the correct amount.<sup>4</sup>

Under the transition relief, even if the operational error occurred in 2007 or an earlier year, if it corrected no later than December 31, 2009, it will be treated as having been corrected in the year following the taxable year in which the failure occurred, so that no additional Section 409A taxes will apply to the non-Section 16 insider.<sup>5</sup>

### Arrangements subject to Section 409A

As discussed in our prior *Cooley Alert* at [www.cooley.com/58815](http://www.cooley.com/58815), the broad categories of arrangements (those entered into on or after January 1, 2005, and in some cases prior to that date due to limited “grandfathering”) that may be subject to Section 409A include:

- ▶ Certain stock rights (e.g., deferred compensation settled in shares, restricted stock units, phantom stock, discounted stock options and discounted stock appreciation rights).
- ▶ Separation pay arrangements (plans and individual agreements providing severance benefits, including those payable upon or after a change in control).
- ▶ Account balance plans (deferred compensation arrangements expressed in the form of individual account balances, including supplemental executive retirement plans utilizing individual account balances).
- ▶ Non-account balance plans (individual arrangements and supplemental executive retirement plans expressing a benefit in terms of a defined benefit formula).
- ▶ Reimbursement plans (plans and individual agreements providing for taxable expense reimbursements).
- ▶ Bonus plans, including “carve-out” plans.

The Compensation & Benefits Group is prepared to help you to identify arrangements that are subject to Section 409A, bring them into compliance with its requirements, and make use of available Section 409A correction procedures. If you would like our assistance, please contact one of the attorneys listed above. ■

### CIRCULAR 230 DISCLOSURE

The following disclosure is provided in accordance with the Internal Revenue Service’s Circular 230 (21 CFR Part 10). Any tax advice contained in this Alert is intended to be preliminary, for discussion purposes only, and not final. Any such advice is not intended to be used for marketing, promoting or recommending any transaction or for the use of any person in connection with the preparation of any tax return. Accordingly, this advice is not intended or written to be used, and it cannot be used, by any person for the purpose of avoiding

tax penalties that may be imposed on such person.

### NOTES

1 See, e.g., BNA Pension & Benefits Daily on October 23, 2009 “IRS Official Tells of Future Random Audits On Fringe Benefits, Executive Compensation.”

2 IRS officials have informally confirmed this result under the proposed income inclusion regulations.

3 It is worth noting that amending for Section 409A compliance is not the equivalent of amending an arrangement to be exempt from application of Section 409A. For example, a non-exempt severance arrangement with an officer of a publicly traded entity may be amended prior to the year of termination of service to bring the arrangement into compliance with Section 409A by adding the requisite six-month delay in payment requirement to the severance benefits, and thereby avoid adverse tax consequences. By comparison, any amendment to such severance arrangement attempting to exempt the severance benefits from application of Section 409A and thereby avoid imposition of a six-month delay in payment requirement would be disregarded by the IRS unless other material consideration is provided (e.g., provision of additional material severance benefits in consideration of adding risks of forfeiture to “good reason” resignation triggers).

4 Note that correction of discounted option grants is not included as one of the operational errors eligible for correction under the transition relief. The Notice provides that for non-Section 16 insiders, discounted option grants may be corrected not later than the earlier of (i) exercise of the option or (ii) the year following the year of grant.

5 Under the Notice, for non-Section 16 insiders, adverse Section 409A tax consequences can be completely avoided for operational errors that are corrected no later than the following taxable year (but interest payments by the individual may be required) and for operational errors that are not corrected until the second year following the year of the failure, some Section 409A taxes will apply, but not to the maximum extent authorized.