

IRS Enforcement of Section 409A

Section 409A, which regulates non-qualified deferred compensation (NQDC) plans, was enacted in late 2004 as a part of the American Jobs Creation Act, largely in reaction to abuses of deferred compensation payouts to executives. Given the complexity of the 409A rules, a significant number of companies remain noncompliant due to plan document failures. The IRS's most recent notice allows taxpayers to voluntarily correct inadvertent and unintentional failures in NQDC plan documents. (See Notice 2010-6, January 5, 2010.) Two common examples of noncompliant provisions found during plan reviews include:

- > Provisions that allow participants to elect payout options immediately prior to the commencement of the payout
- > Provisions that allow a participant to make or cancel deferral elections at any time

Taxpayers that find and correct applicable document failures will be able to make corrections without current income inclusion or additional taxes under 409A. The transition period for this relief is open through December 31, 2010 - companies should act now to ensure that their plans are in compliance.

Section 409A overview

Section 409A places significant limitations on deferred compensation plans and imposes severe penalties for noncompliance. Section 409A has three main objectives:

- > Provide detailed rules regarding the timing of deferral elections
- > Prohibit most acceleration of payments
- > Permit payment only upon the occurrence of certain specific events

Section 409A is very broad in its application. NQDC plans are governed by Section 409A regardless of entity size or type (i.e., public, private, or incorporated). Examples of plans covered include:

- > Elective deferred compensation plans covering salary and/or bonus
- > Non-elective (company contributory) deferred compensation plans commonly known as SERPs or supplemental executive retirement plans
- > Salary continuation plans
- > Severance plans
- > Change in control agreements
- > Most "golden parachute" arrangements
- > Discounted stock options
- > Many stock appreciation rights (SAR) plans
- > Phantom stock plans
- > Most split dollar insurance arrangements
- > Section 457(f) plans (applicable to non-profits and government)
- > Many independent contractor agreements
- > Plans for non-employee directors

(continued)

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IRS enforcement initiatives

According to a former Treasury official, the IRS is serious about enforcing 409A.

- > NQDC plan inquiries will be part of the IRS's Employment Tax Research Study, which will randomly select 6000 employers over the next three years for detailed payroll and employment tax audits, including 409A plan examinations.
- > All employers under IRS audit should be expected to receive detailed Information Document Requests (IDRs) concerning their NQDC plans.
- > "Golden Parachute" plans will be targeted.
- > The IRS will closely examine compliance issues.

All NQDC plans must be compliant by January 1, 2011. The IRS has a limited-scope correction program open until December 31, 2010, for corrections made after January 1, 2011.

The penalties for noncompliance are severe and imposed directly on the individual participant. Penalties can include:

- > Immediate taxation of plan benefits
- > Interest
- > An additional penalty of up to 20 percent

Recommended action for companies with NQDC plans

The penalties for noncompliance are severe. However, as noted above, there is still an opportunity to make corrections. Given the complexity of the 409A rules, companies should begin taking steps now to ensure that plans are in compliance, including:

- > Conducting a review of bonus and deferred compensation plans to correct any non-compliant plan language or policies
- > Preparing an internal response team to plan for responses to IRS inquiries

Baker Tilly can assist with all aspects of Section 409A planning and compliance. If you have any questions, contact your Baker Tilly Tax Advisor or send an e-mail to tax@bakertilly.com.

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