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Section 409A One Year Later: The Importance of a Year-End Review

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Section 409A One Year Later: The Importance of a Year-End Review

Agenda

- Summary of IRS correction program/proposed regulations on income inclusion
 - Understanding the importance of year-end reviews
 - Understanding the importance of a 2009 year-end review
- Review common administrative issues that should be addressed to avoid §409A violations and eliminate the need to use the correction program
- “To Err is Human; To Forgive, Divine”
 - When it comes to §409A, administrators are more human than the IRS is divine
 - §409A demands perfection or penalties apply; therefore constant review is a best practice



§409A Year End Review

IRS Guidance on Correction

- IRS Notice 2008-113
 - Limited correction program for operational errors
 - Does not cover document errors
- IRS Proposed Regulations §1.409A-4
 - Address calculation of amount includible in income due to §409A violations
 - Not a correction program, per se, but provides guidance on some correction issues and how to limit penalties otherwise applicable
- IRS considering a correction program for document failures



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➤ IRS Notice 2008-113

- Limited correction program for operational (not document) errors
- Not available if employer experiences substantial financial downturn or “financial or other issues,” if there is a risk of nonpayment when due
- Relief more limited for “insiders”
 - Directors, officers and 10% owners
- Need reasonable steps to correct error and generally must disclose use of program to IRS on the employer and service provider tax returns
 - Query what to disclose if provider files electronically
- Consider: type of violation, how it was corrected, amount involved, who was affected (insider vs. non-insider)



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- IRS Notice 2008-113 covers:
 - Failures corrected in same tax year as violation
 1. *Failure to defer* even if valid election made or incorrect payment of amount due in a later year (other than 6-month rule violation)
 - Repay in same tax year
 - Possible repayment plan for non-insiders
 - If more than §402(g) amount, interest owed
 2. *Early payment* of amount scheduled for same tax year
 - Repay in same tax year and hold for payment based on number of days it was paid early
 - May not adjust for earnings, may adjust for losses



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- IRS Notice 2008-113 covers:
 - Failures corrected in same tax year as violation
 3. *Excess deferred* amount
 - “Excess deferral” includes a late/delayed distribution because the amount is deferred for a longer period
 - Pay out excess deferral
 - Adjust for earnings required for insiders; optional for non-insiders
 4. *Correction of exercise price* of otherwise excluded stock rights (e.g., options/SARs granted with exercise rights below FMV)
 - Reset exercise price (increase it) to FMV on grant date before end of year of grant and before exercise



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- IRS Notice 2008-113 covers:
 - Failures corrected in first tax year following the year of the error (for non-insiders), including
 - *Excess deferred* amount, including delayed distributions (Section V.D.)
 - Pay out based on amount owed without interest
 - No 20% penalty; disclose on returns
 - Failures corrected in second tax year following the year of the error, including
 - *Excess deferred* amount, including delayed distributions (Section VII.D.)
 - 20% penalty applies; no premium interest; disclose on returns



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- IRS Notice 2008-113 covers:
 - 2009 Transition Rule. Non-insider errors before January 1, 2008, can be rolled up and treated as a 2008 violation if fixed before January 1, 2010
 - Essentially applies to pre-2009 errors identified (and fixed) in 2009
 - Result is that 2009 correction falls under Section V based on correction in the year after the year of failure
 - This is one reason why a 2009 year end review is so important; find the old violations and consider correction under the special transition rule



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- IRS Notice 2008-113 is not always clear and requires careful review and analysis
 - ❖ **Real World Example:** IRS Notice 2008-113 covers “excess deferrals” including late distributions as follows:
 - **The Problem:** Payment owed in year 1, not made from the plan until year 2, then paid out WITHOUT interest for time value
 - **The Answer:** Correction should be under Section V.D., not Section VII.D
 - Pay in year 2; adjust account to reflect payment and earnings; may be adjusted for losses retroactively to the date the excess amount was inappropriately kept in the plan
 - Comply with notice and administrative requirements in Notice 2008-113



§409A Year End Review

- ❖ Modified Example: Payment owed in year 1, not made from the plan until year 2 AND the employer pays interest through the date of payment to compensate for time value
 - The Problem: Interest to compensate for late payment takes you out of Section V.D. correction
 - The Answer: Consider repaying the interest in the year of payment and treating late payment of principal amount as correctible under Section V.D
- If employee does not repay the interest, the failure does not fit under Section V.D. and §409A tax and penalties could apply as to the entire amount (not just interest)
- Key to using Section V.D. for late payment is to avoid compensating employee for delayed payment



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Other considerations:

- Weigh the pros/cons of using correction program
 - Is it better to use the program and attach statements to tax returns disclosing violations, etc. or simply pay the §409A taxes and penalties and have it reported on W-2 with a Code Z?
 - Also, the IRS correction program has degrees of violations/corrections; it is not all or nothing
 - Employer can “gross-up” employees for §409A tax, but
 - Cannot accelerate previously deferred compensation to pay employee’s §409A tax and penalties
 - It is permissible to accelerate previously deferred compensation to pay amounts included in income due to §409A violations (Treas. Reg. §1.409A-3(j)(4)(viii))



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More IRS Guidance on Correction

- IRS Prop. Treas. Reg. §1.409A-4:
 - Proposed regulations provide detailed guidance on how to calculate the amount to be included in income
 - IRS tried to provide some “taxpayer friendly” rules
- Each year’s violation stands on its own (*e.g.*, error in year 1 does not taint year 2 if compliant in year 2); therefore, fix it and the plan can move on
 - No plan aggregation rule for plan document errors
 - Once an amount is included in income, only earnings on that amount are included in the future
 - Valuation of includible amounts generally done at the end of the year (amounts paid out during the year are added back)



§409A Year End Review

- IRS Prop. Treas. Reg. §1.409A-4:
 - As explained in preamble, allows for the possibility of curing even a document violation completely and without penalty before amounts are vested; under this rule:
 - if no amounts are vested by the end of the year, and
 - the plan, as written is in violation and needs to be fixed, then
 - the plan may be re-written to be compliant
 - This rule even potentially allows non-compliant distribution options to be cured without regard to the 1-year/5-year rule



§409A Year End Review

IRS Guidance on Audits

➤ *IRS Audit Program/Audit Questions*

- IRS has begun §409A audits and issued Information document Requests (“IDRs”) on §409A issues, including
 - Identification of plans subject to §409A or not and the basis for why plan is not subject to §409A
 - Terms for deferral elections, changes, deadlines for changes
 - Identify any acceleration decisions and the basis for them
 - Disclose specified employees and how they were identified and whether payments were made to specified employees
 - **AND – Have you identified/reported violations and/or participated in IRS correction programs?**



§409A Year End Review

Summary

➤ Importance of Year-End Review

- Minimize penalties in Notice 2008-113
- Possible fix under IRS proposed regulations if deferred comp not vested by year end

➤ Importance of 2009 Year-End Review

- Roll up pre-2008 non-insider violations and fix before 2010 for transition relief
- Prepare for new IRS audit initiative



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Erroneous deferrals

- **The Problem:** Employer was supposed to pay a bonus by 12/31/2009 for services performed during 2009 and “by mistake” deferred it under the deferred comp plan
- **The Answer:** Pay the amount by March 15, 2010 and it could still qualify as a “short term deferral” and no §409A violation

Pay after March 15, 2010 and if there is no definite payment date, there could be a §409A violation, but correctible under Notice 2008-113



§409A Year End Review

Administering Deferral Elections

Last day of the year crosses over 12/31

- **The Problem:** For the pay period beginning in December 2009 and ending in January 2010 (when the payment is made), which deferral election governs?
- **Answer 1:** The election made by 12/31/2008
- **Answer 2:** The election made by 12/31/2009



§409A Year End Review

Administering Deferral Elections

Last day of the year crosses over 12/31 (cont.)

- The Regulations (§1.409A-2(a)(13)):

Unless the plan provides otherwise,

- The Answer: The election made by 12/31/09

So, what does your plan say and how will you administer this?

- OK to amend your plan and change your answer, but the amendment cannot be effective for 12 months from adoption



§409A Year End Review

Administering Deferral Elections

Performance-Based Pay

- **The Problem:**

Calendar year plan with an existing §409A performance-based bonus deferral. You allow deferral elections by June 30 and a newly-eligible participant is hired April 1. What is the latest date for this participant's bonus deferral election?

- Answer 1: April 30 (based on 30-day rule)?
- Answer 2: June 30 (based on 6-month rule)?



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Administering Deferral Elections

Performance-Based Pay

- The Regulations (§1.409A-2(a)(8) and §1.409A-1(e)):
 - **The Answer:** April 30
- **The Regs require:**
 - (1) a 12-month performance period; and
 - (2) continuous employment from the beginning of the performance period through the date of the election



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Administering Deferral Elections

Performance-Based Pay

- **The Problem:** Plan has an existing §409A performance-based bonus deferral. If a participant retires during the year (or is involuntarily terminated), the participant is eligible for a bonus “at target.” Are participants eligible for a June 30 bonus deferral election?
- The Answer: No



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Administering Deferral Elections

Performance-Based Pay

- The Regulations (§1.409A-2(a)(8) and §1.409A-1(e)) require:
performance-based pay not be paid regardless of performance.
Therefore, the June 30 election is not valid. See also IRS Rev. Rul. 2008-13 (re: comparable rule under Code §162(m)).
- Should be OK to pay without regard to the performance-based deferral election without violating §409A
 - Same as if employee made an invalid 1-year/5-year election



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Administering Deferral Elections

- **The Problem:** Participants made Plan A deferral elections for 2009 by 12/31/2008. In June 2009, an employee:
 - ceases to be eligible for Plan A and becomes eligible for Plan B
 - changes employment classification with the employer and loses eligibility, or
 - suffers a pay cut and becomes not highly compensated



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Administering Deferral Elections

- The Problem: Can employees get out of their elections because they are no longer eligible?
- The Answer: No
 - Once election is made, it is irrevocable
 - Even if employee falls out of being a “top hat” eligible individual, deferral must continue
- Concern is abuse of letting employees out of their elections by re-assigning them



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Irrevocable Elections – Indirect (Impermissible) Changes

- The Problem: Participant deferred 10% of salary before 2009. Mid-year 2009, employer cuts salary; but increases short-term bonus
 - Is that overriding the “irrevocable” election?
 - Also hits other mid-year changes such as:
 - Plan allows deferrals of cash pay; employer pays part/all in non-deferred stock to preserve cash
 - Employer decides to change from cash to RSUs so instead of deferring cash, employee is “paid” in RSUs
 - CEO cuts pay to \$1



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Irrevocable Elections – Indirect (Impermissible) Changes

- The Problem: Employer decides, mid-year, to give choice to employees to be paid remaining salary/bonus in stock options or restricted stock, subject to §83
 - Election between comp alternatives where neither is under §409A, no §409A timing rules apply
 - HOWEVER, where either alternative involves §409A deferred comp, election must comply with §409A rules
 - Therefore, if implication of choice is reduction in deferred comp amount previously “irrevocably elected,” consider whether there is a violation
 - This issue is under study by IRS



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Irrevocable Elections – Indirect (Impermissible) Changes

- The Answer: Mid-year changes that increase or decrease deferrals are a potential §409A violation
 - Issue arises whether or not change is due to employee election
 - When comp that otherwise would have been deferred is paid currently or comp that would be paid is deferred, there's a problem
 - If there is only a pay cut (or pay raise) with nothing else, should be OK
 - Does it matter if changes are made for a good business reason unrelated to §409A? Perhaps (not).



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Irrevocable Elections – Indirect (Impermissible) Changes

- The Answer: Solve the problem for next year by:
 - Fix up your election forms and plan document by explaining that the deferral applies without regard to mid-year adjustments
 - Mandate that deferrals be expressed as flat dollar amounts, regardless of the form of non-deferred pay



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Irrevocable Elections – Indirect (Impermissible) Changes

- The Problem: Nonqualified plan #1 pays benefits by offsetting amounts owed under nonqualified plan #2. Plan #1 pays in installments/annuity payments and plan #2 pays in a lump sum
 - Problem is that differences in time and form of payment under the two plans may violate §409A inadvertently
 - Could move amounts from Plan #1 to Plan #2 and create an acceleration or from Plan #2 to Plan #1 and create a further deferral



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Irrevocable Elections – Indirect (Impermissible) Changes

- The Answer: If it is possible to cure based on the IRS proposed regulations because amounts are not vested by year end under one of the plans, re-draft to cure the violation.
 - Consider plan amendment language and whether there might be contractual issues with amending
 - If distributions can be brought in synch operationally, regardless of plan terms, this may help
 - Keep an eye out for any relief on correction program for document failures
 - At the end of the day – might need to report a document violation and fix the plan subject to 1-year/5-year rule



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Reemployment and Effect on Payment

- The Problem: Former participant is being paid in installments/annuity payments and is reemployed; plan suspends payment and re-commences (with subsequent deferrals) at later separation from service
 - Effectively allows for a further deferral upon reemployment without regard to the 1-year/5-year rule
 - §409A regulations do not specifically address this; but it is addressed in the preamble



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Reemployment and Effect on Payment

- The Answer: Two possible solutions:
 - Continue payments regardless of reemployment
 - Forfeit payments otherwise made during a period of reemployment (true forfeiture with no make-up or substitute payments)
- **Other considerations:**
 - Before implementing a forfeiture, check plan language re: protections for employees' benefits (e.g., no amendments allowed which "reduce" benefits)
 - Before reemploying someone, make sure they understand what will happen



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Your questions??

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