EMPLOYMENT SERVICES ALERT

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IRS Begins Code Section 409A Audit Program

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Background

Congress added Section 409A to the Internal Revenue Code of 1986, as amended ("Section 409A") as part of the American Jobs Creation Act of 2004. Section 409A dramatically increased the federal regulation of deferred compensation. The scope of Section 409A is broad and covers "any plan that provides for the deferral of compensation," including nonqualified plans, certain bonus arrangements, severance arrangements, employment agreements, reimbursements, and more.

Generally, Section 409A imposed numerous new requirements regarding initial and subsequent deferral elections, permissible distribution events, and the timing and form of distributions. In addition, Section 409A imposed a prohibition on the acceleration of benefits in most instances. Section 409A requires both document and operational compliance.

Since the enactment of Section 409A, the Internal Revenue Service ("IRS") has issued numerous notices, proposed regulations, and final regulations. This IRS guidance clarified the law and provided opportunities for employers to correct both document and operational failures.

Section 409A imposes harsh penalties on employees that participate in deferred compensation arrangements that violate these new rules. Specifically, the employee must take all deferred compensation (current and prior tax years) into current taxable income, to the extent vested, which eliminates the employee's tax deferral. Employees are also subject to an additional 20% tax and interest at the underpayment rate plus 1%.

In the case of an operational failure, the penalties are imposed on the employee associated with such operational failure. In the case of a document failure, the penalties are imposed on all employees who participate in the plan.

Formal Audit Program

Although most of the activity has been on the regulatory side, the IRS has recently announced that it will commence a formal audit program to determine whether employers are complying with the document and operational requirements of Section 409A. Initially, the audit program will be limited to approximately 50 large employers and to the 10 most highly compensated employees of those companies.

The focus of the audit program will examine (a) initial deferral elections, (b) subsequent deferral elections, and (c) compliance with the distribution requirements.

Depending on what the IRS discovers when conducting these initial audits, the scope of the audit program could be expanded or revised.

Action Steps for Employers

Whether your company has or has not already done so, this would be an opportune time to conduct a self-audit of your deferred compensation arrangements, regardless of whether or not your company is a potential target of this initial audit program.

We recommend that your company take the following action steps as part of its self-audit:

- Determine what nonqualified plans, bonus arrangements, severance arrangements, employment agreements, and reimbursements the company maintains that are governed by Section 409A.
- Review all arrangements governed by Section 409A and confirm that such documents comply with Section 409A.
- Determine whether the arrangements governed by Section 409A comply with the requirements of the statute in operation with particular attention to those items the IRS will focus on during its initial audit program.
- Take appropriate action steps to correct any document or operational failure by utilizing formal correction programs sponsored by the IRS.

For further information or assistance in conducting a self-audit, please contact any of the following Roetzel attorneys:

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