

**Employee Benefits &
Executive Compensation
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Employee Benefits Update

IRS Provides a Limited Opportunity to Correct Operational Failures under Section 409A by December 31, 2009

Introduction

Congress added Section 409A to the Internal Revenue Code as part of the American Jobs Creation Act of 2004. Section 409A dramatically increased the federal regulation of deferred compensation. Generally, Section 409A imposes numerous new requirements regarding deferral elections, permissible distribution events and the timing and form of distributions. The new rules also prohibit the acceleration of benefits in most instances.

Section 409A imposes both documentation requirements and operational requirements. This U&H client update discusses certain theories to correct document failures and a limited opportunity to correct certain operational failures under Section 409A by December 31, 2009.

Overview of § 409A Coverage and Noncompliance

The scope of Section 409A is broad. Section 409A covers "any plan that provides for the deferral of compensation" including certain bonus arrangements, severance arrangements, employment agreements, traditional nonqualified plans, and more. Noncompliance with Section 409A can be very costly. Generally, (i) the affected employee of an operational failure, and (ii) all plan employees in the case of a document failure, must take all deferred compensation (current and all prior tax years) into current taxable income, to the extent vested (i.e. the tax deferral is lost). Employees are also subject to an additional 20% tax and interest (underpayment rate plus 1%).

Document Failures

Each covered arrangement was required to be amended to conform to Section 409A by December 31, 2008. This begs the question: What happens when a covered arrangement was not timely amended or not properly amended?

Unfortunately, there is currently no IRS relief program for document compliance failures. Employees may be able to mitigate legal exposure for document failures, under one or more of the following theories:

1. **Grandfathered Benefits Exception.** Section 409A does not apply to certain "grandfathered" deferred compensation. Such compensation must have been earned and vested by December 31, 2004.
2. **Regulatory Exception.** The Treasury regulations issued under Section 409A set forth several exceptions from the definition of "deferral of compensation". Arrangements that satisfy one of these exceptions are not governed by Section 409A. For instance, Section 409A does not apply to a "short-term deferral" (i.e. compensation that is

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received by an employee no later than 2½ months after the end of the taxable year in which the compensation vests). An employer may avoid or reduce its document failure exposure by carefully reviewing these regulatory exceptions with tax counsel.

3. *Unvested Amounts Exception.* Based on statements made by the IRS in recent 409A proposed regulations, Section 409A may not apply to deferred compensation that is not yet vested (i.e. is still subject to a “substantial risk of forfeiture”). If this is true, Section 409A would not trigger a penalty for a document failure until the tax year in which the deferred compensation becomes vested. Accordingly, a plan documentation failure may be avoidable if the document is amended before the tax year in which any amounts are vested under the plan.

Relief from Operational Failures

In Notice 2008-113, the IRS provides relief for certain Section 409A operational failures (i.e. where the plan document is correct, but the plan is not operated in accordance with the plan). The IRS has conditioned this relief, however, on the employer and employee meeting several eligibility requirements and qualifications, including:

- *Avoidance of Recurring Operational Failures.* Taxpayers with recurring 409A operational failures that are the same or “substantially similar” are not eligible for relief for tax years after December 31, 2009. Taxpayers with multiple violations must correct their plans before the end of 2009 or the employer must demonstrate that it “established practices and procedures” reasonably designed to ensure such operational failure would not recur and that it had taken “commercially reasonable steps” to avoid a recurrence of the operational failure. Employers must (i) correct existing operational failures by December 31, 2009, and (ii) develop internal compliance practices and procedures to be eligible for corrective relief in the future.
- *Inadvertent and Unintentional Failures.* Relief is only allowed for failures that are “inadvertent and unintentional.”
- *Substantial Financial Downturn Exception.* Relief is not available for Section 409A operational violations made in a year in which the employer experienced a “substantial financial downturn.”

In Notice 2008-113, the IRS set forth four different “programs” that provide varying types of relief for “described” operational failures. The availability of each “program” (and the relief described therein) may depend on (a) when the operational failure was corrected (i.e. the same tax year of the failure, the following tax year of the failure, the second tax year following the failure), (b) whether the employee is an “insider” (as defined by the IRS), (c) whether the operational failure involved certain limited amounts (i.e. less than \$16,500), and (d) other factors.

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1. Operational Failures Corrected in Same Tax Year. Generally, taxpayers who correct their Section 409A violations within the same tax year are not subject to Section 409A penalties, regardless of their status as insiders. Corrections usually consist of returning the amount erroneously deferred or paid, according to the terms of the plan.
2. Operational Failures Corrected in Following Tax Year. Taxpayers who correct their Section 409A violations within the year immediately following the year of the failure are not subject to Section 409A penalties. This program is only available to non-insiders.

A special extension applies to non-insiders for certain operational failures occurring on or before December 31, 2007. For any of these operational failures, the employee's 2009 taxable year will be treated as the taxable year following the year in which the failure occurred.

3. Operational Failures of a Limited Amount. Taxpayers with Section 409A failures that include amounts less than \$16,500 qualify for special treatment. Instead of correcting by making a repayment, the taxpayer may choose to include the amount erroneously deferred or paid as income. The taxpayer is relieved, however, from paying the entire amount of deferred income normally required by Section 409A. The employee is also subject to the 20% additional tax, but not the premium interest rate. This relief is available for two years following the year in which the failure occurred.
4. Operational Failures Corrected in Subsequent Tax Year. Under the last program, taxpayers may correct their Section 409A violations as late as two years after the year in which the failure occurred, regardless of the amount involved. However, the taxpayer must correct the violation by repaying the amount erroneously deferred or paid. The amount is also includible in income in the year in which the amount was erroneously paid or deferred, and is subject to the 20% additional tax, but not the penalty interest rate.

A special interest rate applies to insiders under this program.

Conclusion

Various limitations and documentation requirements apply to the relief outlined above. Some avenues for relief expire after 2009, so prompt consultation with executive compensation counsel is advisable.

Ungaretti & Harris' Employee Benefits Group handles all aspects of employee benefit plan and executive compensation representation. We serve as general employee benefits counsel to numerous companies, and also serve as ERISA counsel to banks, trust companies, insurance companies, investment managers, and third-party recordkeeping firms. Please call any member of the Employee Benefits and Executive Compensation Group if you have questions regarding ERISA compliance.

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