

2009 Offers Section 409A Correction Opportunities

February 11, 2009

As employers come to grips with the new inflexibility of fully implemented section 409A requirements, potential section 409A violations and resulting adverse tax consequences are becoming a reality. Even so, there are some tools available for addressing section 409A compliance failures that can limit, and in some cases eliminate, the adverse tax consequences associated with an inadvertent failure to follow the rules under section 409A. In Notice 2008-113, the IRS provided lengthy and detailed guidance for operational failures that are fixed within certain limited periods following the occurrence of the failure. It is important to note however, that Notice 2008-113 generally does **not** offer relief with respect to a failure to satisfy the documentary requirements of section 409A. In addition, as discussed below, a special opportunity for correction during 2009 is provided, but the opportunity requires action in 2009.

Correcting Section 409A Operational Failures

Notice 2008-113 offers correction opportunities that vary based on whether the affected individual is an “insider” or not. For this purpose, an insider is determined under the Section 16 rules of the Securities Exchange Act, applied without regard to whether the company’s securities are registered. Accordingly, nonpublic companies are also treated as having “insiders” for purposes of these rules.

The availability and method of correction also vary based on the proximity of correction to the error (e.g., same year, next year, or by the end of the second following year). The method of correction required is specified based on the nature of the error—such as delayed payment, inadvertent payment in an earlier year, or inadvertent early payment in the same year or in violation of the six-month delay requirement for specified employees.

Finally, there is a special rule for corrections involving amounts not greater than the limit on elective deferrals under Code section 402(g) (\$16,500 for 2009). An operational failure may be “fixable” under more than one category of correction, and attention should be given to the most administratively and otherwise attractive alternative for correction.

The rules for correction under Notice 2008-113 are detailed, and in some cases, administratively complex, requiring repayment of early distribution amounts and interest charges in some instances. The recordkeeping involved for such corrections represents a challenging task with respect to plans administered by outside vendors or on a large scale. Prompt attention to early detection and correction of mistakes is encouraged.

In general, corrections of errors in the same year, or with respect to non-insiders, are treated with greater leniency than later corrections or those of insiders. For example, errors can generally be corrected in the same year without incurring the otherwise applicable additional taxes under section 409A. For non-insiders, it is possible to correct in the next following year without additional section 409A taxes. For insiders and non-insiders, corrections of violations involving limited amounts (up to the section 402(g) limit) and corrections made by the end of the second year following the year of the error require a payment of the 20% additional tax only (avoiding the additional interest tax and application of the much-dreaded section 409A aggregation rules, which, if applicable, would require application of the 20% tax to all plans of the same “kind”).

In all cases, the relief under Notice 2008-113 is only available if reasonable steps are taken to prevent reoccurrence of the failure. Under all available correction methods described in the Notice, some type of disclosure to the IRS and affected plan participants is required, either in the form of a prescribed statement or in the form of reporting under “Code Z” on an applicable W-2 or Form 1099. On a more troubling note, the Notice specifies that the correction relief is not available for inadvertent early payments where the payor is subject to a substantial financial downturn. Given the broad challenges facing employers in the current economic environment, concerns have been expressed to the IRS regarding the application of this rule and its impact on the availability of correction relief.

Special 2009 Opportunity for Correcting Failures for Non-Insiders

Under a potentially valuable transition rule in Notice 2008-113, there is an opportunity to correct any specified operational failure occurring prior to 2009 with respect to a non-insider without incurring section 409A additional taxes. This provision allows for identification and correction of such failures in 2009, going back to the effective date of section 409A on January 1, 2005. This opportunity to correct old mistakes under this more beneficial regime will expire at the end of 2009, so prompt attention is required.

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