



One Minute Memo[®]

§409A Errors That Can Still Be Corrected By December 31, 2009

Although December 31, 2008, was the official deadline for bringing all deferred compensation plans and agreements into compliance with the new IRS regulations under Code §409A, there are still several steps an employer can take by the end of 2009 to correct, or at least mitigate the effect, of failures to comply with §409A.

By way of background, Code §409A imposes complex new limits on the use of any type of deferred compensation plan or arrangement, and the IRS has broadly defined “deferred compensation” to include things like severance plans and individual employment agreements including severance provisions, certain types of annual bonus and long-term incentive plans, and split dollar life insurance. Failure to comply with the strict rules of §409A can result in all of an employee’s deferred compensation—not just the amount involved in the error—being immediately subject to tax, plus a 20% penalty tax and retroactive interest if the error is not corrected using the IRS guidelines.

Correction of Operational Errors

The IRS has issued a correction program that allows employers to correct “operational errors” that occur in the administration of a deferred compensation plan. The most common operational errors are:

- Failure to defer compensation in accordance with the plan. For example, an employee elected to defer 10% of his compensation, and due to a payroll processing error the deferral election was not implemented, or was implemented later in the year.
- Failure to pay deferred compensation at the time specified in the plan. Under some circumstances this can result in a §409A violation even if the compensation was paid in the same year.
- Failure to pay out in the form specified in the plan. For example, the employee had elected payment in five annual installments, but instead he was paid in a lump sum.
- Deferring compensation under an election that was made after the beginning of the year.
- Payment of deferred compensation to an officer of a public company within six months after termination of employment.
- An error under another plan resulted in an error under the deferred compensation plan. For example, the employee’s pension was calculated incorrectly under a qualified plan and, therefore, the excess benefit plan. The employee terminated and received payment of the erroneous amount and is now entitled to an additional payment.

It is particularly important for companies to identify this type of error in the same year that it occurs if the error affects a corporate officer or directors, since under the IRS guidelines the correction of errors affecting a corporate insider in a later year will still result in penalties, even if the penalties are reduced.

Ordinarily, an operational error must be corrected by the end of the year in which it occurred, or the following year. However, under a special transitional rule, operational errors that occurred in 2005 through 2009 can be corrected by December 31, 2009.

Accordingly, all employers who maintain nonqualified deferred compensation plans should review the operation of those plans over the past five years to determine whether any errors have occurred that should be corrected by the end of 2009.

Amendment of Severance Plans and Agreements, and Other Unvested Plans

Severance plans, and employment agreements including severance provisions, are a common source of §409A violations. Any severance plan or agreement that provides for payment of severance in installments, that provides for severance after a change in control or resignation for good reason, or that requires the employee to execute a release in order to receive the severance, may raise §409A issues.

In general, all plans and agreements were required to be amended to comply with §409A by the end of 2008, and errors in the drafting of plans cannot be cured using the IRS procedure described above. However, if the employee's right to the severance has not yet "vested" by the end of 2009, it may be possible to amend the agreement and avoid a §409A violation if the amendment is adopted by the end of 2009. Generally, a right to severance does not "vest" until the employee has terminated (although there are some exceptions), which means that plans and agreements for active employees who have not terminated by the end of 2009 can still be amended to eliminate some §409A violations.

In addition to severance plans and agreements, this same method can be used to correct any plan providing for benefits that have not vested by the end of 2009, including supplemental retirement plans, and incentive plans including grants such as restricted stock units.

Among the §409A errors that may be corrected by a timely amendment are:

- Plans and agreements that do not provide a specific time or method of payment, or that allow the employer to either accelerate or defer payments.
- Provisions allowing severance to be paid in a different form (i.e., a lump sum) following a change in control, if the definition of change in control doesn't satisfy the IRS definition.
- Provisions allowing severance payments to be offset by certain amounts owed to the employer.
- Failure by a public company to include the mandatory six month delay of payment of severance paid to officers.
- Provisions requiring the employee to sign a release to receive the severance, but not specifying a time for the signing of the release.

Any company that did not succeed in amending all of its severance plans and employment agreements to comply with §409A by the end of 2008 (or that has discovered additional plans or agreements since then) has a second chance to correct them if the benefits have not vested by the end of 2009.

For more information, please contact the Seyfarth attorney with whom you work, or any Employee Benefits attorney on our website (www.seyfarth.com/EmployeeBenefits).