

Executive Compensation Alert: Section 409A Error Corrections Before Year End

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IRS Notice 2008-113 (the “Notice”) permits employers to correct certain operational errors for purposes of Section 409A of the Internal Revenue Code (“Section 409A”). The Notice provides transition relief that allows certain errors that occurred between 2005 through 2007 to be corrected in 2009 as if they were corrected in the tax year following the occurrence of the errors. Employers only have until the end of 2009 to take advantage of this relief with respect to 2005 through 2007 tax years.

Section 409A is designed to place restrictions on non-qualified deferred compensation arrangements and subject noncompliant arrangements to a 20% additional Section 409A tax (with an additional 20% tax in California). Section 409A’s reach potentially extends far beyond traditional deferred compensation arrangements into employment agreements, bonus provisions and even certain stock rights. The complexity and confusion of Section 409A has created inadvertent and unintentional operational errors under Section 409A. The Notice permits certain of these errors to be corrected through a correction procedure.

The type of errors that can be corrected under the Notice include:

- (i) failure to defer amounts;
- (ii) incorrect payment of amounts;
- (iii) payments in violation of the six-month deferral rule for public company specified employees;
- (iv) excess deferrals; and
- (v) correction of the exercise price of stock rights that would otherwise be exempt from Section 409A.

The Notice designates three categories for corrections based on how quickly the error is corrected:

- (1) The first category is corrections that are made in the same tax year as the error, which generally avoid the 20% additional Section 409A tax and the Section 409A premium interest rate.
- (2) The second category is corrections that are made within the next tax year following the year of the error and which do not involve “insiders” (“insiders” generally includes 10% owners, directors and officers). These next year corrections also avoid the 20% additional Section 409A tax and the Section 409A premium interest rate.

- (3) The third category is corrections that are made within the second tax year following the year of the error, which corrections avoid the Section 409A premium interest rate but not the 20% Section 409A tax.

Generally, there are no corrections procedures for errors beyond the second tax year following the error.

The Notice also provides transition relief for errors that occurred in 2005 through 2007, and if such errors are corrected in 2009, they will be treated in the second category, i.e., as if they were corrected in the next tax year after the errors occurred. This transition relief does not apply to insiders.

The IRS has recently begun Section 409A audits, focusing primarily on tax years 2006 through 2008. Because companies have only until the end of the year to take advantage of the transition correction procedure set forth in the preceding paragraph, we encourage employers to review their deferred compensation arrangements and take actions to correct, before the end of the year, any errors that are discovered.

For more information, we encourage employers to contact any attorney in the Executive Compensation and Employee Benefits Group.

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