

Company Self-Audits Help Avoid § 409A Penalties

Although companies are operating under severe budget and resource constraints, many have concluded that it is both worthwhile and cost-effective to engage in a self-audit of the administration of their nonqualified deferred compensation arrangements to ensure compliance with section 409A of the US Internal Revenue Code.

Reasons for Early Self-Audit

Section 409A applies to nonqualified deferred compensation, as that term is very broadly defined by the tax code and IRS regulations. The requirements imposed by section 409A are complex, and penalties for noncompliance are often severe. Although most violations of those requirements result from actions by the company, the tax penalties for violations of section 409A are imposed on the employee or other service provider (the “participant”). There is limited opportunity to correct even minor or inadvertent failures in documentation or administration, except pursuant to the terms of a correction procedures that the IRS designed to encourage companies to take early steps to ensure compliance with the rules.

During the ramp-up to the December 31, 2008 effective date for full documentary compliance, attorneys and benefits personnel at many companies developed an understanding of the application of section 409A’s rules to their respective companies’ compensation arrangements, and established procedures to satisfy those requirements. However, the failure

to actually follow the procedures established for each of the many steps needed to satisfy the section 409A requirements has resulted in violations. We believe that, in many cases, it will be important for companies to review whether the operation and administration of their deferred compensation plans in fact conform to the company’s procedures and plan documents.

In determining whether a section 409A self-audit is worthwhile, the following factors may be relevant:

New Procedures. IRS representatives have likened the complexity of the section 409A rules to the complexity of the tax rules applicable to qualified plans (such as 401(k) plans). This complexity, combined with the fact that the administrative procedures for nonqualified plans are still comparatively new, has increased the desirability of a self-audit to confirm that such plans are being operated properly.

Incentive for Proactive Approach. IRS representatives have said that a significant purpose of the correction procedures is to provide an incentive for companies to be proactive and take timely steps to ensure compliance with section 409A. To accomplish this purpose, much of the relief available under the correction procedures is more generous if corrections are made early.

IRS Audits. IRS audits have, in some cases, included a comprehensive review of the company’s documentation and procedures for nonqualified deferred compensation plans.

Generally, the availability of the correction procedure (with its reduced penalties) is lost for corrections made after commencement of an IRS audit of the plan with respect to the affected participant or the plan sponsor. An early self-audit, with corrections made before an IRS audit of the plan has commenced, will preserve the ability to use the correction procedures.

Difference from Qualified Plans. For qualified plans, there is an extensive IRS program permitting correction of failures. IRS representatives have commented that the tax rules reflect a policy of encouraging the establishment and maintenance of such qualified plans. They note that, in contrast, there is no government policy encouraging the establishment and maintenance of nonqualified plans, and so IRS representatives may be more aggressive in seeking settlement of section 409A-related failures.

Steps in a Self-Audit

Section 409A applies to a wide variety of arrangements, including many that would not typically be considered deferred compensation. Such arrangements can include not only plans intended to supplement qualified plan benefits, but also arrangements such as employment agreements, severance plans, equity-based compensation, bonus arrangements, fringe benefits arrangements, expense reimbursement arrangements, indemnification arrangements, change in control agreements and tax gross-up arrangements.

In part because of that variety, as well as the wide variety of terms that can be included in almost any such plan, we do not believe that it is feasible to establish a single self-audit approach that will be appropriate for all companies and all types of nonqualified plans. However, in designing and implementing a self-audit, a company may find it worthwhile to consider the following.

Collection of Documents. It is important to identify all arrangements maintained by the

company that are subject to section 409A. This can be a challenge because of the broad reach of section 409A and also because of the difficulty associated with determining whether an arrangement will in fact be subject to section 409A. Adding to the difficulty is the fact that, at many companies, employment and compensation arrangements are established at a local level and not necessarily reviewed by legal, human resources, or other personnel who are familiar with the section 409A requirements. It will generally be worthwhile for a company (including its affiliates) to establish a procedure for promptly identifying all compensation arrangements that may be subject to section 409A, and conform the administration of the arrangement to those rules. In addition to helping ensure compliance with section 409A, such a procedure will be helpful in complying with the requests of IRS representatives in an audit.

Election Form Revisions. Confirm that procedures are in place to ensure that any changes to existing deferred compensation arrangements are timely and accurately communicated to participants and reflected in participant election forms.

Deferral and Distribution Elections. Confirm that the necessary participant elections covering the amount of deferral and time of distribution are consistent with the terms of the plan, and that such elections are being collected in a timely manner and retained in an accessible location.

Data Entry. Consider establishing a method to double-check the accuracy of all data entry reflecting company or participant decisions and elections for each select plan. Also consider maintaining a general calendar of deadlines to ensure that required tasks are handled in a timely way.

Initial Deferral. The special rule allowing mid-year deferral elections for initial participation generally will be available only if the individual is not participating in any other plan of the same

type maintained by any company in the affiliated group. A self-audit should confirm that there is a method in place to ensure that an individual being given the opportunity to make a mid-year deferral election satisfies this requirement.

Transfers - Coverage. Confirm that procedures are in place for handling transition issues for a participant transferring from one position, division or company to another within the affiliated group, including, in particular, a participant who may be leaving active coverage in one plan, and beginning coverage under another plan.

Transfers - Separation from Service.

Confirm that the affiliated group of companies has a method for determining whether a participant who leaves a position has incurred a separation from service or has transferred to another position, division or company in the affiliated group.

Leave of Absence. Section 409A provides rules for determining when a participant who is on a leave of absence is to be treated as having incurred a separation from service. Confirm that the procedures used to track participants on leave reflect the appropriate section 409A requirements to determine whether and when the participant has incurred a separation from service.

Cross-Border. Section 409A does not provide an exception for non-US plans. As a result, deferred compensation plans maintained by non-US sponsors that cover US citizens and permanent residents, as well as aliens temporarily residing in the US, may need to satisfy Section 409A. For an affiliated group with companies that maintain non-US plans, a self-audit should confirm that procedures are in place for determining whether participants subject to US tax who are moving into or out of the United States are covered by any non-US arrangements that would be subject to section 409A and, if so, whether such arrangements satisfy the requirements of section 409A. Confirm that there is a method for

tracking benefits after the participant returns to his or her native country (US or elsewhere).

Changes to Distribution Elections. Changes to established times and forms of payment of nonqualified deferred compensation are permitted under certain limited circumstances in accordance with special rules, including a requirement that the plan document allows such changes. If participants are permitted to change distribution dates of previously deferred amounts, a self-audit generally should confirm that the administration of such distribution changes is consistent with the plan document, and that administrative practices do not allow such changes if they are not consistent with the requirements of section 409A.

Delay Pending Release of Claims. Earlier this year, the IRS, in Notice 2010-6, stated that conditioning the time of payment on an action to be taken by the participant (such as execution of a release of claims) will generally violate section 409A if the effect is to give the participant the ability to delay or accelerate the timing of payment. A self-audit should confirm that any plans or agreements and any related procedures that condition payment on participant action do not give the participant the ability to delay or accelerate the timing of payment.

Payroll Tax. Nonqualified deferred compensation is generally subject to withholding of Social Security and Medicare tax at the time such compensation becomes vested, rather than at the time of later distribution. Section 409A generally permits satisfaction of this withholding requirement through a reduction of the participant's account balance or accrued benefit made prior to the scheduled date of distribution of benefits to the participant, subject to satisfaction of certain requirements. If such Social Security and Medicare withholding is to be satisfied through such a reduction in benefits, a self-audit should confirm that the process satisfies the requirements of section 409A.

Linking Distribution to Qualified Plan.

Nonqualified plans sometimes provide benefits that cannot be provided under a qualified plan (for example, by reason of the limits on qualified plan benefits). Prior to the enactment of section 409A, and during the period of transition to full effectiveness of section 409A, those plans frequently provided that the nonqualified plan benefits would be distributed in the same manner as the benefits of the related qualified plan. Generally, such linkage is no longer permitted. A self-audit should confirm that the time of distribution for the nonqualified plan is based on the terms of that plan, including timely participant elections under the nonqualified plan, rather than determining the time of distribution based on the terms of the related qualified plan.

Short-Term Deferrals. Benefits paid within 2-1/2 months after the end of the year in which such benefits vest will generally be exempt from section 409A as short-term deferrals. The short-term deferral exception to section 409A is generally satisfied if payment is made by that 2-1/2 month deadline, regardless of whether the plan providing for the benefits contains this deadline. A self-audit should confirm that amounts that are intended to be exempt from section 409A as short-term deferrals are being paid by this deadline. Note that if a plan provides that, under some circumstances, payment of benefits may be made after the short-term deferral deadline, it will generally be impossible to bring the benefits within the short-term deferral exception. This is true even if payment is in fact made not later than 2-1/2 months after the end of the year of vesting.

Dividend Equivalents. Some plans provide for deferred compensation based on company stock, with dividend equivalents to be paid at the same time dividends are paid to other shareholders. If the company maintains such an arrangement, it may be worthwhile to confirm that the dividend equivalents are being distributed in a timely manner.

Revisions to Administrative Procedures.

Confirm that procedures are in place to ensure timely and accurate communication to third-party administrators of any changes in existing arrangements.

Protection of Grandfather Status. Confirm that procedures are in place to ensure that benefits vested before 2005 that are “grandfathered” (and therefore not subject to section 409A) are not materially modified so as to lose the grandfather protection and become subject to section 409A.

Specified Employee Determination. Confirm that procedures used to identify “specified employees” are being properly applied, and that the six-month payment delay following separation from service is correctly administered.

Record of Facts. The actions required by section 409A will, in some cases, be significantly dependent on seemingly minor or subjective aspects of the facts and circumstances relating to the participant’s situation. As part of a self-audit, it may be worthwhile to confirm that, in such cases, the facts forming the basis of the plan administrator’s decisions are in the company’s records and are accessible. For example, it may be helpful to retain a record of the circumstances surrounding a participant’s separation from service where the participant is expected to perform consulting services after termination of employment. Also, in some cases, records of the relevant facts will be helpful to demonstrate that the company has consistently followed an established set of practices.

Record of Legal Interpretations. IRS representatives have informally acknowledged that there are many areas where the meaning and interpretation of the section 409A rules is less than clear. In some cases, where there is such a lack of clarity, it may be helpful to include in the company’s files a brief statement of the legal basis for the administrative actions taken under the company’s nonqualified plans. Such a record may also provide helpful guidance to

the company when it faces a similar issue in the future.

If you would like more information about the foregoing, please contact any member of our Employment Benefits and Executive Compensation practices, or the author of this Legal Update, listed below.

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