



## *You Have a Section 409A Violation: Now What?*

As of January 1, 2009, all plans and agreements under which employees' or independent contractors' compensation is deferred must be operated in accordance with Section 409A final regulations and under a plan document that itself is in full compliance with those regulations.

A violation of Section 409A may cause a participant's full account balance to be subject to immediate income taxation, an additional 20% penalty tax, and premium interest on deferred compensation measured from the year of original deferral (even if the tax year of the original deferral is closed). Is there anything that can be done to avoid this draconian result? In some cases, yes.

In late 2008, the IRS issued Notice 2008-113, which provides procedures under which employers and plan participants may obtain relief from the full application of Section 409A income inclusion and penalty taxes for certain operational failures under Section 409A. The Notice incorporates and expands upon prior Notice 2007-100, which it replaces.

This article outlines operational failures that may cause a failure of Section 409A and discusses whether such failures may be corrected under Notice 2008-113 and what the consequences are of the failure and its correction. First, however, there is one important Section 409A failure that cannot be corrected under Notice 2008-113, document failure, discussed immediately below.

### **Document Failure**

As of January 1, 2009, a nonqualified deferred compensation plan governed by a non-compliant plan document is in automatic violation of Section 409A.

#### **General Results of Notice 2008-113 Corrections**

**Errors corrected in the same tax year.** In general, these corrections result in no adverse tax consequences.

**Errors corrected in the next following tax year.** For non-insiders, such corrections result in current taxation with respect to the amount in error but will avoid the 20% tax penalty and premium interest charges.

**Errors corrected by the end of the second tax year following the year of error.** Corrections will result in taxation of the erroneous amount, plus imposition of the 20% penalty, but will avoid premium interest charges.

## Document Failure (Cont.)

Examples of document failure:

- Failure to provide for time or form of payment
- Provision for impermissible payment events (for example, permitting payment at any time at the election of the participant or the employer)
- Provision for changes in deferral or distribution elections (except under limited circumstances and with stringent requirements)

A Section 409A document violation in 2009 will require that the present value of the participant's vested benefit in the plan<sup>1</sup> as of December 31, 2009 be:

- Included in participants' taxable income on their 2009 tax return, and
- Subjected to Section 409A's 20% penalty tax, but
- Generally, no interest charge will be assessed.<sup>2</sup>

If a document failure is discovered, the employer will be required to:

- Report taxable amounts in box 12 of participants' W-2's, using Code Z.
- Withhold income tax due on taxable amounts, treating amounts as supplemental wages.
  - Withholding is not required for the 20% penalty tax.

When a document failure is discovered, the employer will want to consider one or more of the following additional actions:

- Amend plan prior to the end of 2009 to comply with Section 409A, if the employer wishes to continue the plan for years subsequent to 2009. If corrected, the non-compliance during 2009 will not taint amounts deferred under the plan after 2009.
- If the plan is amended, a distribution may be made to each participant up to an amount equal to the taxable amount. Such a distribution will not result in any further Section 409A violation.
- Terminate and liquidate plan.<sup>3</sup> Distributions, unless otherwise due under the terms of the plan, cannot be made until at least 12 months following the action taken to terminate. In addition, no new plan of the same type, i.e., that would be aggregated with the plan under Section 409A, can be instituted for three years following the action taken to terminate the plan.

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<sup>1</sup> Vested benefits from all plans aggregated with the plan under Section 409A must be included. If any part of vested benefit is grandfathered, it is not subject to taxation under Section 409A.

<sup>2</sup> It is assumed there has been good faith compliance with Section 409A for the years 2005 through 2008. If not, the premium interest penalties may apply.

<sup>3</sup> Termination cannot occur proximate to a downturn in the financial health of the service recipient. All plans and agreements aggregated with the plan under Section 409A must also be terminated and liquidated.

## Document Failure (Cont.)

- If the plan is terminated, a nonqualified plan of a type that would not be aggregated with the terminated plan under Section 409A could be established immediately to provide prospective benefits. For example, if a defined benefit SERP were terminated, a voluntary deferral plan could be established as a replacement.

## Operational Failures

Notice 2008-113 provides relief for certain operational failures, including failures to properly distribute benefits or defer compensation. The Notice imposes certain requirements that must be met regardless of the type of failure before relief will be granted.

### Eligibility Requirements for Opportunity to Correct under the Notice:

The basic eligibility requirements for relief under Notice 2008-113 are:

- The failure must be operational and must not occur as a result of plan terms.
- The employer must take commercially reasonable steps to avoid recurrence of the failure.
- The employer must not be under IRS examination for the tax year of failure.
- The failure must be inadvertent and unintentional.
- If there is an erroneous payment during a year in which the employer experiences a substantial financial downturn or experiences other issues that indicate there is a significant risk the employer will not be able to pay the amount deferred, no relief will be granted.
- Disclosure to IRS of the failure on the employer's tax return. Such disclosure must also be provided to participants and must be filed by affected participants with their tax return.
- Note: errors with respect to insiders<sup>4</sup> are often subject to more stringent rules than non-insiders.

### Correction Categories and General Results of Corrections

The Notice, in general, categorizes corrections and their consequences by the time when errors in distributions or deferrals are corrected. In order of best results for employer and participant, they are:

**Errors corrected in the same tax year in which they occur.** In general, such corrections result in no adverse tax consequences, although both employer and participant will need to disclose the error on their tax returns.

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<sup>4</sup> Directors, officers, and 10% shareholders of company determined in accordance with Section 16 of the Securities Exchange Act of 1934 regardless of whether the employer is public or whether the employer is a corporation.

## Correction Categories and General Results of Corrections (Cont.)

**Errors corrected in the next following tax year.** For non-insiders, such corrections will result in some taxation with respect to the amount in error but will avoid the 20% tax penalty and premium interest charges. For insiders, such corrections are treated the same as corrections within the second following tax year, as described below.

**Errors corrected by the end of the second tax year following the year of error.** Corrections generally result in taxation of the amount in question, plus payment of the 20% penalty, but will avoid premium interest charges.

The operational failures that may be corrected, how they may be corrected, and the tax results of correction are detailed below.

### **Failure to Properly Distribute Benefits or Defer Compensation in accordance with Section 409A**

Distributions earlier or later than those specified in the plan, as well as a failure to properly defer compensation, will cause a Section 409A violation that may be corrected under the Notice as follows:

- 1) Erroneous payments to a participant (not in violation of 6-month rule for key employees) or a failure to defer may be corrected as follows:
  - a) Payment or failure to defer may be corrected by participant repayment to the employer in the same taxable year of the payment.
    - i) Insiders will need to pay interest if the amount of the erroneous payment exceeds the 401(k) elective deferral limitation for the year (\$16,500 in 2009).
    - ii) Result: no taxable income, no 20% penalty, no interest penalty.
  - b) If the participant is a non-insider, an erroneous payment or a failure to defer may be corrected by participant repayment in the taxable year next following the year in which the error occurred.
    - i) Repayment must be with interest.
    - ii) Result: payment is taxable income to the participant in year of payment, deduction for repayment (not including interest) from participant's gross income in year of repayment, no 20% penalty, no interest penalty.
  - c) If erroneous payment or a failure to defer does not exceed the 401(k) elective deferral limitation for the year (\$16,500 in 2009)<sup>5</sup> then:
    - i) No repayment by participant to employer is required.
    - ii) The amount is included in income under Section 409A, but the amount is limited to the amount of the erroneous payment and does not taint the participant's full account balance.
    - iii) Result: erroneous payment is taxable income in year of payment, the 20% penalty is applied, but no interest is charged.

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<sup>5</sup> All erroneous payments (including failure to defer) from all plans aggregated under Section 409A must be added to determine whether the limit has been exceeded.

## **Failure to Properly Distribute Benefits or Defer Compensation in accordance with Section 409A (Cont.)**

- d) Erroneous payment or failure to defer may be corrected by participant's repayment before the last day of the participant's second taxable year following the year of error:
  - i) If the participant is an insider, repayment must be with interest.
  - ii) Result: taxable income in the amount of the erroneous payment in the year of payment, the 20% penalty is applied, but no interest is charged. In addition, no deduction may be taken by the participant for the repayment; however, the amount repaid will not be taxed when distributed.
- 2) Erroneous payments to participant that should not have been paid until a later date in the same taxable year but were paid more than 30 days prior to the time specified in the plan document or paid during the 6-month delay period applicable to key employees may be corrected as follows:
  - a) Payment may be corrected by participant's repayment in the same taxable year.
    - i) If repayment occurs prior to the original due date of payment, the new due date of payment is delayed from original due date by the number of days between the original payment by the employer and the repayment by the participant.
    - ii) If repayment occurs after the original due date, the new due date of payment is delayed by the number of days between the original payment by the employer and the original due date.
    - iii) Result: no taxable income, no 20% penalty, no interest charged.
  - b) If participant is a non-insider, the erroneous payment may be corrected by participant repayment in the next following taxable year.
    - i) Repayment is without interest
    - ii) The new due date of payment is delayed by the number of days between the original payment and the original due date
    - iii) Result:
      - (1) Taxable income to participant in year of payment.
      - (2) If repayment by the participant and second payment to the participant occur in same taxable year, no further tax reporting is required.
      - (3) If repayment by the participant and second payment to the participant do not occur in same taxable year, participant may take a deduction for repayment from the participant's gross income in year of repayment, but will be required to include the second payment by the employer in income.
      - (4) No 20% penalty, no interest charged.

## **Failure to Properly Distribute Benefits or Defer Compensation in accordance with Section 409A (Cont.)**

- c) If erroneous payment does not exceed the 401(k) elective deferral limitation for the year (\$16,500 in 2009)<sup>6</sup> then:
  - i) No repayment by participant to employer is required.
  - ii) The amount is included in income under Section 409A, but the amount is limited to the amount of the erroneous payment and does not taint the participant's full account balance.
  - iii) Result: erroneous payment is taxable income in year of payment, the 20% penalty is applied, but no interest is charged.
- d) Payment may be corrected by participant's repayment before the last day of the participant's second taxable year following the year of payment.
  - i) Repayment is without interest.
  - ii) The new due date of payment is delayed by the number of days between the original payment and the original due date.
  - iii) Result: taxable income in the amount of the erroneous payment in the year of payment, no deduction may be taken for the repayment, the 20% penalty is applied, but no interest is charged.

## **Failure to Properly Defer Compensation in Accordance with Section 409A**

- 1) A failure to defer compensation when it should have been deferred is correctable as described above for erroneous distributions.
- 2) Excess deferrals of compensation may be corrected as described below:
  - a) An excess deferral may be corrected by employer payment to the participant of the excess amount in the same taxable year of the deferral.
    - i) The participant's account balance must be reduced to reflect the payment by the employer. The employer may (but is not required to) pay interest on the payment to the participant.
    - ii) If the participant was an insider, the account balance must be adjusted for earnings retroactive to the date the excess amount was incorrectly credited to the account.
    - iii) If the participant was not an insider, the account balance may (but is not required to) be adjusted for earnings.
    - iv) If the amount was subject to losses, the remaining account balance is not required to be adjusted, but may be adjusted for such losses retroactive to the date the excess amount was credited.
    - v) Result: the amount is treated as income in the year of payment, but is not treated as an amount deferred and therefore not subject to Section 409A.

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<sup>6</sup> All erroneous payments (including failure to defer) from all plans aggregated under Section 409A must be added to determine whether the limit has been exceeded.

## Failure to Properly Defer Compensation in Accordance with Section 409A (Cont.)

- b) If the participant is a non-insider, an excess deferral may be corrected by employer payment to the participant of the excess amount in the taxable year next following the year of the excess deferral.
  - i) The participant's account balance must be reduced to reflect the payment by the employer. The employer must not pay interest to the participant.
  - ii) The account balance must be adjusted for earnings and may be adjusted for losses retroactive to the date the excess amount was incorrectly credited to the account.
  - iii) Result: the amount is treated as income in the year of payment, but is not treated as an amount deferred and therefore not subject to Section 409A.
- c) If the amount of the excess deferral does not exceed 401(k) elective deferral limitation for the year (\$16,500 in 2009)<sup>7</sup> then:
  - i) The excess deferral must be paid to the participant by the end of the second taxable year following the year of the excess deferral.
  - ii) Earnings allocable to the excess deferral through the date of payment must be either forfeited or added to the payment to the participant.
  - iii) Losses allocable to the excess deferral through the date of payment must either be permanently disregarded or subtracted from the payment to the participant.
  - iv) Result: the amount is treated as income in the year of payment, and is subject to the 20% penalty, but not the premium interest tax, under Section 409A.
- d) Excess deferral may be corrected by employer payment to participant of the deferral before the last day of the participant's second taxable year following the year of deferral:
  - i) The payment must be reported as income to participant for the taxable year in which the excess deferral was made.
  - ii) The participant's account balance must be adjusted for earnings allocable to the excess deferral through the date of payment retroactive to the date the excess deferral was credited.
  - iii) The participant's account balance may be adjusted for losses allocable to the excess deferral through the date of payment retroactive to the date the excess deferral was credited.
  - iv) The employer must not pay interest to the participant.
  - v) Result: the amount is treated as income in the year it should have been paid and is subject to the 20% penalty, but no interest will be charged, under Section 409A.

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<sup>7</sup> All erroneous nondeferrals and payments from all plans aggregated under Section 409A must be added to determine whether the limit has been exceeded.

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