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Correcting § 409A Document Failures Prior to Year of Vesting

The deadline for Internal Revenue Code § 409A amendments to deferred compensation arrangements as well as the transition rules have expired. There are in many cases, however, ways to correct failures that may arise, even document errors.

Notice 2008-113 provides relief from Code § 409A operational failures with certain methods for correcting such failures, provided the corrections are made in the year of failure or in certain cases in the first or second year following the year of failure. See EBEC Law Update of Feb. 28, 2009, which sets forth the specific rules for this correction procedure.¹ This correction procedure by its terms only applies to operational failures and not to documentary errors.²

There is, however, a way to correct both operational and form (document) failures if such correction takes place before the year in which the deferred compensation vests. Proposed regulations regarding calculation of amount includible in income issued December 8, 2008³ (discussed in EBEC Law Update of Jan. 6, 2009⁴) provide that there will only be tax and penalties under § 409A in the year of failure, and only if the deferred amounts will have vested prior to the end of such year.⁵ Thus, as stated in the Preamble to the proposed regulations, if deferred amounts are unvested, and a deferral election or acceleration that does not comply with § 409A (in form or operation) occurs in such year but the plan complies in form and operation in the year in which the amounts vest, there will be no § 409A tax or penalty.⁶

Thus, there is often an opportunity to correct both operational and documentary violations in a year prior to the year of vesting, so that § 409A tax will be avoided entirely. Note, however, that

¹ http://www.ebeclaw.com/memos/EBEC_Law_Update_-_Notice_2008-113_-_409A_Correction_Methods.pdf
The text of Notice 2008-13 is at http://www.irs.gov/irb/2008-51_IRB/ar12.html.

² Letters to the IRS have requested a correction program for document errors. See, e.g., letters from Skadden Arps and from the NYS Bar Association referenced in 36 BNA Pen. & Ben. Rptr. 943 (04/21/2009).

³ 73 Fed. Reg. 74380 (Dec. 8, 2008), <http://www.smartpdf.com/register/2008/dec/08/74380A.pdf>

⁴ http://www.ebeclaw.com/memos/EBEC_Law_Update_-_Calc_of_409A_Tax_&_Reporting.pdf

⁵ Prop. Treas. Reg. §§ 1.409A-4(a)(1)(i)(B), -4(a)(1)(ii)(A) & -4(a)(2)(i).

⁶ Preamble to proposed regulations, 73 Fed. Reg. 74380, 74382 (Dec. 8, 2008).

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EBEC Law Update - 409A Document Corrections

deferred compensation amounts of the same type, e.g., contributions to all the participants' account balance arrangements, will be aggregated under the 409A regulations.⁷ Thus, if some arrangements have violations in the years vested this can taint all like arrangements of the participant.⁸ Also, the IRS will, under special anti-abuse provisions, disregard the fact that the deferred amounts are not yet vested and will impose tax under § 409A as if vested if the facts and circumstances indicate that the employer has a pattern or practice of permitting changes in time and form of payment in years prior to vesting.⁹

For 409A failures - both operational and documentary - that are isolated and unintended, the ability to amend the documents prior to the year the participant vests in the deferred compensation can be a very useful method of correction.

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⁷ Treas. Reg. § 1.409A-1(c)(2).

⁸ See, Prop. Treas. Reg. § 1.409A-4(f)(2) and Preamble, 73 Fed. Reg. at 74382 n. 2.

⁹ Prop. Treas. Reg. § 1.409A-4(a)(1)(ii)(B); Preamble, 73 Fed. Reg. at 7382. See similar anti-abuse provisions in Prop. Treas. Reg. § 1.409A-4(b)(7).