

IRS Enforcement: Focus on Executive Compensation

**PEBA: The PenJerDel Employee Benefits and
Compensation Association**

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Introduction

- IRS has begun examinations of employer compliance in payroll tax practices and related areas
- “Employment Tax National Research Project” (the “NRP”)
- “Research study” of 6,000 employers
- Treasury perception of significant payroll tax noncompliance

Introduction

- Areas to be reviewed
 - Deferred compensation plans under Section 409A
 - Section 162(m) cap on deductions for compensation in excess of \$1 million
 - Stock-based compensation
 - Other executive benefits
 - Worker classification
 - Fringe benefits
 - Payroll taxes
- Is this information gathering, as the IRS says, or revenue generation, or “baring the fangs”?

Introduction

- Examinations of deferred compensation plans are part of the overall enforcement scheme
 - Change in law
 - Good faith compliance
 - Delayed effective dates and transition relief
 - Good faith reliance on proposed regulations
 - Limited period correction programs
 - Extended correction programs
 - Enforcement

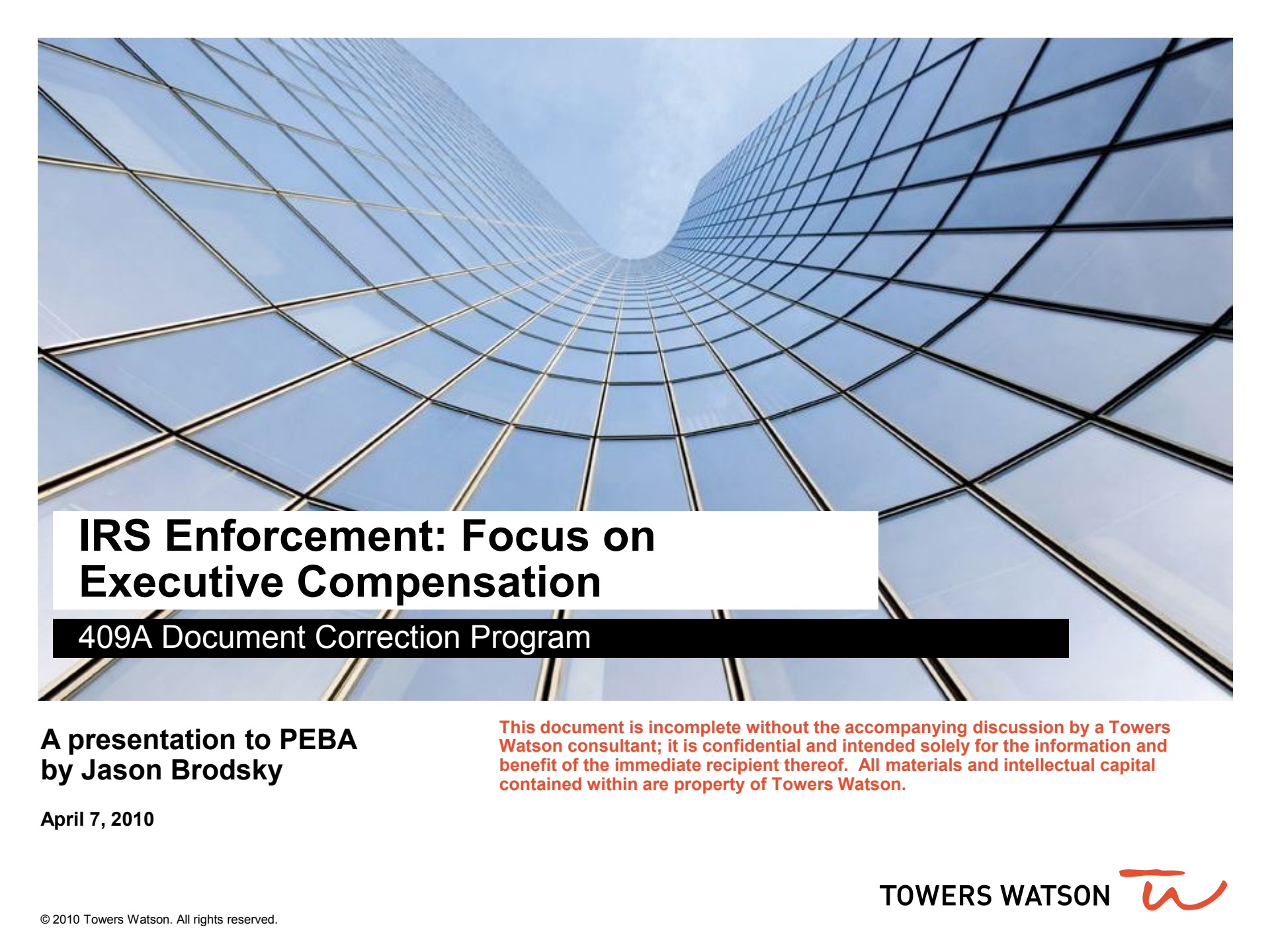
IRS Examination of 409A Compliance

■ Areas of Review

- Timing of deferrals, redeferrals and accelerations of deferred compensation in general
- Timing of elective bonus deferrals
- Payments to “specified employees”
- Payments made on events that are required to be objectively determinable
- Operational errors previously corrected

IRS Examination of 409A Compliance

- Areas of review involve operation of plans but also adequacy of plan documents
- Correction programs address documentary and operational defects.



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409A Document Correction Program

**A presentation to PEBA
by Jason Brodsky**

April 7, 2010

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Agenda

- Background
- Basic Principles
- Correction Program Details
 - General Eligibility Requirements
 - Permissible Corrections
 - Information and Reporting

Background

- Since 2008, limited program available to correct operation failures of 409A violations
 - Correction relieved taxpayer of some of the tax sanctions normally applicable to 409A violations
- Relief for plan document failures was generally not available
- January 2010, document failure correction program released
 - Notice 2010-6
 - Applies to plan or contract that provides for 409A deferred compensation which has terms that do not meet the 409A requirements
 - *“This document correction program is intended to encourage taxpayers to review nonqualified deferred compensation plans to identify provisions that fail to comply with the requirements of § 409A”*

Basic Principles

- Transition relief for failures corrected by December 31, 2010
 - No income inclusion or application of the 20% tax for the plan document failure
 - Any actual payments (or failures to pay) attributable to plan defect is treated as an operational failure and must be corrected by December 31, 2010
 - Income inclusion for correction of operational failure still required in certain circumstances
- Document failures may be corrected at any time
 - No income inclusion or the 20% tax
 - Provision being modified must not affect actual operation of the plan for a period of one year following the correction
 - If condition not fulfilled, relief still available to limit amount included in income and additional taxes

Basic Principles (cont.)

- Clarification regarding ambiguous, but relatively common wording, not treated as causing the plan to violate 409A.
 - To correct, cannot have a pattern or practice of interpreting the phrase inconsistently with 409A
- Correction can be made without any income inclusion or application of the 20% tax during a limited period after the adoption of a new plan
 - Plan must be first of its type maintained by the employer
 - Disregard grandfathered arrangements and terminated plans (where all amounts paid or forfeited)

General Eligibility Requirements

- Take commercially reasonable steps to identify and correct all other nonqualified deferred compensation plans with similar document failures
- Failure must be inadvertent and unintentional
- Executive must fulfill tax obligations required by correction
- Employer must comply with the information and reporting requirements
- IRS may examine taxpayer's eligibility for relief

Not Eligible for Correction

- Linked plans
 - Except for transition period through end of 2011
- Stock rights
- Employer or executive is under examination for period covering failure with respect to nonqualified deferred compensation
 - Executive under examination if Form 1040 being audited for the year of failure.
 - Employer under examination if it receives written notification of audit specifically citing nonqualified deferred compensation as an issue
 - Transition rule for corrections made before 2012
 - Employer treated as under examination only with respect to specific document failures identified by the IRS during audit

Ambiguous Plan Terms

- “As soon as practicable”
 - Not a plan document failure
 - But, failure to pay on timely basis is operational failure
 - Timely basis: end of year or, if later, 15th day of 3rd month following payment event
 - May qualify for the correction of operational failure correction program
 - Pattern of untimely payment treated as not having permissible payment date
- Ambiguous/Lack of definition for permissible payment date
 - Applies even if could be *interpreted* to include non-409A payment events
 - e.g., “termination of employment”
 - No document failure if 409A “interpretation” clause
 - If no “interpretation” clause or undefined term, then payment/failure to pay in violation of 409A treated as operational failure if, by end of year, add:
 - Specific 409A definition
 - 409A “interpretation” clause
 - Cannot narrow or expand payments events through this correction

409A Payment Event, Impermissible Definition

- “Separation from service”
 - Correct before non-409A separation payment event occurs and before date that would be 409A separation from service
 - If pre-correction payment event or 409A separation from service occurs within 1 year of correction, then 50% of the amount deferred under the plan included in income under 409A in year of separation from service
- Change in Control
 - Correct before non-409A change in control payment event occurs
 - If pre-correction payment event occurs within 1 year of correction, then 25% of the amount deferred under the plan included in income under 409A in year of change in control
- Disability
 - Correct before non-409A disability payment event occurs
 - If payment already made, may be able to correct under operational correction program
 - Unlike “separation from service” and “change in control,” can correct by removing as payment event and by changing the definition of disability to comply with 409A

Impermissible Post-Payment Event Periods

- Payment period more than 90 days after 409A payment event
 - Remove post-event payment period, or reduce to within 90 day period
 - If amend within reasonable time after payment event and pay within 90 days, then 50% of the amount deferred under the plan included in income under 409A in the year the payment is made
 - Executive cannot have right to designate year of payment
- Payment period after 409A payment event tied to employment-related actions
 - Remove employment-related actions prior to payment event
 - If payment period following event, amendment must provide for payment only on last day of such period
 - If no payment period following event, amendment must provide for payment 60 or 90 days after event
 - Amendment cannot otherwise change time/form of payment

Non-409A Payment Events and Schedules

- Plan has 409A payment event(s) and non-409A payment event(s)
 - No correction available for a payment event, where occurrence at discretion of employer or executive
 - Correct before executive elects non-409A payment event by removing event
 - Correct after executive elects non-409A payment event, but before payment made, by removing event
 - If non-409A payment event occurs within 1 year of correction, 50% of the amount deferred under the plan included in income under 409A in year of payment event
- Plan only has non-409A payment events
 - Correct before non-409A payment event occurs, and replace with later of
 - Separation from service, or
 - 6th anniversary of correction date
 - 50% of the amount deferred under the plan included in income under 409A in year of correction

Non-409A Payment Events and Schedules (cont.)

- Plan has more than 1 time/form of payment tied to 409A payment event
 - If different schedules/forms for voluntary and involuntary separation from service
 - Correct before separation from service
 - Change voluntary schedule/form to same as involuntary schedule/form
 - If voluntary separation within 1 year of correction, then 50% of amount deferred under the plan included in the income under 409A in year of payment event
 - If different schedules/forms tied to other 409A payment event
 - Correct before payment event by removing schedules/forms that do not comply with 409A
 - Ordering for removing schedules
 - Remaining form must be schedule that result in latest final payment date
 - If more than 1 schedule has same final payment date, keep schedule that has later start date
 - If payment event within 1 year of correction, then 50% of amount deferred under the plan included in the income under 409A of in year of payment event

Non-409A Payment Events and Schedules (cont.)

- Impermissible discretion with respect to schedule following 409A payment event
 - If plan has default schedule, and no discretion to change time/form of payment after payment event occurs, then no failure if
 - Discretion not exercised
 - Discretion revoked more than 1 year before payment event
 - If plan has default schedule, correct by removing discretion
 - If no default schedule, correct by removing discretion and remove schedules
 - Ordering for removing schedules
 - Remaining form must be schedule that result in latest final payment date
 - If more than 1 schedule has same final payment date, keep schedule that has later start date
 - If payment event within 1 year of correction, then 50% of amount deferred under the plan included in income under 409A in year of payment event occurs

Non-409A Payment Events and Schedules (cont.)

- Impermissible discretion by employer to accelerate payment
 - Correct before earlier of
 - Date discretion exercised (and irrevocable)
 - Date payment made pursuant to exercise of discretion
 - Correction: Remove discretion, or allow discretion that is permitted under 409A
- Impermissible reimbursement (for in-kind benefits)
 - Correct before executive eligible to receive reimbursement
 - With respect to 409A requirement that reimbursement in a year cannot affect reimbursement in another year, amend plan to provide pro-rata reimbursement allocation over period in which executive entitled to reimbursement
 - If reimbursements over lifetime, prorate based on life expectancy
 - If reimbursements available for a period ending with an event, prorated period can be based on reasonable assumptions
 - Prorated period may not be less than 3 years
 - If event qualifying for reimbursement occurs within 1 year of correction, then 50% of amount deferred under the plan included in income under 409A in year of payment event

6 Month Delay Not Included

- Correct before separation of service
- Correction: add 6 month delay and provision that affected payments may not be made before later of
 - 18 months after correction
 - 6 months after separation from service
- If an executive separates from service within 1 year of the correction, then 50% of the amount deferred under the plan included in income under 409A in year of separation from service

Impermissible Deferral Election

- Provision that permits deferral that does not comply with 409A deadlines
- No income inclusion if corrected before impermissible deferral election made
 - Deferral election must be revoked before 409A deadline or election is deemed to be made as of the deadline
- If election made, then correct by end of 2nd year following year of election
- Correction: remove ability to make impermissible election
 - Amounts deferred during this period must be corrected under operational failure correction program
 - Correction has no effect on amounts that fall outside the 2 year correction window, and the plan provision will remain a plan document failure for such years and any resulting deferral will remain an operational failure

Initial Adoption of Plan

- Correctable document failures may be corrected by later of
 - End of year in which plan became effective
 - 15th day of the 3rd month following date in which plan became effective
 - “Plan” includes all similar 409A plans
- Amounts paid/deferred due to document failure must be corrected under operational failure correction program
 - Must correct by end of by the end of the calendar year in which the document failure is corrected
 - If timely corrected, then no income inclusion under 409A

Transition Relief

- 2010 corrections
 - No income inclusion under 409A if document failures corrected by the end of 2010
 - Occurrence of pre-correction payment event within 1 year of correction will not trigger income inclusion
 - Pre-correction payments made and payments that should have been made (based on corrected plan terms) prior to date of document correction must be corrected under operational failure correction program by end of 2010

Transition Relief (cont.)

- Linked plans
 - Correction must be prior to end of 2011
 - Correct if amount and time/form of payment under nonqualified plan based on amount and time/form of payment under another nonqualified plan
 - Correction: Make time or form of payment identical under both plans
 - 409A payment events must be retained
 - If plans have same events, but different definitions, use narrower definition
 - If plans have same events, but different schedules, use schedule with latest final payment date (or, if same final payment date, use schedule with later commencement date)
 - Pre-correction payments made and payments that should have been made (based on corrected plan terms) before document correction are treated as operational failure and must be corrected by end of 2011

Transition Relief (cont.)

- Impermissible payment schedule
 - Not have objectively determinable with respect to amount and time of payments
 - Amend by end of 2011
 - Pre-correction payments made and payments that should have been made (based on corrected plan terms) before document correction are treated as operational failure and must be corrected by end of 2011
- Limited exception for audits
 - Document failures not identified on audit may be corrected
 - Exception applies to audits for period beginning on or before December 31, 2011

Information and Reporting Requirements

- Employer obligations
 - Attach statement of correction to income tax return for year of correction
 - Attach statement to following year's return if income included as part of correction
 - Provide statement of correction to executive
- Executive obligations
 - Attach statement of correction received from employer to income tax return for year of correction
 - Attached statement to following year's return if income included as part of correction
- Notice sets forth information required to be included in correction statement
- Employer and/or executive must notify IRS agent at the start of an audit of reliance on document failure correction program for years covered by audit



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PEBA: The PenJerDel Employee Benefits
and Compensation Association

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April 7, 2010

IRS Examination of 409A Operational Compliance

- ◆ Areas of review
 - Arrangements that are thought to be exempt from 409A requirements
 - Stock options and stock appreciation rights
 - Short-term deferrals
 - Separation pay
 - Timing of deferrals in general
 - Deferral of bonuses
 - Timing of payments to “specified employees”
 - Accelerations of deferred compensation

Correction of Operational Failures Under Section 409A

◆ What's the problem?

- Generally, payment too soon or too late
- Inconsistency between plan terms and operation
 - Example: Incentive plan provides for payment at the end of a five-year plan period, but vested participants terminated before the end of the plan period are paid upon termination of employment.

Correction of Operational Failures Under Section 409A

- ◆ What's the problem?
 - Options granted below fair market value
 - SARs with a base below fair market value
 - Deferral of bonus within six months of the end of the performance period, or after the bonus has been determined (even if more than six months before the end of the performance period)
 - Prior defects improperly corrected

Correction of Operational Failures under Section 409A

- ◆ What's the problem?
 - Compliance with a defective plan document
 - Example: Plan pays deferred compensation upon a change in control, but the definition of “change in control” in the plan document is deficient under 409A. In addition to the document failure, the employer has not the paid deferred compensation upon one of the six permitted conditions.

Correction of Operational Failures under Section 409A

- ◆ Risks of noncompliance
 - Employee (or other service provider): Accelerated income tax, penalty tax and interest.
 - Employer: Penalties for incorrect reporting and withholding, and potential liability to the service provider.
 - Is the entire plan “disqualified” under 409A? What is the effect on other participants?

Correction of Operational Failures Under Section 409A

- ◆ The challenge to employers (service providers)
 - Identifying the 409A operational failure
 - Operational requirements are evolving (that is, the rules keep changing)
 - Disconnect between permissible plan terms and permissible--but inconsistent--routine operation.
 - “That’s not what we meant.”
 - “It always worked that way.”
 - Determining proper correction

IRS Notice 2008-113

- ◆ Limited opportunity to correct specified operational failures
- ◆ Does not address “form” or documentary failures
- ◆ Relief only available if reasonable steps are taken to avoid recurrence of failure
- ◆ Relief for erroneous payment may not be available where service recipient is subject to substantial financial downturn

Notice 2008-113: General Considerations

- ◆ All corrections under the Notice entail some form of disclosure to the IRS
- ◆ Availability of correction or terms of correction may be limited if affected service provider is an “insider”
- ◆ For this purpose, insiders generally include directors and senior management, determined under Securities Exchange Act rules (without regard to whether the company is public)

Navigating Notice 2008-113

◆ Section III: Eligibility

- Service recipient must act to avoid recurrence
- Two strikes and you're out - - if the same or similar failure occurs again, relief is not available after 2009 unless service provider can show “diligent” efforts to avoid recurrence.

Navigating Notice 2008-113

◆ Section III: Eligibility

- Relief not available to providers under examination
 - NRP is not “examination”
- Required information filing (under Section IX)
- Relief available only for inadvertent and unintentional failures

Navigating Notice 2008-113

- ◆ Section IV: Correction of Certain Operational Failures in the Same Taxable Year as the Failure Occurs.
 - Deferred compensation erroneously paid but corrected in the same tax year (including amounts that should have been deferred from that year)
 - Compensation that is deferred but should not have been deferred
 - Example: Employee elects to defer one-half of a bonus, but the employer treats the entire bonus as deferred compensation

Navigating Notice 2008-113

- ◆ Section IV, continued
 - Correction of exercise price of a stock right

Navigating Notice 2008-113

- ◆ Section V: Correction of Certain Operational Failures in the Immediately Following Taxable Year
 - Applies to non-insiders only
 - Failure to defer amount payable in a subsequent year
 - Incorrect payment of an amount payable in a later year
 - Incorrect payment of an amount due later in the same year
 - Failure to satisfy six-month delay for payment to specified employee

Navigating Notice 2008-113

- ◆ Section V, continued
 - Excess deferral corrected in the year following the mistake
 - Correction of exercise price of certain stock rights

Navigating Notice 2008-113

- ◆ Section VI: Failures Involving Limited Amounts
 - May be used in lieu of Sections V or VII
 - Section IV doesn't apply because the errors described in Section VI are not corrected in the year the error occurs.
 - Failure to defer an amount that should have been deferred, up to 402(g) limit (\$16,500)
 - Failure to pay deferred compensation when due
 - Limited to 402(g) limit
 - Deferral of income that should not have been deferred
 - Limited to 402(g) limit

Navigating Notice 2008-113

- ◆ Section VII: Certain Other Operational Failures
 - Generally, same operational failures as are addressed in Sections IV and V but which are not corrected in the same or first year immediately following the errors.

Navigating Notice 2008-113

◆ Section VII:

- Payment mistakes - - failure to pay, premature payment, failure to defer, incorrect deferral - - that are corrected by the end of the second taxable year following the year in which the error occurred.

Navigating Notice 2008-113

- ◆ Section VIII: Transition Rule for Non-insiders
 - Generally expired in 2009 - - basically a one-year window to correct pre-2008 mistakes

Navigating 2008-113

- ◆ Section IX: Information and Reporting Requirements
 - Compliance statement for service provider tax returns for year of failure
 - Compliance statement for service recipient tax return
 - Additional compliance statements depending on nature of correction
 - Amended 2009 returns for certain relief

Correction of Failure in Same Taxable Year

- ◆ Failure to defer or incorrect payment (other than a 6-month delay violation) of amount otherwise due in a later year
 - Repay in same taxable year to correct
 - Extended repayment by employee / service provider (up to 24 months, with interest) permitted for non-insiders
 - If subject amounts are in excess of section 402(g) limit, interest must be added to repayment amount for insiders

Correction of Failure in Same Taxable Year

- ◆ Early payment of amount scheduled for same taxable year or ahead of the six-month delay date
 - Amount must be repaid in same taxable year and held for later payment based on number of days necessary to eliminate benefit of earlier erroneous payment
 - Adjustments may not be made for earnings but may be made for losses

Excess Deferral Corrected in Same Taxable Year

- ◆ Repay excess deferral in same taxable year
- ◆ Adjustment for earnings required for insiders, permissible for non-insiders.

Stock Rights – Correction of Exercise Price

- ◆ Prior to the end of the year of grant (and prior to exercise of stock right), the exercise price can be reset (i.e., increased to an amount not less than the fair market value of the underlying stock on the date of grant)

Correction in Next Following Taxable Year

- ◆ Failure to defer or incorrect payment scheduled for later year corrected by repayment with interest; adjustments for earnings may be made.
- ◆ Payment in violation of six-month delay requirement or ahead of scheduled payment date in same year may be corrected by repayment held for the number of days of acceleration.

Correction in Next Following Taxable Year

- ◆ Excess deferrals can be paid out without interest
- ◆ Stock right exercise price may be corrected (but this relief does not apply for insiders)

Correction Involving Limited Amounts

- ◆ Failures involving amounts not greater than 402(g) limit
- ◆ Requires Code Z reporting and payment of 20% tax on affected amount

Correction by End of Second Year Following Year of Failure

- ◆ Failure to defer, certain erroneous payments, excess deferred amounts
- ◆ Repayment, 20% tax and Code Z reporting required

Examples

- ◆ Premature payments
 - Failure to give effect to a deferral election
 - Pure administrative error
 - Payroll “coding” issues
 - Failure to correctly determine separation from service date
 - Plan interpretation questions: does the plan require deferral of all “bonus” or “salary”?

Examples

- ◆ “Late” Payments
 - Administrative errors in calculating amount to be paid
 - Failure to start payments due to administrative error
 - Separation from service definitions
 - Coding errors for amounts
 - How broadly may we interpret the “failure to pay” rule?
 - Must the employee make a claim for benefits if the employee has no actual acknowledge of the error?

Examples

- ◆ Incorrect application of the 6-month delay for key employees
 - Mistake in categorizing short term deferrals or separation pay
- ◆ If the result is a “late” payment, is there any protection in a “conservative” application of the six-month delay?
- ◆ Is the correction method in Notice 2008-113 the sole method for correcting or is it a “safe harbor”?

Examples of Correction under Notice 2008-113

- ◆ Incentive plan provides for payment “following” an award period that ended December 31, 2008
 - Plan implied that the award period would be extended in case of awards that were not fully vested by December 31, 2008
 - Plan also provided for distribution on a “liquidation event” that might or might not meet the 409A rule for permitted distributions in connection with a change in control

Examples of Correction under Notice 2008-113

- ◆ Some distributions were made to terminated vested participants in 2008, and 2007, but should not have been distributed until after December 31, 2008
 - Requires repayment to the plan, with interest, in 2010

Examples of Correction under Notice 2008-113

- ◆ Premature distribution, continued
 - Distribution should be made in the correct year.
 - Because repayment and distribution would both occur in 2010 in this case, repayment and new distribution are not required, but the service provider is required to pay interest to the employer on the early distribution.
 - The employer may pay lost appreciation to the employee/service provider (which might entirely offset the interest payable by the service provider)

Examples of Correction under Notice 2008-113

◆ Same facts

- Some distributions that should have been made in 2009 (i.e., after the end of the award period ending December 31, 2009) were not paid.
- Distributions were to be made “as soon as practicable” after the end of the award period

Examples of Correction under Notice 2008-113

- ◆ Correction for failure to distribute
 - Correctible under Section V.D.
 - Non-insiders: Requires distribution in year of correction (2010). Employee / service provider pays statutory interest (but not 20% penalty) in the year of correction.
 - Insiders: Treated as receiving the distribution in correct year (2009), including a corrected W-2 / 1099 and possible amended return. Employee liable for 20% tax, but not interest.

Examples of Correction under 2008-113

- ◆ Document errors in the preceding example are correctible under Notice 2010-6
 - Nonconforming definition of “liquidation event”
 - Distributions “as soon as practicable” when due

Observations on Notice 2008-113

- ◆ The Notice is complicated and not user-friendly—but addresses virtually all early and late distribution events
- ◆ Current opportunity to address issues that might be picked up on IRS “review”
- ◆ Ongoing relief for mistakes corrected promptly—within the year of the mistake
- ◆ Relief with minor sanctions for errors corrected in year following the mistake

Observations on Notice 2008-113

- ◆ Relief with some sanctions (generally, payment of statutory interest) for correction with regard to non-insiders if corrected within two years
- ◆ Relief with 20% penalty but no statutory interest for correction with regard to insiders if corrected within two years

Notice 2008-113: Conclusions

- ◆ Notice 2008-113 covers most common situations and offers a good, practical result.
- ◆ Does it cover all situations? What correction, if any is available if the Notice doesn't apply?
- ◆ What about small or incidental failures?
- ◆ Is the Notice the sole method of correcting operational failures?

Notice 2008-113: Conclusions

- ◆ Now what?
 - Are there alternative correction methods?
 - Will the IRS extend the program for mistakes voluntarily corrected after two years?