**2014 End-of-Year Self-Audit Summary: 409A Nonqualified Deferred Compensation Pension Type Plans (October, 2014)**

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**Introduction**

The end of the plan year is an important time to self-audit nonqualified pension type plans, typically *employee and employer account balance*, and *employer non-account balance plans*, especially as to Section 409A.  Section 409A compliance is now the most important objective of an annual self-audit, and is especially true beginning this year (2014-2015).  In the late spring of this year, the IRS launched a limited so-called Compliance Investigation Project (CIP) to audit a selected group of public companies for their compliance with a number of operational Section 409A compliance issues. The results of this CIP audit are to be used for the purposes of training and directing agents toward Section 409A compliance problem areas the IRS discovered.   This means that self-audits of Section 409A-covered (and those that are designed to claim an exemption or exception from coverage) nonqualified deferred compensation plans are more important than ever as we enter 2015.  Self-audits are important, regardless of the size of the company, since Section 409A covers defined plan types and not business entity types. Section 409A requires both: a.) documentation and b.) operational compliance with Section 409A requirements.

Failure to comply with these Section 409A form and operational requirements can cause impacted executives to face current and even back federal income taxes (applying AFR+1% penalty interest rate) to date of violation, and up to a 20% excise tax.  Also, an error discovered after a plan is the subject of an IRS audit, will generally not be eligible to take advantage of any of the current Section 409A correction procedures (either for documentation or operational errors), and will result in the worst case income taxation for impacted plan participants. Note that Section 409A type plans are NOT eligible for correction under the more liberal and flexible IRS qualified plan correction procedures. Thus, the end of a calendar plan year is an important deadline for correcting any and all form and operational errors under Section 409A.  When corrected soon after an error, the correction can usually be accomplished without incurring the full worst case income taxation impact.

In general, reduced penalties and correction processes are available for operational Section 409A violations (operational corrections are even embedded in most documentation form error corrections), but ramp up to the full penalties noted over a three plan year period for plans covered by Section 409A.  Therefore, early identification and quick correction of Section 409A documentation and operational administrative errors is thereby a best practice for plan sponsors.

Therefore, as we come to the end of 2014, all plan sponsors of existing 409A-covered plans need to consider the following audit items as to plan documentation and operational administration prior to calendar year end.

**Section 409A Special Transition Deadlines Are Over**

There are currently *no* special section 409A transition deadlines for form or operational errors remaining this year (2014).  All such special Section 409A relief deadlines expired as of December 31, 2012.  Plans subject to Section 409A are now supposed to be in full (not “good faith”) compliance with both the *form* and *operational* requirements of Section 409A effective January 1, 2009. Notices 2010-6 and 2010-80 did provide an opportunity to *retroactively* correct some plan documentation primarily during 2010 and 2011.

**Documentation Errors**

1. **2014 409A Plan Documentation Corrective Actions- 2014 New Plans**

***1.)***  Under the guidelines in Notice 2010-6, § 10 governing plan documentation compliance and corrections, plan sponsors of ***new 409A-covered*** ***plans*** ***started and*** ***giving a legally binding right to deferred compensation in 2014*** are given *until December 31, 2014* (end of this current calendar year) to amend and correct the language in their plan documentation necessary to correct any Section 409A form errors found after the start date.  If they do so, sponsors generally avoid the balance of the applicable correction, reporting and disclosure requirements necessary to correct. *Note: If the legally binding right to first benefits under the new plan is later than the end of the calendar year, the sponsor has until 2 ½ months following the date the first benefits become legally binding to make such documentation error corrections without penalties or reporting.*

**a.** Assuming the benefits are legally binding in the first year, once beyond the end of the first calendar year, a correction in documentation would likely require correction, reporting and penalties as imposed by Notices 2010-6 and 2010-80 for plan documentation errors, except in cases when the legally binding right to new plan benefits is later than the end of the year as noted above.  In essence, new plans are generally given to the end of their first calendar year (even partial year) to make documentation corrections to comply with Section 409A without application of the correction and reporting requirements as well as the penalties imposed by Section 409A.

**b.**  Sponsors should note that *only* those documentation errors noted in Notices 2010-6 and 2010-80 are currentlycorrectable.  Moreover, even those that are correctible under the Notices often require onerous corrective, reporting compliance and some measure of Section 409A penalties, although not always the maximum (i.e., 20% excise tax).  Therefore, a final careful review of a *new 2014 plan’s documentation* before end of the year (or the date the benefits become legally binding if later than the end of the year) is strongly recommended.  Of course, such documentation modifications would need to be approved and made before the end of the year to comply with Notice 2010-6 documentation error correction guidelines.

**TIP:***IRS Notices 2010-6 and 2010-80, especially 2010-6, not only provide a great checklist to assist in drafting a Section 409A form compliant plan, but also provide a great checklist for self-auditing a new or existing document for form compliance.  Both Notices even provide suggested plan language in a few important cases.*

1. **Nonqualified Deferred Compensation Plans intended to be Exempt Under the Short Term Deferral Exception**

**1.)** Plans are to be characterized as covered or exempt from Section 409A at inception of the plan.  Notice 2010-6 does not allow a plan intended to be exempt (but with a documentation `error that would cause it to be covered) to be corrected to bring the plan back under the Short-Term Deferral (STDE).  However, the fact the plan does not qualify for the STDE does not necessarily mean it is in violation of Section 409A. The sponsor will need to have a separate assessment of the plan’s documentation made to determine if the plan is otherwise compliant with Section 409A requirements.

**2.)** It is also important to note that plans that have benefits vested from plan inception (thus, not ever subject to a Section 409A “substantial risk of forfeiture”) would generally not qualify for STDE from Section 409A coverage.  Therefore, generally speaking, no corrective action would be possible to make it exempt after benefits become legally binding.  Such a plan would have to comply in both form and operation as a Section 409A covered plan.

**3.)** However, note that it is possible to correct an *operational* error when a plan, properly drafted to claim the Section 409A STDE in “the first instance,” is not operationally complying with its STDE plan documentation.  This operational error usually occurs because of the sponsor’s failure to distribute benefits when they vest and on a timely basis as required by the STDE - not later than 2 ½ months following the year in which the benefits vest. IRS Notice 2008-113 provides for the proper procedure for correction, reporting, and penalties to make such an operational error correction.

1. **Other Required & Necessary Plan Documentation Modifications**

***1.)*** Consider correcting Section 409A document failures for amounts that have yet to vest or are still subject to a Section 409A substantial risk of forfeiture until the end of the year.Based upon the language in Proposed Treas. Reg. § 1.409A-4 (still not final as of 10/7/2014),many commentators believe that Section 409A document failures can be corrected prior to the year in which deferred amounts vest, or prior to the year in which any contingency lapses that acts as a Section 409A “substantial risk of forfeiture” on the payment of the deferred compensation. *If the sponsor’s counsel agrees*, the sponsor may yet correct document compliance failures discovered before the end of this year without Section 409A reporting, taxes or penalties.  *Note: the deferred compensation amounts in question must remain unvested or subject to the necessary contingency through December 31, 2014, and the document corrections must be made prior to that date to so qualify for such a correction.*

***2.)*** Confirm that all necessary and/or desirable plan documentation modifications have been made to all potential 409A-covered plans as might have been required by most recent plan documentation guidance in IRS Notices 2010-6 and 2010-80 (see above). Ask the question- “Has the plan been amended by legal counsel since January 1, 2009 (effective date for full form and operational compliance with Section 409A)?  If not, the plan may need immediate review and likely amendment by legal counsel to conform to Notices 2010-6 and 2010-80 that raised documentation issues not apparent  to the legal bar generally when final Section 409A-compliant documents were required by the end of December, 2008, except as may have been noted above.  *Note: In general, no amendment or modifications should be made to plan documentation without the oversight of client’s own legal counsel.*

**Common Operational Errors:**

**1.)    *Audit all account balance plans to determine that the participant balances are correct or are corrected by year-end if found to be inaccurate.***

**A.**Incorrect participant balance errors are not a 409A error per se.  However, if the balance is incorrect it will eventually translate into incorrect participant distributions that thereby become a distribution error under Section 409A.   As already noted, the longer the balance error with incorrect distribution persists the more painful the Section 409A corrections will generally be in terms of penalty taxation, especially as to so-called 409A “insiders” for purposes of the Correction Notices.

**B.**In addition to a possible Section 409A distribution error, incorrect balances resulting from a failure to complete a deferral during the year according to a participant’s election and the rules of Section 409A governing elections in a voluntary deferral plan is a 409A error in itself according to Notice 2008-113.      This problem can also occur if a participant’s election should be invalid, in whole or in part, for some reason For example, if the participant’s election is not made on a timely basis for Section 409A, it will normally be an invalid election. Hence, no deferral should have occurred for the period of service.

This type of operational error can easily be corrected with minimal correction steps (and no or little reporting or penalty) for both insider employees and non-insider employees *if corrected before the end of the plan year the deferral error* occurs (December 31, 2014).  If an incorrect balance because of a payroll reduction problem (too little or too much), based upon a participant’s election versus actual deferral, is carried into the next calendar year, then there is Section 409A error.

**Tip:** *This type error most often occurs when there is a “percentage of’ salary or base deferral election, and an increase in compensation occurs mid-year and the resulting increased deferral to the plan (based upon the elected percentage) is not reflected by payroll reduction. However, an error in the deferral amount can also be a result of a simple payroll coding error (40% instead of 50%); or use of the wrong definition of “compensation” from the plan that is subject to a percentage deferral election, especially in a new plan.  This is another reason to carefully check a new plan before the end of the first calendar year.*

1. These account balance errors may also often occur when dividends or other special stock or other unique crediting events occur (e.g., stock split) on plans, and do not get credited to a participant account as provided by the plan document.

**D.** Whenever plan account crediting indices and/or vesting provisions impacting distributions are complex or complicated in calculation, a periodic review of the calculations to confirm their correctness up against the plan documentation and actual account crediting is recommended.

***2.)    Check all participant distributions made during the past plan year to assure that they:***

1. Are made in accordance with a participant’s election (including any subsequent elections) for the amount distributed as of the date of the distribution (e.g., if elected to be paid in installments, not paid in lump sum or vice versa, or paid in the wrong number of installments, if payable in installments)
2. Are in the correct amount as discussed above so there is no issue of acceleration or late payment.

       **C.** Are made within the limited number of *permissible* distribution events (as specially and uniquely defined) permitted under Section 409A and according to the requirements of that distribution as follows-

i.  Fixed date or schedule

ii.  Disability (special definition - “disabled” - under 409A)

iii. Unforeseeable emergency (special financial hardship definition and preconditions under 409A)

iv. Separation from service/termination of contract for IC (special definitions as to each category under 409A)

v.  Change in ownership or effective control, (a special definition of change in control & special rules apply under 409A)

                  vi.  Death

vii.  Plan termination (special preconditions and restrictive rules apply under 409A)

viii. Domestic Relations Order (DRO)

ix.  Federal, state, local, foreign “Conflict of interest laws” distribution

x.  Distribution to prevent a “nonallocation year” under 409A(p) with respect to an ESOP sponsored by an S Corp.

xi.  Applicable employment/withholding taxes on permissible distributions under plan terms

xii.  Applicable employment/withholding taxes on distributions in violation of 409A

xiii.  Applicable employment and income taxes imposed because of vesting in 457(f) plans

xiv.  Section 402(g)(1)(B) small amount acceleration ($17,500 in 2013; and will be the same in 2014 as well)

**D.** As to all 409A “specified employees” (or *all* employees if the plan so handles distributions in this manner) at the date of distribution, payment of participant distributions were delayed the required 6 calendar months.  *Note: This requirement is apparently an area of high focus on plan audits by the IRS.  While there are some exceptions to the requirement of delayed payment, like death, a client should assess its situation with its own legal counsel if this operational error is believed to have occurred after a review of the year’s activities.*

**3.)    *Confirm that no “material modifications” (an improvement in the plan or its benefits) have been made to any “grandfathered plan”, either as to administrative procedures (or documentation) during the plan year, that would pull the plan back under Section 409A requirements and perhaps cause it to fail 409A immediately.***

 In effect, confirm the grandfather portion of the plan followed the prior plan provisions *in operation*, and also that have no modifications been made to the plan document that is a benefit or improvement to the plan.

1. A common procedural mistake on a grandfathered plan is to have added a provision or administratively allowed a financial hardship or disability withdrawal when there was no provision for it in the grandfathered plan as of the effective date of Section 409A for such existing plans.

**B.** Consult with legal counsel immediately if a possible error, even if only an operational error is discovered as to a grandfathered plan, since some operational errors, like that described in “A.”, can cause loss of 409A grandfathering with a subsequent failure under Section 409A.

**In 2014 for 2015:**

1. ***Make certain that all participant elections to defer for the coming 2015 year on plans using calendar year (and most fiscal year compensation) are completed, received and made final by December 31, 2014.***
	1. Exceptions are available for certain 409A defined “performance-based compensation” and fiscal year bonus compensation, but the compensation must qualify for the Section 409A definition in each case.
	2. *Note: Contrary to what might be expected based upon a reading of the final Section 409A Regulations, wholly discretionary performance bonuses are treated like salary for election timing purposes according to the IRS in Commentary to Section 409A Prop. Regulations.  This Commentary is seemingly counter to a plain reading of the “legally binding” language in the final Section 409A Regulations, but reflects the IRS’s interpretation of its “prior to the period of service” and “legally binding” election timing rules when integrated together.*
	3. A participant election received later than the end-of-year deadline date required by Section 409A must be treated as invalid for the entire 2015 plan year, except as to certain Section 409A “performance-based compensation” bonuses already mentioned.

**TIP*:****Bonus compensation that qualifies as Section 409A “performance-based compensation” does not become irrevocable, unless the plan documentation makes it so, until 6 months prior to the end of the 2015 performance period. Therefore, a plan sponsor may wish to allow an election to be made on performance-based compensation before the end of 2014, and then give eligible participants the opportunity to reconsider the desired election on the performance-based compensation in another enrollment before the “6-month-prior” deadline, assuming proper plan language to support this election process.  This way a participant will have an election on record should he or she neglect to make an election during the “6-month-prior” election enrollment period.*

1. ***Make certain that newly eligible plan participants were brought in properly during 2014 and for 2015 plan years.***

 *Note: The IRS takes the position that participants must enroll in plans of the same 409A plan type (for example, multiple “employee account balance” plans) at the same time in the year in order to comply with the Section 409A election do defer timing requirements.*

**Section 409A Annual Informational Reporting to the IRS**

***1.)*****Annual informational reporting of nonqualified deferred compensation plan deferral liability amounts (both voluntary deferral and SERP plans) for 2014 is still not yet required since income taxation regulations in Proposed Treas. Reg.1409A-4 are not yet final.**

*Note: However, annual informational reporting to the IRS under Section 101(j) on any EOLI contract (acquired in connection with a plan) values IS required.*

**General Tips**

***1.)Make corrections of all identified operational or documentation errors as soon as possible after discovering the error.***

Section 409A penalty taxation and correction procedures are generally less burdensome based upon the length of time the error has existed before correction.  As noted, if the error is caught in an IRS audit rather than by the sponsor, the Section 409A corrective procedures are *not* available.  This is another reason for periodic, even annual, self-audits.

***2.)To the extent a procedural error is identified in the plan’s administration contrary to 409A requirements, see Notice 2008-113 for the steps necessary to make a correction.***

 *Some legal commentators believe the IRS’s strict liability interpretation of 409A is incorrect and that some 409A plan corrections, at least, may be made under legal theories and approaches other than Notice 2008-113, since 409A is additive law. Of course, the IRS would disagree, so a client would need to assess its risk tolerance with its own legal counsel.*

1. ***To the extent a documentation error is identified in the plan’s documents contrary to 409A requirements, see Notices 2010-6 and 2010-80 for the steps necessary to make a correction.***

 *Note:  Some legal commentators believe the IRS’s strict liability interpretation of 409A is incorrect and that 409A plan corrections may be made under legal theories and approaches other than Notice 2010-6, or Notice 2010-80, since 409A is additive law.  Of course, the IRS would disagree, so a client would need to assess its risk tolerance with its own legal counsel.*

***4.)    Document the corrective procedures taken to prevent the error from happening again.*** The Section 409A corrective procedures are only available if the IRS finds this is not a repeating error that has not been addressed by corrective actions to platforms or administrative procedures and processes of the sponsor and any TPAs.  Therefore, a corrective action to prevent a repeat of the error should be noted in the file after a “root cause” analysis is done.

***5.)    Operate in “year-end-mode” with quality control steps during the entire year to ensure compliance by catching and correcting Section 409A errors (any other errors) as early as possible.***  This advice is especially important when a plan sponsor and a TPA share responsibilities for the plan’s on-going compliance.

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