Noncompliance With 409A: How Serious an Issue?
By Jeff Capwell - McGuireWoods — July 21, 2009

At the request of subscribers, Compliance Week offers a Remediation Center, in which readers can submit questions—anonymously—to securities and accounting experts. Compliance Week’s editors will review all questions and then submit them—confidentially, of course—to specialists who can address the issues. The questions and responses will then be reprinted in a future edition of Compliance Week. Below is one of the Q&As; ask your own questions by clicking here.

QUESTION
We are a pension administration firm and have a client who signed a deferred compensation agreement in May 1998; no updates since then, but there are benefits that have vested since 2004. The legal department of a major insurance carrier has determined that the agreement and its documentation are non-compliant with Section 409(a)—the part of the tax code that governs deferred compensation—and said that the client would need to contact an attorney or accountant to correct the current situation before the carrier would issue a policy on the client. We’re trying to figure out what is involved with correcting the situation. What’s the next step for the client? Should we self-disclose this to the IRS? Is this a big mess?

ANSWER
Since your role seems to be limited to providing administrative services for this deferred compensation arrangement, you generally would not have an obligation to confirm the insurance company’s concerns. Instead, you should communicate this concern to the employer so that the company can engage an experienced tax adviser to provide it with an independent assessment. If the arrangement is not compliant with Section 409A, and that non-compliance triggered adverse tax consequences to the worker, the employer would be required to report those consequences on a Form W-2 for the affected employee.

Still, you raise the larger question of what to do with compensation agreements not in compliance with Section 409A. The deadline to comply with Section 409A was Dec. 31, 2008. If the agreement (or any related documents) did not contain all required terms by that date, or if they contained any terms prohibited under Section 409A, the arrangement could be in violation of the code. In reviewing this issue, the employer’s tax adviser should consider the following:

- Are any of the amounts deferred under the arrangement grandfathered under Section 409A?

Section 409A applies to amounts that are deferred on or after Jan. 1, 2005. Amounts deferred before then are not subject to Section 409A if, as of December 31, 2004, the employee had a legally binding right to those amounts and they were earned and vested. In addition, the plan under which the grandfathered amounts were deferred must not have been “materially modified” since Oct. 3, 2004. Because the arrangement in question has been in place since 1998, it is possible that all or a portion of the...
deferrals since that date are grandfathered. But compliance with Section 409A would be
required for amounts deferred after 2004, or amounts deferred before 2005 that fail to meet
the grandfathering conditions (such as amounts that were unvested on Dec. 31, 2004).

- **If there are non-grandfathered amounts under the arrangement, do the
documents meet Section 409A’s written plan requirements?** A plan that covers
non-grandfathered amounts must be written and have certain terms. These terms can be
contained in more than one document. Required terms include a description of the amount
defered (or the method for determining that amount), and the time and method for payment
of the amount deferred. Additional provisions are necessary if the amounts were deferred at
the employee’s election or if the employee has the ability to make subsequent changes in the
time or method of payment. Finally, the plan may be required to contain a provision
imposing a six-month delay on payments linked to the employee’s termination of
employment.

- **If the documents are non-compliant, are any of the non-grandfathered
amounts unvested?** Based on proposed regulations regarding the calculation of tax for
Section 409A violations, there appears to be a limited opportunity to amend documents with
respect to unvested deferrals. Under the proposed regulations, unvested deferrals are not
included in income until the taxable year in which they vest. Furthermore, if the arrangement
is amended to comply with Section 409A prior to the beginning of the taxable year in which
the amounts do vest, then the amounts will not be included in ordinary income until the
intended distribution date, and will avoid Section 409A penalty and interest taxes completely,
assuming ongoing operational compliance with section 409A.

The potential relief for such corrective plan amendments would not extend to any vested amounts.
While there is a correction program in place for non-compliance with Section 409A in operation,
there is no similar correction program for failures to comply with the plan document requirements.
As a result, vested deferrals that are not grandfathered would likely be subject to the adverse tax
consequences that result from non-compliance with Section 409A.

Finally, your question highlights the need for third-party administrators to review their internal
processes and service agreements in light of Section 409A. An administrator generally should not be
responsible for compliance with the Section 409A document requirements, but its administrative
processes should be structured to follow the plan’s terms. Therefore, administrators should confirm
that their service agreements clearly define their responsibilities and appropriately protect against
potential liabilities resulting from Section 409A non-compliance.