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Series of Limited Scope 409A Audits Underway

The IRS has launched an audit initiative aimed at compliance with the rules for nonqualified deferred compensation plans under Code section 409A. A series of audits of a “limited scope” are underway. The IRS will assess what further steps, if any, to take after the results of these audits are in. While IRS agents have sometimes raised section 409A issues on audits, this appears to be the first systematic IRS initiative to review compliance with the complex regulatory scheme under Code section 409A. We outline below some actions that employers may consider to prepare for a potential audit on section 409A issues.

At the beginning of an IRS audit, employers will receive Information Document Requests (“IDRs”) where the IRS requests documents likely to be relevant to the issues under audit. Employers selected for examination should quickly review the IDRs received and be prepared to discuss them with the IRS. Typically, the IDRs will be presented in draft form and there will be time to negotiate the scope of the documents requested and the deadline for providing them. For large employers, negotiation on these points will be critical, as new IRS guidelines (issued by the Large Business and International Division) on IDRs provide agents with limited flexibility to provide relief from deadlines.

Prior to receiving notice of an audit, employers should seriously consider self-auditing plans subject to Code section 409A for operational and plan document compliance. Many types of problems can be corrected under the IRS 409A correction programs (one exists for plan document problems and one for operation problems) prior to audit. However, once an employer or an executive is under an IRS audit on these issues, these programs may become unavailable. We list below some of the key areas an employer may begin to review for plans subject to Code section 409A:

- **Initial deferral elections.** The general rule is that an employee may elect to defer compensation only if the election is made before the year the compensation is earned. However, there are exceptions that permit elections to be made at a later date. At the time an election is made to defer compensation, the time and form of distribution for the compensation must also be documented.
- **Subsequent deferral elections.** Subsequent elections to change the time or form of payment originally established are permitted only where (1) the election does not take effect for 12 months, and (2) the payment generally must be deferred for at least 5 years from the date payment would otherwise have been made.
- **Distribution triggers.** Payments may only be made upon a fixed date or upon one of five “trigger” events: (1) a separation from service, (2) death, (3) disability, (4) change in control, or (5) unforeseeable emergency. A plan may provide for distributions upon the earlier of, or the later of, two or more specified permissible events.

- Key employees. Key employees of public companies (generally, up to the top 50 highest paid officers) may not receive distributions for six months if a payment is triggered by their separation from service.
- No acceleration of payments. Generally, the time of payment may not be accelerated except as permitted under regulations. Some useful exceptions exist, including for domestic relations orders, limited cash-outs, and payment of FICA taxes.
- Funding restrictions. Nonqualified plan benefits may not be funded through an offshore trust or a trust that becomes off-limits to a company's creditors in the event of financial troubles for the company.

In light of this renewed potential for IRS audit, we recommend that employers take this opportunity to review their plans for compliance with Code section 409A. Since its inception, we have assisted our clients with designs, compliance, and corrections in accordance with the section 409A rules. As a result, we are well positioned to assist an employer with an efficient self-audit of its plans subject to Code section 409A.

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