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IRS BEGINS SECTION 409A AUDITS

The Internal Revenue Service ("IRS") has begun auditing companies' compliance with Section 409A of the Internal Revenue Code ("Section 409A"). This news may come as an unwelcome surprise to many who were hoping that the complexities and uncertainties of Section 409A might delay the IRS's enforcement efforts until more guidance was available and practices further developed. Information Document Requests ("IDRs") from the IRS to companies undergoing audits reveal that the IRS requires an audited company to disclose details of pay practices that could be subject to Section 409A and also to consider the possible application of Section 409A to these practices.

Enacted in 2004, Section 409A and its interpretative regulations establish a detailed and complex framework governing the timing and form of nonqualified deferred compensation payments. Operational and documentary violations of the rules may result in severe tax penalties on affected employees and other service providers (for convenience, we will refer herein to all service providers as "employees").

Section 409A IDRs require audited companies to identify detailed payment information with respect to the applicable year of audit and take potential legal positions with respect to such information, including identification of the following:

- Each plan and arrangement providing for a legally binding right in one year and payment in a subsequent year that is not subject to Section 409A; the basis for the position that the plan is not subject to Section 409A; and if that basis is predicated on the short-term deferral exclusion, the terms of the plan or arrangement, including any relevant substantial risk of forfeiture;

- Terms for deferral elections and any relevant deadlines for making such elections;

- Terms for subsequent deferral elections (*i.e.*, changes to prior deferral elections), including the original payment date and the rescheduled payment date;

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- Any acceleration in payment made before the originally scheduled payment date, including due to elections made under available transition relief and the deadlines for such elections; identification of the original payment date and the actual payment date;

- The names of "specified employees" in public companies and the period during which such individuals were specified employees;

- Payments of nonqualified deferred compensation made during the applicable year to specified employees upon separation from service, and whether such payments were made within six months after the date of separation from service;

- Certain information on stock rights that may be subject to Section 409A;

- The funding of deferred compensation as a result of any event that relates to a decline in the company's financial condition; and

- Any violations of Section 409A and whether the company participated in the Section 409A corrections program.

OBSERVATIONS

Section 409A audits present special challenges because penalties for noncompliance are borne primarily by the employees, even though the timing of payments and the manner in which those payments are disclosed are controlled by the company. Consequently, a Section 409A audit of the company has the potential to result in severe adverse tax consequences for employees. It remains to be seen how the IRS will attempt to coordinate Section 409A audits of companies with the potential assertion of tax deficiencies against the participating employees. The IDRs issued in Section 409A audits require companies to provide detailed information regarding payments made to employees at all levels (all employees are subject to Section 409A, not just top executives) and to take positions on complex legal issues. In this manner, the IDRs function as more than a simple request for documents. This is consistent with a growing general trend to involve IRS counsel at an early stage of tax audits and to issue IDRs that are more like detailed litigation discovery requests than traditional IDRs. This trend is particularly apparent in technically complex areas like Section 409A.

A company undergoing audit is likely to receive a Section 409A IDR relatively early in the process. While it may have been a company's practice to let the company's tax or accounting department take the lead in responding to IRS audit requests, companies should coordinate internally (particularly between the tax, accounting, legal, and human resources departments) with respect to Section 409A issues to provide cogent and consistent responses to IRS inquiries. Given the complexity of these issues and particularly in light of increased IRS counsel involvement, companies should also consider obtaining assistance from legal counsel prior to responding to a Section 409A IDR. The IRS audit remains an informal process, and even in a complex area like this, it may be possible to work with the IRS agents or counsel to limit the scope of the questions and requested documents. The goal is to provide the IRS with the meaningful information it needs, while lessening the burden to the company of compliance with sometimes overly detailed IDRs.

Finally, it appears that receipt of a Section 409A IDR does not necessarily preclude a company from participation in the Section 409A operational corrections program under IRS Notice 2008-113. The applicable IRS guidance cuts off corrections program eligibility for an employee once the relevant individual income tax return is under examination. Therefore, a Section 409A IDR recipient may consider participation in the corrections program even as it evaluates its response to the IDR.

CONCLUSION

The IRS has been signaling for several years that it is more serious about auditing tax issues relating to executive compensation. Thus, the proliferation of Section 409A IDRs, however unwelcome, should not come as a surprise. Unfortunately, given the breadth, complexity, and uncertainties associated with Section 409A, the IDRs will likely reveal numerous situations that the IRS views as violations of Section 409A. Therefore, company responses to the IDRs may be only the initial phase of a long, drawn-out controversy with the IRS.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

John R. Cornell
New York
+1.212.326.8332
jrcornell@jonesday.com

Travis DeHaven
Atlanta
+1.404.581.8373
tdehaven@jonesday.com

Dennis B. Drapkin
Dallas
+1.214.969.4850
dbdrapkin@jonesday.com

Daniel C. Hagen
Cleveland
+1.216.586. 7159
dchagen@jonesday.com

Colleen M. Hart
New York
+1.212.326.7898
cmhart@jonesday.com

Karl L. Kellar
Washington, D.C.
+1.202.879.3824
klkellar@jonesday.com

Rory D. Lyons
Atlanta
+1.404.581.8550
rlyons@jonesday.com

Manan Shah
New York
+1.212.326.3986
mdshah@jonesday.com

Charmaine L. Slack
New York
+1.212.326.8381
cslack@jonesday.com

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