

Executive Compensation and Benefits Alert

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If you have any questions regarding the matters discussed in this memorandum, please contact any of the attorneys listed on Page 2, or call your regular Skadden contact.

IRS Section 409A Audit Initiative May Signal Increased Enforcement Activity

Since the adoption of Section 409A of the Internal Revenue Code, employers and practitioners have wondered when and how the IRS would enforce it. With the recent IRS announcement of an audit initiative with respect to Section 409A, it appears that question may be answered.

Early in May, IRS personnel unofficially announced that they have begun conducting a review of Section 409A compliance at approximately 50 corporate taxpayers (all of which previously had been identified for employment tax audits). In addition to reviewing a small number of taxpayers, the IRS has limited its review to the top 10 most highly compensated individuals of each taxpayer and intends to examine compliance with only a few, relatively basic, Section 409A requirements. The requirements at issue relate to the rules governing initial deferral elections, subsequent changes to deferral elections and the application of the six-month delay rule for specified employees of publicly traded taxpayers.

For taxpayers that are not part of this audit initiative, there are some lessons to be drawn from this news. Most importantly, the IRS intends to enforce Section 409A compliance, which dashes the hopes of some practitioners who felt that the scope and complexity of the statute and regulations would stifle enforcement activity. Second, taxpayers should not be lulled into complacency by the limited scope and focus of this initiative. While only a few basic issues are being examined, there are many potential complexities that could trip up even those taxpayers that are conscientious with respect to Section 409A compliance. In addition, should the review reveal significant compliance issues, such a finding could open the door for broader IRS enforcement activity, including examining more taxpayers and other aspects of the rules. The fact that compliance issues likely will affect highly compensated executives — and potentially generate headlines — may provide further impetus for more Section 409A enforcement activity, given the current political and media climate.

Taxpayers with compensation arrangements that are (or could be) subject to Section 409A should consider the possibility that the new Section 409A audit activity portends a more active IRS enforcement of these rules and revisit their Section 409A compliance processes. We are available to discuss any questions you may have relating to this new development and the general Section 409A compliance of your compensation arrangements.

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