



# Client Alert

October 28, 2010

## December 31, 2010 Deadline To Correct Non-Qualified Deferred Compensation Plans

Section 409A of the Internal Revenue Code requires documents governing a non-qualified deferred compensation arrangement or plan ("NQDC") satisfy certain requirements. A description of these rules is in an October 13, 2008 Client Alert entitled "Year End Action Required with Respect to Non-Qualified Plans and Arrangements." This article is on our website at [www.armstrongteasdale.com](http://www.armstrongteasdale.com) in the "Client Alerts Archive" section under News and Publications.

Documents governing NQDCs were required to be in compliance with Section 409A by December 31, 2008. The documents governing some NQDCs do not currently comply with Section 409A because of the complexity of the law, subsequent guidance that changes prior understanding of certain rules and the fact that some arrangements simply were not identified and modified before December 31, 2008.

**On January 5, 2010, the IRS released Notice 2010-6 that provides some relief for documents that do not comply with Section 409A. Generally, there is a tax cost associated with corrections under Notice 2010-6; however, most document failures can be corrected on or before December 31, 2010 without additional tax cost. Under this notice, employers have one last opportunity to review NQDCs and make the appropriate corrections without additional tax cost. Because of the high cost of non-compliance, identifying and correcting non-compliant NQDCs should be a priority.**

Failures that can be corrected under Notice 2010-6 include:

- Ambiguous plan language
- Improper definitions of payment events
- Improper payment periods
- Failure to provide for a six month delay in payment to "specified employees" of publicly traded corporations

Any failure must have been inadvertent and unintentional, commercially reasonable steps must be taken to avoid reoccurrence of the failure and neither the employee/participant nor the employer may be under examination by the Internal Revenue Service at the time of correction.

NQDC features can be present in any plan or arrangement that provides for payment for services in years subsequent to the year in which services are performed. Such plans and arrangements include non-qualified deferred compensation plans and arrangements, bonus plans and arrangements, employment contracts, offer letters, phantom stock and stock appreciation agreements, discounted stock options, separation and retention plans and agreements, post-retirement fringe benefits, certain types of split dollar life insurance agreements, top hat and supplemental retirement plans ("SERPs"), Section 457(f) plans and arrangements and change in control agreements.

The tax consequences of failing to comply with Section 409A are severe. They are as follows:

- All vested deferrals and accruals under a non-compliant NQDC, plus earnings, are taxable for income tax purposes at the time of violation even though the benefits are not yet distributable under the terms of the arrangement.
- The amount taxable under the prior paragraph is also subject to a 20 percent excise tax.
- All vested accruals and deferrals under the non-compliant NQDC are subject to an additional excise tax equal to the interest rate charged by the Internal Revenue Service ("IRS") on tax deficiencies (currently 4 percent) plus 1 percent.

- The employee/participant is responsible for all taxes imposed under Section 409A. The employer is required to report the Section 409A violation to the IRS and withhold the amount of regular income tax for which the employee is liable.

One potential downside to making the correction is that both the employer and the employee/participant are required to report the correction on their 2010 income tax returns even though there are no tax consequences associated with making the correction. Internal Revenue Service personnel have informally indicated this may not be required but, to date, nothing to this effect has been published by the government.

Finally, the Internal Revenue Service has made it clear that the transition relief described in this Client Alert is a special, one time offer and that it will not be available after the end of this year.

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