

Employee Benefits Alert

NOVEMBER 9, 2010

Section 409A Compliance: A Second Bite at the Apple Ends December 31st

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Introduction

Section 409A of the Internal Revenue Code ("Section 409A"), which regulates non-qualified deferred compensation arrangements, was signed into law in 2004 and went into effect January 1, 2005. Not only did Section 409A establish many new requirements for deferred compensation, but it also expanded the traditional notion of deferred compensation to include, among other arrangements, bonus plans, reimbursement policies, severance agreements, change in control agreements, and employment agreements.

If a plan or arrangement is not otherwise exempt from Section 409A and does not comply with its provisions, the employee/participant is subject to accelerated income tax on vested amounts (without regard to whether the amounts are currently payable), an additional 20% penalty tax (in addition to regular income tax), and possible interest penalties if the accelerated income taxes are not paid on time. There may also be additional tax consequences under state law.

Prior to January 1, 2009, arrangements covered by Section 409A did not have to comply with Section 409A in form, but did have to comply in operation. The final deadline by which all plans were to be amended to comply with Section 409A was December 31, 2008. Previously, the IRS issued Notice 2008-113, which provided an opportunity to correct certain operational errors which did not comply with Section 409A. As discussed more fully below, in 2010, the IRS issued guidance for correcting document failures related to Section 409A, but the deadline for taking advantage of this correction program ends December 31, 2010.

The Notice 2010-6 Document Correction Program

In January 2010, the IRS issued Notice 2010-6, which supplements and modifies Notice 2008-113 and provides companies an opportunity to correct certain documentary violations in order to reduce or avoid the adverse tax consequences under Section 409A. Notice 2010-6 provides tax relief for certain Section 409A non-compliant plans or agreements that are corrected *in a timely fashion* in accordance with the Notice.

In 2009, the IRS announced that it is randomly auditing 2,000 businesses each year from 2010 through 2012 under its Employment Tax National Research Project to determine if taxpayers are properly complying with the employment tax laws. ***It is important to note that companies may not take advantage of the relief available under Notice 2010-6 once an IRS audit has commenced.*** With less than 10 weeks remaining in 2010, companies should take note of Notice 2010-6 and where they stand with respect to Section 409A compliance. For companies and individuals that failed to conduct a Section 409A review in 2008, Notice 2010-6 presents an opportunity to conduct a thorough review now and mitigate the adverse consequences that violations of Section 409A may cause. For companies and individuals that took timely action to comply with Section 409A's written

documentation requirements previously, Notice 2010-6 provides an opportunity to review newly established arrangements and revise previously amended arrangements with the additional understanding we have about Section 409A today.

As stated above, deferred compensation arrangements drafted in violation of Section 409A are subject to acceleration of income recognition, taxes, and penalties even if no payments have been made under the arrangements. Therefore, Notice 2010-6 gives companies a “second bite at the apple” to possibly avoid these adverse consequences.

Note: Depending on the timing of the correction under Notice 2010-6 and the timing of certain events like the occurrence of an improper payment event within 12 months of the correction, Notice 2010-6 may provide only limited relief (e.g., only a 50% reduction in the penalty tax).

Document Failures Eligible for Correction

The documentary failures that may be corrected under Notice 2010-6 include common Section 409A pitfalls, such as:

- Payment periods following a permissible payment event that are dependent upon the employee executing a release;
- Plan terms, such as “separation of service,” “change in control,” and “disability” that do not meet the definitional requirements of Section 409A;
- Payment periods that are longer than 90 days following a permissible payment event;
- Impermissible payment events;
- Impermissible company discretion to accelerate payment events; and
- Alternative payment schedules that depend on which type of permissible payment event occurs.

There are certain reporting requirements that a company must comply with if they correct any of the plans or agreements under Notice 2010-6. Finally, the company is also required to take commercially reasonable steps to identify and correct any other plans with substantially similar failures.

Recommended Actions

Companies should review all of their non-qualified deferred compensation arrangements to ensure that they comply with Section 409A and, if they do not comply, act now to take advantage of the Notice 2010-6 document correction program, as the relief available under Notice 2010-6 expires at the end of this year.

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0765-1110-NAT-ELB