

Client Alert.

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End of the Year Deadline for Correction of Certain Section 409A Failures and Relief from Penalties is Fast Approaching

By Michael T. Frank and Yong Li Yeh

As discussed in a previous [Morrison & Foerster alert](#), the Internal Revenue Service issued Notice 2010-6 on January 5, 2010. Notice 2010-6 offers opportunities for companies to correct documentary problems with nonqualified deferred compensation arrangements and permits their employees to avoid certain adverse tax consequences that would otherwise apply under Internal Revenue Code Section 409A.

Companies that correct problems by **December 31, 2010** may permit their employees to avoid (i) an *acceleration of income recognition*, (ii) a *20% federal tax*, and (iii) *additional penalties*. Corrections under Notice 2010-6 after December 31, 2010 will not generally permit employees to avoid Section 409A penalties. It is important to note that Section 409A penalties may be assessed even if no payments have yet been made with respect to noncompliant nonqualified deferred compensation plans.

BACKGROUND

Notice 2010-6 provides an opportunity for companies to review their nonqualified deferred compensation plans for documentary failures under Section 409A and to voluntarily correct such failures. Companies that do so during 2010 can permit employees to *avoid* current income inclusion and additional taxes under Section 409A.

ELIGIBILITY FOR CORRECTION

Many documentary failures may be corrected under the Notice, including:

- Plan terms (such as “separation from service,” “change in control event,” and “disability”) that do not meet the definitional requirements of Section 409A;
- Payment periods of longer than 90 days following a permissible payment event;
- Payment periods following a permissible payment event that are dependent upon the employee completing certain employment-related actions (such as executing a noncompetition agreement or a release of claims);
- Impermissible payment events (such as an initial public offering that does not constitute a change in control event under Section 409A);
- Alternative payment schedules that depend on which type of permissible payment event occurs;
- Company or employee discretion regarding payment schedules following a permissible payment event (including subsequent deferral elections);

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- Impermissible company discretion to accelerate payment events;
- Impermissible reimbursement of in-kind benefit provisions; and
- Failure to provide for the required six-month delay for payments to specified employees.

Note that relief under Notice 2010-6 is generally not available with respect to stock rights (stock options and stock appreciation rights).

Notice 2010-6 imposes certain other general requirements that need to be satisfied to take advantage of the correction program, most notably the requirement that the IRS (and the affected employees) be notified of the correction, even if the correction requires no inclusion of income.

For California income tax purposes, the California Franchise Tax Board generally follows the approach presented under Notice 2010-6. However, California companies are *not* required to attach additional statements to their California income tax returns.

RELIEF

If a company corrects any noncompliant nonqualified deferred compensation plan(s) for documentary violations of Section 409A prior to **December 31, 2010**, and such corrections do not impact the operation of the plan(s) for one year following the corrections, then all taxes and penalties under Section 409A may be avoided; provided that any payments made before December 31, 2010 would have been made before December 31, 2010 under the plan(s) as amended, and any payments made after December 31, 2010 would have been made after December 31, 2010 under the plan(s) as amended.

CONCLUSION

The Internal Revenue Service has provided a valuable opportunity for companies to avoid or reduce paying additional taxes under Section 409A for correcting noncompliant nonqualified plans and arrangements. Companies should consider making such corrections by **December 31, 2010**.

If you have any questions, contact your Morrison & Foerster attorney or any member of the Employee Benefits and Executive Compensation Group.

Contacts:

Michael T. Frank
Palo Alto
(650) 813-5627
mfrank@mofo.com

Paul Borden
San Francisco
(415) 268-6747
pborden@mofo.com

Patrick R. McCabe
San Francisco
(415) 268-6926
pmccabe@mofo.com

Timothy G. Verrall
Northern Virginia
(703) 760-7306
tverrall@mofo.com

Yong Li Yeh
Palo Alto
(650) 813-5672
yeh@mofo.com

Jessica L. Rice
San Diego
(858) 720-5144
jrice@mofo.com

Yana S. Johnson
San Francisco
(415) 268-7136
yjohnson@mofo.com

Sonja K. Johnson
San Francisco
(415) 268-7694
sjohnson@mofo.com

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