

## WSGR ALERT

OCTOBER 2010

# IRS TRANSITION RELIEF PRESENTS OPPORTUNITY TO CORRECT 409A DOCUMENT ERRORS PRIOR TO YEAR-END

Employers have a time-sensitive opportunity to correct certain documentary violations in plans or contracts subject to Internal Revenue Code Section 409A under the Internal Revenue Service's (IRS's) recently introduced voluntary document correction program. Corrections made by **December 31, 2010**, will, in most instances, allow employees to avoid recognizing additional taxable income and taxes under Section 409A that generally will apply after 2010.

Employers who have identified errors eligible for correction should strongly consider participating in the correction program by year-end. Action before this deadline generally will enable employees to avoid any additional taxes under Section 409A. Corrections after 2010 may require the employer to report additional taxable income to employees under Section 409A at a reduced rate provided under the correction program.

Even employers who previously have reviewed and amended arrangements for Section 409A may find the correction program worthwhile. The IRS has issued new interpretations relating to Section 409A document provisions since the December 31, 2008, compliance deadline that have raised questions about 409A language in some arrangements that previously were expected to be in compliance based on existing Section 409A guidance. The correction program gives employers a generally tax-free opportunity to review and update these provisions. A particular area where the IRS position has evolved since 2008 is the language that the IRS requires in arrangements that condition

payments on the execution of a release or non-competition agreement. In some cases, language previously thought to be acceptable will not satisfy the current IRS interpretation, and consequently the correction program can be used to bring such arrangements into documentary compliance.

The consequences of Section 409A violations can be severe. Documentary violations can result in immediate taxation of the employee (requiring employer tax reporting and withholding) on vested amounts, plus imposition of a 20 percent federal penalty tax (and in California, an additional 20 percent state penalty tax) on such amounts and potential interest charges.

### Errors Eligible for IRS Correction Program

The IRS established the correction program (published in Notice 2010-6) as an IRS-approved means of correcting noncompliance with certain Section 409A requirements. The IRS correction program describes specific errors for which relief is available, including the following:

- Arrangements with impermissible definitions of payment events or that fail to include 409A-compliant definitions for payment events such as "separation from service," "change-in-control event," and "disability."
- Arrangements that provide for payments of deferred compensation after a Section 409A-compliant payment event during a payment "window" exceeding 90 days

after the event and that do not begin and end in a single tax year. The provision is not intended to apply to amounts paid on fixed schedules over time, which are permitted under Section 409A.

- Arrangements in which severance payments are conditioned on execution of a release or non-competition agreement giving the employee the ability to manipulate the timing of the payment and impermissibly delay or accelerate taxation of the payment.
- Impermissible payment events such as payments of deferred compensation on a non-409A-compliant event (e.g., enrollment of an employee's child in college).
- Arrangements with non-compliant alternative payment schedules such as different times and forms of payment for a single payment event (e.g., lump-sum severance upon involuntary termination and installment payments for voluntary termination).
- Arrangements that allow discretion to change payment schedules, such as the ability to elect to receive severance in a lump sum or in installments at the time of payment.
- Arrangements that permit employers to impermissibly accelerate payments.
- Public company arrangements that do not have a six-month delay clause for a "specified employee" in a severance arrangement.

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## IRS Transition Relief . . .

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- Deferral elections that do not comply with 409A.
- Arrangements that include impermissible reimbursement or in-kind benefit provisions.

The correction program is not available to correct documentary errors related to stock options and stock appreciation rights.

### Procedure for Correcting Errors

Certain general eligibility and procedural requirements apply to the correction program, including that the violation be inadvertent and the taxpayer not be under IRS examination. An employer participating in the correction program must attach a statement containing specific information to its federal income tax return and provide a statement to the affected employees, who also must attach a copy of the statement to their personal income tax return. In addition, if an employer corrects a document failure, the employer must take steps to identify all other arrangements with similar failures and correct those failures within the IRS program.

### Advantages of Correcting During 2010 Transition Period

After 2010, corrections under the correction program may require the employee to pay taxes, in a reduced amount, under Section 409A. For example, correction of an arrangement that permits payments more than 90 days after a payment event will require the employee to recognize 50 percent of the deferred amount as Section 409A income and pay related 409A taxes if, within one year after the correction, an event occurs that would have triggered payment under the corrected provision.

However, if a document failure is corrected by December 31, 2010, under the correction program it is deemed to have been corrected as of January 1, 2009. This means that corrections can be made under the correction program without being subject to the income inclusion and tax penalties described above. The correction program can enable employers to correct document failures even if amounts previously were paid. However, an operational failure will be deemed to have occurred (and should be corrected under the separate operational failure correction program before December 31, 2010) if (1) any payment is paid prior to December 31, 2010, that would not have been paid under the amended arrangement, or (2) any payment is not paid prior to December 31, 2010, that would have been paid under the amended arrangement.

Due to this transition relief, employers should strongly consider reviewing their deferred compensation arrangements, including severance pay arrangements, in order to identify and correct any arrangements that may be out of documentary compliance.

If you have any questions regarding this WSGR Alert, or would like assistance reviewing your documents for compliance with Section 409A, please contact any member of the Wilson Sonsini Goodrich & Rosati Employee Benefits & Compensation practice:

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