



Employee Benefits Advisory

October 5, 2010

Last Chance to Possibly Avoid 409A Penalties

Through the end of this year, the IRS is giving an opportunity to fix certain documentary compliance problems that may still exist in your compensatory arrangements with your employees and independent contractors that are subject to Section 409A of the Internal Revenue Code ("409A"). As background, arrangements with employees and independent contractors are generally subject to 409A if they provide for compensation earned in one year to be paid in a later year. The list of arrangements covered by 409A is extremely broad. Typical examples include bonus programs, employment, severance, and change in control agreements, deferred compensation plans and other incentive plans. The IRS previously required all affected arrangements be brought into documentary compliance with 409A by the end of 2008, but many companies missed this deadline. **Noncompliance with 409A triggers immediate taxation, plus a 20% penalty, plus interest.** Additional penalties may apply at the state income tax level as well. For example, California adds another 10% penalty on top of the 20% federal penalty.

We are pleased to report that the IRS is offering relief from certain 409A penalties if companies make corrections on or before December 31, 2010. If you qualify and the corrections are properly and timely made, the IRS will treat your program as having been in compliance on January 1, 2009 (the first day after the original documentary compliance deadline), and generally no penalties will apply. We highly encourage companies to review your plan documents to confirm that they comply with 409A, and, if necessary, to amend them before year-end.

The IRS placed certain conditions on your eligibility to take advantage of this relief, including:

- only inadvertent or unintentional failures may be corrected;
- failures related to listed transactions may not be corrected;
- you must take reasonable steps to identify and correct similar failures in all of your programs covered by 409A;
- neither you nor your worker's federal tax return may be under audit with respect to deferred compensation matters; and
- the correction must be adopted by December 31, 2010.

CONTACTS

If you have questions or need assistance complying with these requirements, please contact any of the McKenna Long & Aldridge LLP attorneys or public policy advisors with whom you regularly work. You may also contact:

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Certain corrections may trigger taxes for your worker and information and reporting requirements for you both. This may be the case if, for example, your worker has already received payments inconsistent with the amended program. In that case, the worker must pay all taxes associated with the 409A correction and you and the worker must satisfy certain information and reporting requirements related to the correction.

After December 31, 2010, certain corrections can still be made, but penalties will apply. Therefore, even if you have revised your deferred compensation arrangements for 409A compliance in the past, we recommend that you conduct another review to make sure you don't miss this opportunity.

Next Steps:

(1) Review Plan Documents. Remember that the list of arrangements covered by 409A is extremely broad, and includes bonus programs, offer letters, severance agreements, employment agreements, and commission programs. There are quite a few potential 409A compliance issues and available corrections, such as those relating to ambiguous plan terms, impermissible payment events, impermissible payment periods, and impermissible deferral elections.

(2) Amend Noncompliant Documents. Although the deadline to avoid penalties is not until December 31, 2010, we recommend that you begin the review and amendment process now to avoid the strains of last-minute compliance.

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