



Benefits Alert

Legal developments affecting employee benefits

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IRS releases correction program for 409A plan documents

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The Internal Revenue Service has released Notice 2010-6, which offers employers an opportunity to correct nonqualified deferred compensation arrangements that do not comply with Code Section 409A. This guidance permits corrections of several common plan document failures, which, if timely adopted, can avoid the severe adverse tax consequences of 409A violations.

Background

Section 409A imposes strict rules on nonqualified deferred compensation arrangements. The effects of Section 409A are far reaching, because of the exceptionally broad definition of “deferral of compensation” which includes many employment agreements. Employers were required to update their deferred compensation arrangements to comply with Section 409A by December 31, 2008. A failure to comply with Section 409A can result in accelerated income recognition, an additional 20% tax, and enhanced interest (and in California, an additional 20 percent state tax).

Under Notice 2010-6, many common plan document failures or ambiguities can be corrected without any tax penalty if the correction is made by December 31, 2010. This new program complements Notice 2008-113, which addresses the correction of certain operational failures under Section 409A and remains in effect. As explained below, Notice 2010-6 contains important guidance even for employers that have already updated their plans for 409A.

Eligibility for correction

Not all plan document failures are eligible for correction under Notice 2010-6, but the guidance does cover many of the most common 409A pitfalls, including:

- Clarification that certain ambiguous language will not automatically cause a document failure (e.g., payment “as soon practicable”).
- Certain payment events, such as “termination of employment,” “change in control event,” or “disability,” that are not defined in the document or are improperly defined.
- A payment period that extends more than 90 days following a permissible payment event.
- A payment period that is dependent upon an employment-related action (e.g., execution of a release of claims or noncompetition or nonsolicitation agreement).

- An impermissible payment event, such as an initial public offering (which is not otherwise a change in control under 409A) or enrollment of a child in college.
- Impermissible discretion regarding payment schedules.
- Impermissible employer discretion to accelerate payments.
- Impermissible reimbursements or in-kind benefit provisions after separation from service (e.g., reimbursement of country club dues).
- Failure to include the six-month delay for payments to “specified employees.”
- Impermissible initial deferral elections.

This list is by no means exhaustive. One gap in the correction program, however, is that the Notice does not contain any corrections that specifically target stock rights.

Some common 409A provisions will need to be revisited

This new 409A guidance will be helpful to employers who may have overlooked certain deferred compensation arrangements that were not updated to comply with Section 409A by the December 31, 2008 deadline. But even if your plans have been previously reviewed for 409A compliance, you should not disregard this new guidance. The Notice provides clarifications regarding some common plan provisions that will be considered compliant with Section 409A requirements. For example, the IRS has adopted a new position with respect to employment agreements, severance agreements, or deferred compensation plans that condition payment upon the employee’s execution of a release or other documents, which may require changes to those terms.

Prompt action by December 31, 2010

Early correction of plan document failures is important. Notice 2010-6 includes a transition rule under which eligible plan document failures may be corrected by December 31, 2010, without paying any 409A tax or penalty. (This relief is not extended to operational errors, however, which are subject to Notice 2008-113.) This transition rule is intended to encourage employers to review their nonqualified deferred compensation plans to identify provisions that fail to comply with Section 409A and to correct those plan provisions promptly.

Outside of the correction period defined under this transition rule, if a deferred compensation plan is corrected and the correction affects the operation of the plan within one year, the correction will generally require payment of a reduced penalty (typically 50%) on the amount that would otherwise have been taxed under Section 409A.

Also, the relief under Notice 2010-6 is not available once the Internal Revenue Service has begun an audit, which is another reason for prompt action—especially since the Service is now including 409A compliance issues in its corporate audits.

IRS reporting requirements

To correct a document failure under Notice 2010-6, the employer generally must attach a compliance statement to its federal income tax return for the year in which it corrects the failure. The compliance statement must include, among other things, the name and taxpayer identification number of each affected employee and the amount of the payment involved for each failure. The employer must also provide a compliance statement to each affected employee along with the employee’s W-2, and the employee must attach the compliance statement to his or her income tax return.

Corrections made during the transition period ending December 31, 2010, are not exempt from this reporting requirement. No reporting is required, however, for permitted corrections of certain ambiguous language in the plan document.

Conclusion

Notice 2010-6 provides a valuable opportunity for companies that have not yet achieved full documentary compliance with Section 409A to do so with reduced—or even no—adverse tax consequences. The transitional relief provides a special incentive to identify and correct any plan document problems before December 31, 2010.

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