

**EXECUTIVE COMPENSATION
AND TAX UPDATE****IRS Provides New Opportunities to Fix Section 409A Violations**

The IRS has published a correction program for nonqualified deferred compensation plans that violate Section 409A as a result of certain plan document failures.

In general, if a nonqualified deferred compensation plan violates Section 409A as a result of a document failure, the amounts deferred under that plan are taxable under Section 409A. The plan failure results in the immediate taxation of a participant's deferrals and the imposition of a 20 percent additional tax (and interest) paid by the plan participant. The IRS previously published Notice 2008-113, which provides relief from the penalties imposed under Section 409A as a result of plan **administrative** errors. The recently published IRS Notice 2010-6 (the "Notice") provides relief from the Section 409A penalties that may be imposed as a result of the **plan document failures** described in this bulletin.

GENERAL ELIGIBILITY REQUIREMENTS

Among other requirements to qualify for relief under the Notice, the Notice requires that any administrative errors caused by the document failure be fixed under Notice 2008-113 (along with payment of any Section 409A taxes and penalties related to the administrative error), that the service recipient (employer) and service provider (employee) in most cases submit information about the plan and the correction with their federal tax returns and that the employer take steps to identify and fix similar violations in its other nonqualified plans.

EARLY IDENTIFICATION AND CORRECTION MINIMIZES PENALTIES

The Notice is structured to encourage plan sponsors to identify and fix document failures early. The Notice provides that:

- Plan failures corrected during a 2010 transition period may be corrected without triggering taxes and penalties under Section 409A as a result of the document failure.
- Plan failures of some newly adopted plans may be corrected in the year of adoption (or, if later, within two-and-a-half months of adoption) without triggering taxes and penalties under Section 409A as a result of the document failure.
- Several of the plan failures (discussed more below) may be corrected without triggering taxes and penalties under Section 409A as a result of the plan failure, if the correction is made more than a year before the impermissible provision would have resulted in a payment (or should have resulted in a payment).



CERTAIN PLAN FAILURES REQUIRE MINIMAL CORRECTIVE ACTION

The Notice clarifies that a payment time such as “as soon as reasonably practicable” and ambiguous plan payment events such as payment on “termination of employment” (as opposed to “separation from service” under Section 409A) or payment on an “acquisition” of the employer (as opposed to payment on a “change in control or effective control” of the employer) will generally not be treated as document failures under Section 409A and no Section 409A violation will be deemed to occur so long as the provision has been administered at all times in compliance with Section 409A (and the Notice).

In addition, the Notice provides that the plan failures described below may generally be corrected without treating any amount deferred under the plan as taxable under Section 409A as a result of the plan failure:

- Plan provides an impermissible payment period such as a payment period that is longer than 90 days in length (*e.g.*, payment will be made within 120 days of termination).
- Plan allows the employee to exercise discretion to determine when during a payment period a payment will be made (*e.g.*, upon the execution of a release during the 90-day period that follows the employee’s termination of employment).
- Plan provides the employer the discretion to immediately accelerate the payment event, such as terminating the plan and immediately distributing plan balances.
- Plan provides employees the ability to make deferral elections after the deadline for making such elections under Section 409A has expired.
- Plan provides for payment upon illness, injury or other similar term, but the plan does not define those terms to qualify as a “disability” within the meaning of Section 409A.

However, if an impermissible deferral or payment is made, or an impermissible payment schedule commences, as a result of the plan failure, the amount deferred under the plan would be subject to taxes and penalties under Section 409A. Accordingly, in most cases a plan must be amended to comply with Section 409A before the impermissible payment event or deferral occurs in order to avoid the imposition of taxes and penalties under Section 409A.

TIME-SENSITIVE CORRECTIVE ACTION

The Notice provides that the plan failures described below may be corrected without including any amount in income under Section 409A as a result of the failure, provided the correction is made more than one year **before** the impermissible provision would have resulted in a payment (or should have resulted in a payment under Section 409A):



- Plan provides for payment on “separation from service” or “change in control or change in effective control” of the employer, but those terms do not comply with the requirements of Section 409A.
- Plan contains at least one permissible payment event and one or more impermissible payment event.
- Plan contains certain impermissible alternative payment schedules such as a lump sum payment on involuntary termination, but installments on a voluntary termination.
- Plan allows the employer or employee to accelerate or delay the payment schedule (*e.g.*, payments will be made in installments at age 65, but employer may decide to pay in a lump sum at any time).
- Plan provides for taxable reimbursements in a manner that does not comply with Section 409A.
- Plan does not require a six-month delay on payments made to specified employees on separation from service.

However, with respect to these plan failures, an amount equal to 50 percent of the amount payable pursuant to the impermissible provision (25 percent with respect to an impermissible change in control definition) must be included in income and subject to taxes and penalties under Section 409A, if the impermissible event occurs, or the impermissible payment schedule would have been triggered as the result of an event that occurs, within one year of the amendment to the plan that removes the impermissible provision.

PLANS THAT CONTAIN ONLY IMPERMISSIBLE PAYMENT EVENTS

The Notice requires that if a plan contains only impermissible payment events, then the plan must be amended to provide for payment on the later of the participant’s separation from service or the sixth anniversary of the amendment. In addition, 50 percent of the amount deferred under the plan must be included in income and subject to taxes and penalties under Section 409A.

NEXT STEPS

Based on the guidance and relief provided under the Notice, companies should consider taking the following steps:

- Confirm with all business units and all relevant departments that severance, employment agreements, reimbursement arrangements, commission plans, bonus plans and deferred compensation plans have been reviewed for compliance with Section 409A.
- Review any deferred compensation arrangements subject to Section 409A that contain a release of claims provision (or other similar provision) in light of the guidance in the Notice relative to these types of provisions.



- Ensure that future deferred compensation arrangements contain compliant provisions and terminology (*e.g.*, “separation from service” versus “termination of employment” and “disability” versus “illness of employee”).
- Conduct an internal audit to verify administrative compliance with Section 409A and remind employees of the Section 409A rules, keeping in mind that the IRS has begun to conduct Section 409A audits.

FOR MORE INFORMATION

Please contact any member of our **Employee Benefits & Executive Compensation** or **Tax** practice group for more information.

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