

THE NONQUALIFIED ADVISOR

An Independent Resource for Plan Sponsors and Participants of Nonqualified Plans

Client News Bulletin

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Correction Program for 409A Documentary Failures

On January 5, 2010, the IRS issued Notice 2010-6 offering employers a new opportunity to correct nonqualified deferred compensation plans that do not comply with IRC Section 409A.

The IRS previously released a correction program for certain operational failures; however, until Notice 2010-6, there was no method of correcting plan document failures. This Notice represents the first and probably the last opportunity for taxpayers to correct plan document failures without incurring significant penalties.

Background

Enacted in 2004, Section 409A sets forth strict guidelines for nonqualified deferred compensation arrangements, such as defining the amounts being deferred, the time and form of payments, and the conditions under which deferrals can be made.

Failure to satisfy the requirements of Section 409A results in immediate taxation of all vested amounts under the plan and similar plans, plus an additional 20% penalty on the taxable amount, and interest calculated from the time of deferral.

General Conditions for Relief

To be eligible for documentary relief under Notice 2010-6, the taxpayer must demonstrate that all of the following conditions have been met:

- ❖ All substantially similar document failures are corrected;
- ❖ Tax returns are not be under examination;
- ❖ Failures are inadvertent and unintentional;
- ❖ Employee includes applicable deferred amounts in income, (if required);
- ❖ Employee pays all federal taxes with respect to the 409A correction, including the 20% excise tax;
- ❖ Employer satisfies specified reporting requirements

Failures Eligible for Correction

Only certain types of document failures are eligible for relief under Notice 2010-6. Plans that contain the following documentary failures are generally eligible for correction:

- 1) Impermissible definition of an otherwise permissible payment event. (e.g. defining “separation of service”, “change in control”, or “disability” improperly or using a definition that is not 409A-compliant.)
- 2) A payment period that is more than 90 days following a distributable event.
- 3) A payment period that is dependent upon the completion of an employment-related action. (e.g. signing a non-compete, non-solicitation, release of claim, or other contingency that could enable an employee to influence the timing of a payment.)

Failures Eligible for Correction (continued)

- 4) Plans with an impermissible payment event. (e.g. payment at the time the employee's child enrolls in college.)
- 5) Impermissible alternate payment schedule. (e.g. plans that have more than one time or form of payment for a single event.)
- 6) Impermissible discretion regarding payment schedules. (e.g. a provision that could enable an employer or employee to change the time or form of payment following a permissible payment event.)
- 7) Impermissible employer discretion to accelerate payments. (e.g. providing for payment regardless of whether a payment event as occurred.)
- 8) Impermissible reimbursements or in-kind benefit provisions. (e.g. reimbursement of country club dues.)
- 9) Impermissible initial deferral election provisions. (e.g. allowing a participant to elect to defer in the same year in which the respective compensation is earned.)
- 10) Failure to include a six-month delay for payments made to "specified employees" of publicly traded companies.

Clarification of Ambiguous Plan Terms

In addition to addressing the correction of plan document failures, Notice 2010-6 provided clarification to several 409A provisions.

The Notice clarified that certain ambiguous language, such as payment "as soon as practicable" following a permissible payment event, will not automatically result in a plan document failure.

The Notice also clarified that an undefined or ambiguously defined payment event may be 409A-compliant, provided that the term could reasonably be interpreted to include a permissible payment event under Section 409A. For example, "termination of employment" or "acquisition" could be interpreted to constitute separation of service under 409A.

Finally, the Notice clarified that savings clauses (i.e. plan provisions that require a term to be interpreted to comply with the requirements of 409A) are not ambiguous and are acceptable payment terms under Section 409A.

Effective Date

Taxpayers have until the end of this year to correct documentary failures. Plan document failures corrected on or before December 31, 2010 will be treated as having been corrected by December 31, 2008 deadline.

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