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IRS ADDRESSES SECTION 409A DOCUMENT CORRECTIONS

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New IRS guidance encourages review and correction of deferred compensation plans that otherwise would fail to comply with Section 409A. Notice 2010-6 provides correction methods for various types of "document" failures. Special relief is available until December 31, 2010. Even after the transition period, early correction under the procedures results in reduced (and in limited cases no) penalties.

Background

Commencing January 1, 2009, Section 409A of the Internal Revenue Code went into full effect, requiring that arrangements providing "nonqualified deferred compensation" comply with the detailed provisions of the statute and the related regulations and guidance. These requirements impact even arrangements not traditionally thought of as "deferred compensation." For example, affected arrangements include severance arrangements (including the severance terms of employment agreements), change in control agreements, supplemental retirement plans, phantom stock plans, restricted stock units, discounted stock options and multi-year bonus plans. Non-

compliance with Section 409A results in accelerated taxation of deferred compensation (regardless of whether the amounts have been paid), plus a 20% penalty tax and interest penalties.

The IRS previously issued guidance with respect to "operational failures" under deferred compensation plans. This guidance (Notice 2008-113) provided correction procedures for certain unintentional failures to administer plans in accordance with their terms (but only if the terms themselves complied with Section 409A). Notice 2010-6 (the "Notice") finally provides procedures for correcting the terms of the documents, in certain cases.

One of the stated purposes of the corrections program is to encourage taxpayers to review nonqualified deferred compensation plans and to promptly correct provisions that fail to comply with Section 409A. The program allows certain corrections that are timely made to qualify for reduced penalties (and in limited cases, no penalties).

Transition Relief

For plans eligible for correction, corrections made by December 31,

2010 will be treated as being made as of January 1, 2009. The practical effect of this provision is that for payments that have not yet been triggered, the correction can be made without penalty. For payments that have been triggered, the plan would be treated as if the document had been correct but there was an operational failure. The employer would have to follow the procedures for correcting an operational failure (by December 31, 2010). Depending on the circumstances, operational failures may result in certain penalties, which generally are less than the penalties for an uncorrected violation of Section 409A.

Certain types of corrections receive special relief if made by December 31, 2011. These include corrections of provisions in "linked" plans (which are not eligible for corrections under the Notice after December 31, 2011), and corrections of payment schedules determined by the timing of payments received by the company.

Timing of Corrections

In most cases, corrections still can be made after the transition period, but may receive less favorable treatment. In general, the rules favor early corrections. Eligible corrections made more than one year before payment is triggered generally may be made without penalty. When a correction is made within one year of payment being triggered, a percentage (usually 50%) of the deferred amount would be subject both to current taxation and the 20% penalty. Additional interest penalties would not apply, however.

Reporting Requirements

In order to correct a plan document under the rules, both the employer and the employee must report the correction on statements filed with their tax returns. The statements must include specified information regarding the nature of the documentary failure, the individuals and amounts involved and steps taken to correct the failure. Reporting is required even if the corrections are made by December 31, 2010.

Permitted Corrections

Only specified documentary issues may be corrected under the procedures. Some of the types of permitted corrections are as follows:

- Correction of impermissible definitions of "separation from

service," "change in control event" and "disability" (three of the six permitted payment events under Section 409A, if defined in accordance with the rules).

- Correction of impermissible payment periods following a permissible payment event
- Correction of certain impermissible payment events and payment schedules
- Correction of a failure to include the required six-month delay for "specified employees" of a public company
- Correction of impermissible initial deferral elections

Eligibility and Exclusions

The Notice permits correction only of inadvertent document failures. An employer or individual who is under IRS audit with respect to deferred compensation is not eligible to use the procedures in the Notice. In making a correction, an employer must correct all similar document failures. The corrections procedures do not cover the following: stock rights (such as discounted stock options), provisions designed to take advantage of the short-term deferral exception that fail to meet it, and "haircut" provisions (provisions that would accelerate payment in exchange for the employee's accepting a lesser amount).

Additional Reasons to Review Plans

The Notice also contains clarifications and other interpretive information regarding deferred compensation plans. Plan modifications may be desirable or even necessary, as some of the interpretations appear to add new parameters. For example, the Notice contains detailed provisions regarding payments conditioned on execution of a release that go beyond prior guidance. As a result, provisions designed to comply with previous guidance may now no longer be compliant.

Conclusion

Section 409A continues to evolve as the IRS releases additional guidance. The opportunity the Notice provides for corrections of document failures, particularly prior to December 31, 2010, makes it advisable to promptly revisit deferred compensation plans.

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