ALERT

IRS ESTABLISHES (AT LAST) CODE § 409A DOCUMENT CORRECTION PROGRAM FOR NONQUALIFIED DEFERRED COMPENSATION PLANS

Act Soon! – Brief Window Exists To Make Corrections With No Tax Penalties

February 19, 2010

The IRS has recently stepped up efforts to enforce Section 409A of the Internal Revenue Code (the "Code"). This is bad news for any companies that missed the January 1, 2009, IRS deadline to amend nonqualified deferred compensation plans and arrangements. It is even worse news for participants in those plans and arrangements, because the full force of any Code § 409A violations – including a 20% penalty tax – can hit participants like a ton of bricks.

Beginning in 2005, the IRS began warning companies to put their nonqualified deferred compensation plans and arrangements in writing and to make sure that what is in writing complies with Code § 409A. Many companies did not heed the warning, whether because of ignorance of the rules, confusion over the complex regulations, or for other legitimate reasons. Until now, the best those companies could hope for was that the IRS would not find about the violations of Code § 409A.

Fortunately, the IRS has found a degree of compassion. On January 5, 2010, the IRS established a document corrections program for plans and arrangements that are subject to Code § 409A (Notice 2010-6). This new program allows documents to be amended without incurring the draconian penalties that are normally triggered when Code § 409A is violated. ***For those who act before the end of 2010, complete avoidance of tax penalties on participants may be possible.***

Code § 409A has a broad reach, touching most plans or arrangements that defer the receipt of compensation from one tax year to another. This includes everything from your typical nonqualified deferred compensation plans (e.g., "top hat" plans, phantom stock plans, and excess benefit plans) to many types of severance agreements, incentive/bonus plans, retention plans, reimbursement programs, and employment agreements. (It does *not*, however, affect *qualified* retirement plans, such as 401(k) plans, or certain other types of retirement plans, such as 403(b) plans or 457(b) plans.)

To obtain the maximum benefits possible under the new corrections program, ***quick action is required.*** If you have never reviewed your plans and arrangements with Code § 409A in mind, or if your review and amendments were done prior to the issuance of final regulations in April 2007, we recommend that you immediately review any severance agreements, employment agreements, reimbursement programs, retention plans, and other deferred compensation plans and arrangements to ensure that they are in full compliance with Code § 409A. Errors that can be quickly and inexpensively corrected now may be very costly down the road.

This represents a very brief and simple summary of some very complicated rules. Because of the short time frame for completely avoiding tax penalties, ***we strongly recommend that you or someone in your organization read the attached memorandum.*** If you have questions about the IRS guidance, or if you would like us to review your nonqualified deferred compensation plans and arrangements to ensure that they are in full compliance with Code § 409A, please feel free to call Jim Spencer or Eric Namee at (316) 267-2000.

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<u>MEMORANDUM</u>

IRS ESTABLISHES (AT LAST) CODE § 409A DOCUMENT CORRECTION PROGRAM FOR NONQUALIFIED DEFERRED COMPENSATION PLANS

On January 5, 2010, the IRS finally established a document corrections program for nonqualified deferred compensation plans and arrangements that are subject to Section 409A of the Internal Revenue Code (the "Code") (*see* IRS Notice 2010-6). This new program will allow employers an opportunity to correct most legal defects in such plans without incurring many of the draconian penalties that are normally triggered when Code § 409A is violated.

For employers who use the new program before the end of 2010, *complete avoidance* of tax penalties may be possible. This latest IRS guidance comes not a moment too soon. Just weeks ago, the IRS announced its plans to launch a major audit campaign of executive compensation at businesses across the United States. If you know that your nonqualified deferred compensation plans and arrangements are not in compliance with Section 409A, or if you have a doubt, now is the time to act.

Part I of this Memorandum summarizes the general rules governing Code § 409A, including the types of plans or arrangements that are covered by this statute and the steep penalties for failing to strictly comply with all of the applicable statutory and regulatory requirements. Part II of this Memorandum summarizes the new IRS document corrections program for Code § 409A plans and arrangements, including the specific types of errors that may be corrected under the program and the special relief available only for corrections made in 2010. Part III of this Memorandum summarizes the IRS operational corrections program for Code § 409A plans and arrangements.

I. – BACKGROUND

A. – Types of Plans or Arrangements Subject to Code § 409A

Code § 409A governs many plans or arrangements for both employees and independent contractors that defer the receipt of compensation from one tax year to another. (It does not, however, govern "qualified" retirement plans, such as 401(k) plans, or certain other types of retirement plans, such as 403(b) plans or 457(b) plans.) Among the many types of plans and arrangements that are potentially subject to Code § 409A are the following:

- Excess benefit plans;
- Supplemental executive retirement plans;
- Share/stock appreciation right plans;
- "Phantom" stock plans;
- Retention plans;
- Severance agreements;
- Long-term and annual incentive plans;
- Individual employment contracts;
- Reimbursement programs;

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- Post-employment extended welfare benefits;
- Transaction-based payments;
- Consulting arrangements; and
- Director compensation.

B – Document Requirements of Code § 409A

Section 409A requires that all material terms of a nonqualified deferred compensation plan or arrangement be set forth in writing. In particular, the written document must include the following:

(1) The amount – or the method for determining the amount – of deferred compensation provided under the plan or arrangement;

(2) The events that trigger payment (such as separation from service, death, disability, or a change in control);

(3) The time and form of payment of the deferred compensation; and

(4) Provisions regarding the initial (and, if applicable, subsequent) deferral elections.

Countless traps lurk for the unwary, and the penalties for not adhering to all of these requirements are extremely severe.

C – Penalties for Violating Code § 409A

Violations of Code § 409A trigger substantial tax penalties that are imposed on *each affected participant*. The tax penalties include the following:

(1) Inclusion of all vested amounts in current income;

(2) A 20% penalty tax; and

(3) Interest at the IRS underpayment rate plus 1%.

With top tax brackets likely to increase in the very near future, a participant in a non-compliant nonqualified deferred compensation plan or arrangement could soon become one of Uncle Sam's new best friends, making "extra contributions" to the federal government's deficit reduction efforts.

There are two general types of violations of Code § 409A: document violations and operational violations. A document violation occurs when the plan document is missing something it should have or when it has something it should not have. When there is a document violation, *all* participants in that particular plan are in violation of Code § 409A. An operational violation occurs when the plan is operated in a way that violates Code § 409A. Operational violations only affect the participants whose deferred compensation was handled incorrectly.

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Importantly, there is no *de minimis* exception under Code § 409A for document violations. Nor will the employer's good faith serve as a valid basis for avoiding applicable Code § 409A sanctions. Thus, even the smallest plan document failure, which might have been adopted as a result of an innocent misinterpretation of these complex rules, can result in adverse tax consequences for all participants with deferred amounts in the plan. Because the tax consequences fall on the participants and not the employer, an employer also risks being sued by its unhappy employees who find themselves with a tax burden exponentially higher than they had ever envisioned.

II. – NEW DOCUMENT CORRECTIONS PROGRAM

Unfortunately, although the final Code § 409A regulations were issued nearly three years ago, we are aware that many nonqualified deferred compensation plans and arrangements remain out of compliance with Code § 409A. This could be the result of a variety of reasons:

- Some employers simply might not realize they are sponsoring plans and arrangements that are subject to Code § 409A;
- Some employers might have amended their plans and arrangements in light of Code § 409A, but might have misinterpreted the highly complex Code § 409A regulations or inadvertently failed to include some required provision in their plan document; and/or
- Some employers might have drafted their nonqualified deferred compensation plans and arrangements to comply with the *proposed* Code § 409A regulations (which were issued back in October 2005) but then failed to correctly update their plans and arrangements to ensure that they were in compliance with the *final* Code § 409A regulations issued in April 2007.

Fortunately, the new IRS document corrections program provides a mechanism for employers to voluntarily correct many nonqualified plans' document failures and thereby to avoid, or at least reduce, the tax penalties flowing from Code § 409A violations. Only inadvertent and unintentional failures are eligible, but that will be the case with most employers.

Please note that if an employer never established a written plan document for its nonqualified deferred compensation plan or arrangement, it does not appear at this time that such employer will be able to take advantage of the new document corrections program. Nevertheless, such employers should adopt written documents as soon as possible.

A. – Categories of Correctible Errors

The program provides multiple categories of document errors that may be corrected. These include:

- **Permissible payment events that are not defined or are ambiguous.** For instance, if an employment agreement provides three years of severance upon "termination of employment," termination of employment should be defined to comply with the "separation from service" definition under Code § 409A.
- **Payment events that are improperly defined.** For instance, "separation from service" cannot be defined to include transfers to subsidiaries.
- **A time of distribution that is improperly specified.** For instance, a severance agreement cannot provide that payment will be made "within 180 days" following separation from service, because "within 90 days" is the longest period allowed.

- **Payment events that are not permissible.** For instance, the completion of a major contract or a child going to college are not permissible payment events.

- **Different time and/or form of payment for a single payment event.** For instance, a plan or employment agreement cannot pay severance as a lump sum when the participant has an *involuntary* separation from service, if annual installments would be paid for a *voluntary* separation from service.

- **Discretion to make payments early.** For instance, if payment is supposed to be made in a lump sum in January following separation from service, the employer cannot have discretion to pay the lump sum at the time of the separation from service.

- **Discretion to change form of payment.** For instance, a plan or agreement cannot allow an employee or employer to change from a lump sum to annual installments unless the election to change occurs at least 12 months prior to the original payment date and the new payment date is at least 5 years after the original payment date.

- **Discretion to change time of payment.** For instance, a plan or agreement cannot allow an employee or employer to change the time of payment unless the election to change occurs at least 12 months prior to the original payment date and the new time of payment is at least 5 years after the original payment date.

B. – 2010 Transition Relief: Christmas All Year

The best news of all in the new document corrections program is the transition relief for corrections made in 2010. Specifically, if the sponsor of a nonqualified deferred compensation plan or arrangement uses the new program to correct document defects during 2010, then the IRS will treat the correction as if it had been made back on January 1, 2009. Since January 1, 2009, was the actual deadline for documentary compliance, no penalties will be imposed for the document violation. Please note that this does not "fix" any operational violations that may have happened during 2009 and 2010, but many of those can be taken care of through the IRS's operational correction program (see Part III below).

Unfortunately, the IRS's compassion only stretches so far. After 2010, the document corrections program will still be in place, but without the opportunity to have a retroactive effective date of January 1, 2009. Without the retroactive effective date, it will be difficult to escape from penalties under Code § 409A. Therefore, ***it is important to act now*** by reviewing and amending your plans and arrangements that are (or may be) subject to Code § 409A.

III. – OPERATIONAL CORRECTIONS PROGRAM

In addition to the *document* corrections program that the IRS issued last month, the IRS also established an *operational* corrections program for Code § 409A plans (Notice 2008-113) in December 2008. This program offers taxpayers the opportunity to correct, or at least mitigate the penalties from, operational failures in nonqualified deferred compensation plans and arrangements.

In general, Notice 2008-113 provides that certain Code § 409A penalties may be avoided altogether with respect to certain unintentional operational failures if they are corrected prior to the end of the taxable year in which the failure occurred, or in the following year. Correctable failures include:

- Early payment of an amount that should have been deferred until (i) a subsequent year or (ii) a later date within the same year;

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- Early payment of an amount in violation of the six-month delay requirement applicable to "specified employees" of public companies;

- Improper or excess deferral of a currently payable amount; and

- Grant of a discounted stock option.

The specific corrections procedures to reverse such errors are set out in detail in Notice 2008-113 and must be followed to the letter. If an eligible failure is corrected in the *same year* as its occurrence, there is no requirement that any early income be recognized by the participant, and both the 20% penalty and interest premium normally associated with a Code § 409A violation are avoided. If a correction is made in the year *following* the year of the failure, the 20% penalty is avoided, but any early payments must be included in income in the year in which they are made, and any incorrectly deferred payments must be included in income in the year in which they are actually paid. Moreover, correction during the year following the year in which the failure occurred is available only with respect to payments to individuals that are not "insiders" of the employer. (Insiders include officers, directors, and owners of more than 10% of any class of the employer's stock.)

The operational corrections program also provides limited relief for errors involving (i) amounts less than an inflation-indexed IRS limit ($16,500 for 2010), or (ii) early payments or improper deferrals not corrected within the first two taxable years as described above. Relief is available in such cases only to the extent that the applicable corrections procedures are fully complied with no later than the second taxable year following the year in which the failure occurred. However, while this limited relief does permit taxpayers to avoid the interest premium with respect to such failures, the 20% penalty under Code § 409A is not avoided.

IV. – CONCLUSION

This memorandum represents a very brief summary of some very complicated statutory and regulatory provisions. If you think that you may have nonqualified deferred compensation plans or arrangements that are not fully compliant with Code § 409A, it is important that you come into compliance as quickly as possible in order to stave off substantial penalties and other possible litigation. If you have any questions about any of these developments or would like to discuss this topic in further detail, please feel free to call Jim Spencer or Eric Namee at (316) 267-2000.

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