

409A CORRECTION GUIDANCE ON PLAN DOCUMENT FAILURES

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A window of opportunity has opened. The IRS has issued guidance relating to correcting plan document failures under Section 409A of the Internal Revenue Code. That guidance includes transition relief for employers who take certain actions on or prior to December 31, 2010, and for certain other actions taken on or before December 31, 2011. Therefore, now may be the time to review 409A plans.

Section 409A has been with us since 2004 and has established a new regime in nonqualified deferred compensation ("NQDC") plans. Section 409A imposes general requirements that relate to: (1) The initial deferral election, (2) The timing of payments, (3) Acceleration of payments, and (4) Later deferral elections. Each of these requirements must be spelled out in the plan document, and the plan must be operated in accordance with them.

Taxation costs for noncompliance with Section 409A are high. If at any time during a taxable year a NQDC plan fails to meet the requirements of Section 409A, or is not operated in accordance with those requirements, all amounts deferred under the plan for the taxable year and all preceding tax years, by any participant with respect to whom the failure relates, are includable in gross income for the taxable year to the extent they are not subject to a substantial risk of forfeiture and not previously included in gross income. Interest is also imposed on that income at a rate of 1 percentage point higher than the interest rate on tax under payments. On top of that, a 20% penalty is imposed.

In 2008, the IRS issued guidance on correcting specified operational failures in NQDC plans (Notice 2008-113), and now the IRS has issued guidance on correcting document failures in NQDC plans (Notice 2010-6).

The document correction program is intended to encourage tax payers to review NQDC plans to identify provisions that fail to comply, and to

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correct those plan provisions promptly. Accordingly, the document failure correction notice provides:

- Clarification that certain language commonly included in NQDC plan documents (for example, “as soon as practicable,” or an ambiguous definition of a payment event) will not cause a document failure.
- Correction of impermissible definitions of otherwise permissible payment events (for example, “separation from service,” “change in control,” or “disability”).
- Correction of impermissible payment periods following a permissible payment event (for example, payment periods longer than 90 days following a permissible payment event, payments following the completion of certain employment related actions).
- Correction of impermissible payment events and payment schedules.
- Correction of failure to include 6-month delay of payment for specified employees (applicable to publicly traded companies).
- Correction of provisions providing for impermissible initial deferral elections.
- Corrections made within a limited time period after an employer’s initial adoption of a plan.
- Transition relief for certain corrections made by December 31, 2010.
- Transition relief for certain corrections made before December 31, 2011.

Special note should be taken of the fact that there is special transition relief provided for corrections made on or before December 31, 2010. If a NQDC plan violates Section 409A in a manner that is eligible for correction under this Notice, and the plan is corrected in accordance with the Notice on or before December 31, 2010, the plan can be treated as having been corrected on January 1, 2009. This relief is conditional on correcting any operational failures by December 31, 2010. Correction of the operational failure would need to be done in compliance with the 2008 Notice dealing with the correction of specified operational failures.

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Document failure correction relief is generally not available to service providers and certain service recipients who are under examination by the IRS. However, even then, document failure correction relief is still available for corrections made on or before December 31, 2011 if the particular failure has not yet been specifically identified by the IRS. Also operational correction relief in certain circumstances is more limited if the affected service provider is an “insider” (director, officer or 10% owner).

The availability of transition relief should motivate employers to review their NQDC plans if there is any chance that the correction guidance may be utilized.

If you would like assistance in this area, please contact Newton Kershaw (nkershaw@devinemillimet.com) 603-695-8571, or Patricia McGrath (pmcgrath@devinemillimet.com) 603-695-8537.

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