



Executive Compensation Law Alert

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IRS Offers Ability to Amend Nonqualified Deferred Compensation Plans Without Penalty

The IRS recently gave employers a unique opportunity to correct tax-compliance defects with many executive compensation programs. The IRS issued Notice 2010-6 ("the Notice"), which allows employers to fix limited errors involving Internal Revenue Code Section 409A by December 31, 2011. Most plan documents, however, need to be amended by December 31, 2010. Amending NQDC plans by this deadline could allow employees to avoid immediate taxation on amounts deferred and additional penalty taxes. Employers may amend plan documents after this deadline, but employees may have to include up to 50 percent of the amount deferred under the plan in income and pay an additional 20 percent penalty tax on such amount. This alert summarizes the key points of the corrections program.

I. Background

Section 409A places strict requirements on NQDC plans. These restrictions generally affect both the timing of deferral elections and the timing of payments under an NQDC plan. Further, Section 409A applies to a broad scope of arrangements, including those not typically considered to be NQDC plans, such as employment agreements, change in control agreements, bonus plans, and equity compensation plans. Failure to satisfy Section 409A's deferral timing and payment timing rules results in immediate taxation of the amounts deferred (even if not yet payable to the employee), an additional 20 percent penalty tax on such amounts, plus an interest charge.

II. Eligibility

To be eligible for relief, the Notice requires that several requirements be met, including:

- A. Both the employer and the affected employees report the use of the document correction program on a statement to be included with their tax returns.
- B. Commercially reasonable steps have been taken to identify and correct substantially similar errors in other plan documents, even if those documents affect different employees.
- C. Neither the employee nor the employer may be under examination by the IRS with respect to nonqualified deferred compensation.

- D. The errors must not be intentional and must not relate to listed transactions under Treasury Regulation Section 1.6011-4(b)(2) (which describe abusive tax-avoidance transactions).

III. Errors and Other Issues Employers May Correct Under the Notice

The Notice generally allows employers to amend plans that have the following issues:

- A. *Ambiguous Plan Terms.* The Notice allows employers to amend plan terms that could be interpreted in both a compliant and non-compliant manner with Section 409A (e.g., "termination of employment" rather than "separation from service"). The Notice approves use of a savings clause or catch-all for such purposes, provided it is drafted properly.
- B. *Impermissible Distribution Provisions.* This relief applies to a number of different areas, including:
1. Impermissible definitions of otherwise permitted payment events (e.g., defining a change of control event to include an initial public offering).
 2. Impermissible payment periods following a permitted payment event (e.g., providing for payment period that could exceed more than 90 days after a payment event).
 3. Non-compliant payment events or non-compliant payment schedules (e.g., applying a lump sum payment to an involuntary separation from service but installments to a voluntary separation from service).
 4. Correction of failure to delay severance payments for six months after separation from service for key employees of public companies.
- C. *Impermissible Initial Deferral Elections.* For example, this relief would apply to a plan that allows an employee to make a deferral election on or after January 1st of a year with respect to compensation earned for services provided during that year.
- D. *Grace Period After Initial Adoption of a Plan.* If a 409A-compliance issue is caught after the initial adoption of a plan, the Notice allows the document to be corrected by the later of (1) December 31st of the calendar year in which the legally binding right to deferred compensation arose or (2) the 15th day of the 3rd calendar month after such date.

In many cases, corrections of such errors will allow the employee to avoid current income taxation of amounts deferred as well as the 20 percent penalty and additional interest charge. Both employers and employees need to be careful, however, because several situations could still arise in which the employee must include up to 50 percent of the amount deferred in current income, even if the plan document has been corrected and even if those amounts are not yet payable. Employees also would be required to pay the 20 percent penalty tax on such amounts, but no interest charge. These situations will not arise, however, if employers correct their plan documents by December 31, 2010. As such, it is important that precise attention is paid to the correction procedures, and that employers act quickly to amend their plans.

IV. Action Items

To take advantage of the relief provided in the Notice, employers should take the following actions:

- A. Review all potential nonqualified deferred compensation arrangements promptly to determine whether they are subject to Section 409A.
- B. Determine whether applicable arrangements are compliant with Section 409A or need to be amended.
- C. Amend any non-compliant arrangements by December 31, 2010.