03.01.2010

THE TAX GROUP
at Brownstein Hyatt Farber Schreck

Second Chance to Correct Deferred Compensation Failures

The Internal Revenue Service ("IRS") has issued Notice 2010-6 ("Notice"), providing long-awaited guidance that establishes a document correction program for deferred compensation arrangements under Section 409A of the Internal Revenue Code ("Section 409A").[1] To take advantage of this program immediately, skip to our 2010 Action Plan.

Nonqualified deferred compensation agreements, plans and arrangements ("NQDC plans") have been required to be in full compliance with the requirements of Section 409A and its extensive related regulations since January 1, 2009. Section 409A requires compliance both in the written form of a NQDC plan as well as its operation. Previously, the IRS introduced a correction program solely for operational failures.[2] Now, employers[3] and employees[4] have a meaningful opportunity to correct—in some cases, retroactively—the terms of compensatory arrangements that unintentionally violate the document requirements of Section 409A and to avoid significant penalties.

This correction program provides employers and employees with another opportunity to reform agreements and arrangements that were previously not identified as subject to Section 409A. Commonly missed documents that should now be reformed include employment agreements, severance arrangements and bonus plans. This document correction program also should be used to adjust previously-identified Section 409A arrangements for full compliance and to reflect the past five years' experience with Section 409A issues. Our action plan for identifying these lurking problems is included in this alert.

Required Written Provisions

Section 409A requires all material terms of a NQDC plan to be set forth in one or more written documents. Material terms include:

1) the amount of deferred compensation provided under the plan (or the formula for determining the amount);
2) the time and manner of payment of the deferred compensation;
3) terms of initial and subsequent deferral elections (if applicable);
4) terms for the permissible acceleration of payment (if applicable); and

[1] See IRS Notice 2010-6.
[2] Notice 2008-113 regarding relief and guidance for the correction of certain operational failures of NQDC plans.
[3] Section 409A applies to any "service recipient," which is the person or entity for whom the services are performed and with respect to whom the legally binding right to compensation arises, and all persons with whom such person would be considered a single employer under Code Section 414(b) or 414(c).
[4] Section 409A applies to "service recipients," which includes employees, contingent workers (such as leased and temporary employees) and independent contractors.

Notice: This is an advertisement

5) imposition of a six-month payment delay for payment upon separation from service to any "specified employee" of a publicly-traded employer.

NQDC plans lacking the required terms in writing, or containing written terms that do not comply with Section 409A requirements, are deemed to violate Section 409A. No materiality threshold nor intent requirement applies, so a minor or unintentional document failure can result in a violation of Section 409A with substantial monetary penalties for an employee and potential liability for the employer.

Cost of Noncompliance

The failure to comply with, or be exempt from, Section 409A results in adverse tax consequences for each employee participating in an NQDC plan. The employee's vested "deferred compensation" (even if it is not yet distributable under the plan's terms) is subject to current federal income taxation plus premium interest. The tax rate is equal to the employee's current marginal federal income tax rate plus an additional 20%. The premium interest amount is calculated from the date of the original deferral or vesting to the date the tax is paid. There are aggregation rules that could result in all deferred amounts of a single individual under multiple arrangements being subject to the tax even where only one NQDC plan is noncompliant.[5]

The employer may also be subject to penalties if it fails to timely withhold taxes or report the income, even if the requirement is triggered retroactively as a result of noncompliance with Section 409A.

Timing of Document Correction

Corrections under the Notice generally require an employee to include a portion of his deferred compensation in income in the year of correction or, in the case of payment events that occur within one year of correction, in the year following the year of correction, and to pay the Section 409A 20% additional tax. However, there is a great advantage if eligible plan document failures are corrected by December 31, 2010: these failures can be treated as having been corrected on January 1, 2009, thereby permitting employees to substantially limit the inclusion of deferred amounts in income and the additional taxes that might otherwise apply.

Certain operational corrections also may need to be completed in tandem with the document correction to obtain full relief. For example, payments made on or before December 31, 2010 that would not have been made under the corrected provision, and payments made after December 31, 2010 that would have been made under the corrected provision, must be treated as operational failures and corrected under the operational corrections program of Notice 2008 113 by that date. However, any payments made according to the pre-corrected provision or not made according to the corrected provision must be treated as operational failures and corrected under the operational corrections program of Notice 2008-113.

---

[5] A "plan" for purposes of Section 409A is any deferred compensation arrangement between a service recipient and a service provider. All plans of the same type are aggregated into one of the following nine categories: (1) Account balance plans (nonelective deferrals), (2) account balance plans (elective deferrals), (3) nonaccount balance plans, (4) involuntary separation or window program payments, (5) plans that reimburse expenses or provide in-kind benefits, (6) certain foreign plans, (7) stock rights (other than those exempt), (8) split dollar life insurance arrangements and (9) all other plans subject to Section 409A.

Notice: This is an advertisement

General Correction Principles

Similar to other IRS correction programs, the Notice specifies general correction principles that apply to correction and eligibility for correction under the program:

- The program applies only to unintentional and inadvertent document errors.
- The employer must take commercially reasonable steps to identify and correct all other NQDC plans that have similar document failures.
- Relief under the program is generally not available if, for a year in which the plan document failure exists, the employer's or employee's federal tax return is under examination by the IRS or if the examination specifically cites the NQDC plan as an issue under consideration in the examination. If correction is made before December 31, 2011, however, a non-individual service recipient will not be considered under examination unless the 409A failure has been specifically identified.
- Payment of all taxes, as determined according to the correction method used, is required. The correction method may permit inclusion of a limited percentage—usually 50%, but in some cases a lesser percentage—of the total deferred compensation subject to the failure, and may limit application of the additional 20% tax to that includible amount.
- The employer and employee must each fulfill specified reporting obligations for the correction to be complete. In most cases, this requires a detailed statement of the error and corrective action to be filed with the employer's federal tax return and a notice to be provided to each affected employee, which the employees must then file with their individual income tax returns.

Types of Errors Eligible for Correction

The program specifies the plan document errors that may be corrected, which include the following categories of errors, discussed in more detail below:

- Ambiguous plan terms
- Impermissible payment periods following a permissible payment event
- Faulty definitions of permissible payment events
- Impermissible payment events and payment schedules
- Failure to include six-month delay of payment for "specified employees"
- Impermissible initial and subsequent deferral elections

Ambiguous Plan Terms

Many NQDC plans still state that payment will be made "as soon as reasonably practicable" after a triggering event or on "termination of employment" rather than the Section 409A-sanctioned "separation from service." These ambiguities may now be corrected without adverse consequence to employees. In some cases, correction may not be required if the payment operationally complies with Section 409A. In our experience, however, use of these terms indicates that a NQDC plan may not have been reviewed for compliance with Section 409A and that more significant document issues may need to be addressed.

Notice: This is an advertisement

Faulty Definitions of Permissible Payment Events

Most of the permissible payment events are specifically defined under Section 409A. Permissible payment events under Section 409A are limited to the following:

- Separation from service
- Death
- Disability
- Financial hardship of employee
- Change in control
- A specified date

A faulty definition of a permissible payment event should be replaced with a Section 409A-compliant definition, which in some cases will require word-for-word inclusion of the 409A definition. A plan's failure to properly reflect a definition prescribed by Section 409A, even if compliance is intended, could result in noncompliance. The correction program permits employers to amend incorrect definitions of certain payment events, including separation from service, change in control and disability.

It is important to correct faulty definitions of permissible payment events without delay. If payment would have been triggered under the pre-correction plan terms due to either a separation from service or a change in control (as defined by the pre-correction plan terms) within the one-year period following correction, the affected employee would be subject to income inclusion of a portion of the amount deferred under the plan and additional taxes. If payment is not triggered under the pre-correction terms within the one-year period following correction, the affected employee will not be subject to any income inclusion or additional taxes.

Impermissible Payment Periods Following Permissible Payment Events

Section 409A restricts the payment periods in which employers may make or commence payments following the occurrence of a permissible payment event. The Notice permits employers to correct plan provisions that provide for either:

- Payments to be made or commenced in periods longer than 90 days following a permissible payment event or that permit an employee to choose the taxable year of payment, or
- Payment periods following permissible payment events that are dependent upon certain employee actions, such as execution of a release of claims or non-competition agreement.

Plans containing these payment terms may be amended to comply with Section 409A prior to the payment event with no adverse tax consequences to employees so long as no change is made to the time or form of payment. If correction occurs after the payment event, affected employees will be subject to income inclusion of a portion of the amount deferred under the plan, the additional 20% tax and premium interest tax.

Impermissible Payment Events and Payment Schedules

The correction program also permits relief for NQDC plans containing other impermissible payment events or noncompliant payment schedules. Specifically, the correction program addresses the following types of impermissible payment events or payment schedules:

- Plans that include both Section 409A-compliant payment events and noncompliant payment events;
- Plans that do not include any Section 409A-compliant payment events;

Notice: This is an advertisement

- Plans that permit multiple forms of payment upon the occurrence of a single payment event (such as installment payments upon voluntary termination of employment, but lump sum upon involuntary termination of employment);
- Plans that permit an employer or employee to change the time or form of payment following the occurrence of a permissible payment event, including impermissible subsequent deferral elections (such as a provision permitting an employee to select the year of payment following a triggering event);
- Plans that permit employer discretion to accelerate payment events (such as payment of a lump sum); and
- Impermissible reimbursement or in-kind benefit programs (such as an aggregate multi-year limit on reimbursement of relocation expenses).

Generally, plans may be amended to remove such impermissible payment events prior to the occurrence of any such event and, where necessary, include specific payment triggers required under the correction program. Plans with problematic payment schedules generally can be amended to comply with Section 409A by removing the ability of an employer or employee to alter the timing and form of payment.

Employees may still face income inclusion of a portion of the amount deferred under the plan and the additional 20% tax following amendment of a NQDC plan if an impermissible payment that was deleted pursuant to the correction occurs within one year after the correction.

Six-Month Delay of Payment for Specified Employees

Section 409A requires plans sponsored by publicly-traded companies (including their affiliates) to impose a six-month delay of payments to “specified employees” on account of their separation from service. An NQDC plan may now be corrected prior to a specified employee’s separation from service to add the six-month delay provision, but the correction requires that the plan delay payments to the date that is the later of (1) 18 months following the date of correction or (2) six months following the date of the payment event. If a specified employee then incurs a separation from service within one year of the correction, the affected employee would be subject to income inclusion of a portion of the amount deferred under the plan and the 20% additional tax in the year of separation.

Impermissible Initial Deferral Elections

NQDC plans that, by their terms, allow employees to make impermissible initial deferral elections may also be corrected. An impermissible deferral election feature that has not been applied by an employer or employee may be corrected without any penalties assessed to employees. Impermissible deferral elections that have already been implemented also may be corrected no later than the end of an employee’s second taxable year following the year in which the election applied by amending the plan document and following the operational correction procedures under Notice 2008-113. These correction procedures may involve including amounts previously deferred in an employee’s income and sometimes the imposition of additional taxes.

Additional Errors Eligible for Correction

Notice 2010-6 also permits employers who adopt new types of NQDC plans to correct errors. Employers considering using this correction program will need to review any existing NQDC plans, and may be required to treat any amounts paid under a noncompliant plan term as operation failures and follow the applicable operational correction procedures in Notice 2008-113.

Notice: This is an advertisement

2010 Action Plan

As a result of the more favorable relief available for plan document errors corrected in 2010, we recommend that employers take the following actions as soon as they can:

1) Identify the arrangements that provide for a deferral of compensation.

   It is best not to make assumptions regarding the types of plans that are subject to Section 409A. Many arrangements are considered to result in the earning of compensation in one year, while payment is promised in a later year, thus likely resulting in a deferral. Compensatory arrangements that should be reviewed as potential candidates for correction include the following:

   - Employment Arrangements: Offer letters, employment agreements, consulting agreements, annual bonus programs, long-term incentive programs and non-compete provisions.
   - Separation Pay: Severance plans, termination pay provisions in agreements, retention agreements, change-of-control agreements; post-termination expense reimbursement arrangements (for moving, outplacement, in-kind benefits) of long duration (generally lasting longer than the second tax year following separation from service).
   - Traditional NQDC Plans: Deferred compensation plans for employees and directors, SERPs, excess benefit plans, and 457(f) arrangements (for state and local governments, tax-exempt entities).
   - Equity-Based Plans: Stock options and stock appreciation rights are not eligible for document correction (but may be eligible for operational correction), while other equity-based programs, such as those offering restricted stock units, dividend equivalent rights and phantom stock qualify.
   - Other Programs: Split-dollar life insurance, post-retirement benefits, tax gross-up provisions, tax equalization agreements, and fringe benefits, perquisite arrangements and certain welfare benefit arrangements of long duration.

   Employers should consider any NQDC plan covering a single individual in their review as well.

2) Review these arrangements to determine if there are any document failures that can be corrected under Notice 2010-6. As Section 409A compliance can be a bit tricky, we recommend that you have someone expert with Section 409A perform this review.

3) Adopt amendments to plans that have ambiguous terms or terms that violate Section 409A, including time and form of payment terms. Also, plans should be amended to include or revise their "savings" clauses to provide that the plan must be interpreted to comply with the requirements of Section 409A.[6]

4) Determine whether simultaneous or resulting operational corrections are necessary. Make these operational corrections in accordance with Notice 2008-113.

5) Prepare and attach the required statement of correction to the employer's federal tax return for the year of correction. Provide the required notice of the correction to affected employees. We

---

[6] Review current NQDC plan terms to determine whether these amendments may require obtaining employee consent.

Notice: This is an advertisement

recommend that the notice, which is provided to employees, also be accompanied by a simple, general explanation of the error, its correction, the actions the employee must take and the consequences if an employee fails to act.

6) Monitor time of payments (or would-be payments) under original terms of corrected plans. If necessary, report applicable percentage of income for inclusion and penalty under Section 409A.[7]

The following Brownstein attorneys are ready to help you with your deferred compensation issues, so please contact any one of them with your questions:

Irene F. Gallagher	303-223-1124	igallagher@bhfs.com
Nancy A. Strelau	303-223-1151	nstrelau@bhfs.com
Andrew S. Brignone	702-464-7006	abrignone@bhfs.com
Adam P. Segal	702-464-7001	asegal@bhfs.com
Jason S. Jeskey	702-464-7037	jjeskey@bhfs.com
Cara S. Elias	303-223-1141	celias@bhfs.com
Xanna R. Hardman	702-464-7016	xhardman@bhfs.com

This document is intended to provide you with general information about correcting deferred compensation arrangements. The contents of this document are not intended to provide specific legal advice. If you have any questions about the contents of this document or if you need legal advice as to an issue, please contact the attorney listed below or your regular Brownstein Hyatt Farber Schreck, LLP attorney. This communication may be considered advertising in some jurisdictions.

Albuquerque Office	Denver Office	Las Vegas Office	Santa Barbara Office	Washington, DC Office
201 Third Street NW Suite 1700 Albuquerque, NM 87102 T 505.244.0770	410 Seventeenth Street Suite 2200 Denver, CO 80202 T 303.223.1100	100 City Parkway Suite 1600 Las Vegas, NV 89106 T 702.382.2101	21 East Carrillo Street Santa Barbara, CA 93101 T 805.963.7000	1350 I Street, NW Suite 510 Washington, DC 20005 T 202.296.7353
Timothy R. Van Valen	**Gregory W. Berger** **Cara S. Elias** **Andrew C. Elliott** **Irene F. Gallagher** **Neil M. Goff** **Marybeth K. Jones** **Nancy A. Strelau**	**Andrew S. Brignone** **Xanna R. Hardman** **Jason S. Jeskey** **Adam P. Segal**	**Steven Jung** **Michelle Lee Pickett** **Christine E. Ray** **George G. Short**	**Michael B. Levy**

©2010 Brownstein Hyatt Farber Schreck, LLP. All Rights Reserved.

[7] See "General Correction Principles," above.

Notice: This is an advertisement