Cooley

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Earlier this year the IRS issued Notice 2010-6, which provides formal guidance for correction of Internal Revenue Code Section 409A plan document errors. Generally, the earlier that the plan document error is corrected under the terms of the Notice, the more likely that adverse Section 409A tax consequences can be mitigated or avoided altogether. In addition, the Notice provides transition relief for certain Section 409A plan document errors that are corrected by December 31, 2010. For many Section 409A plan document errors, the guidance under the Notice effectively extends to December 31, 2010 the original Section 409A documentary compliance deadline of December 31, 2008 mentioned in our prior *Cooley Alert*. As a result, employers should take steps now to review their compensation arrangements that are subject to Section 409A for compliance with its documentary requirements and take any necessary corrective actions. Adverse tax consequences under Section 409A may include premature taxation, an additional 20% federal income tax (and possibly an additional state tax equivalent, as is the case in California), and an interest-charge tax. As mentioned in our prior *Cooley Alert*, IRS audits that cover compliance with Section 409A seem a near term certainty.[1]

Arrangements subject to Section 409A

As discussed in our prior *Cooley Alerts*, the broad categories of arrangements (those entered into on or after January 1, 2005, and in some cases prior to that date due to limited "grandfathering") that may be subject to Section 409A include:

- Certain stock rights (e.g., deferred compensation settled in shares, restricted stock units, phantom stock, discounted stock options and discounted stock appreciation rights).
- Separation pay arrangements (plans and individual agreements providing severance benefits, including those payable upon or after a change in control).
- Account balance plans (deferred compensation arrangements expressed in the form of individual account balances, including supplemental executive retirement plans utilizing individual account balances).
- Non-account balance plans (individual arrangements and supplemental executive retirement plans expressing a benefit in terms of a defined benefit formula).
- Reimbursement plans (plans and individual agreements providing for taxable expense reimbursements).
- Bonus plans, including "carve-out" plans.

Fixing Section 409A document errors under the notice

To be eligible for correction under the Notice, the plan document error must be unintentional, inadvertent, and the employer must identify and also correct any other arrangement that has a similar plan document error. Therefore, ensuring proper correction will require an audit of all the employer's compensation arrangements to make certain that they do not contain any similar errors that require correction. In most cases, correction will require filing notifications of correction with the IRS. The types of document errors that are eligible for correction include impermissible payout triggers and payout schedules, violations of deferral election rules, impermissible discretion to delay payments, and impermissible discretion to accelerate payments. Discounted stock options and discounted stock appreciation rights are not eligible for correction under the Notice.[2]

The Notice makes it clear that the IRS does not view all Section 409A plan document errors as equally malevolent and deserving of Section 409A adverse tax consequences. Depending upon the specific type of plan document error, there is a broad range of steps required for correction, each with different tax consequences under Section 409A (including some with no adverse tax consequences). For example, for plan documents that contain certain terms that are ambiguous in their meaning, as long as the plan document is operated in compliance with Section 409A, the employer is not required to take any corrective action to avoid adverse tax consequences. In contrast, for plan documents that contain payout triggers that are clearly impermissible payout events under Section 409A, an immediate Section 409A tax will apply to 50% of the deferred amount at the time action is taken to correct the plan document error, even if the payout event may not occur until several years later. For most plan document errors, if the plan document is corrected prior to payment, and no payments under the plan are actually triggered within the one year period following the date of correction, no Section 409A taxes will apply. However, for most plan document corrections, if payments are triggered within the one year

period following the date of correction, 50% of the deferred amount will be subject to Section 409A taxes.

In many cases, an employer will not know in advance whether a payout event will be triggered within the one year period following the date of correction of a plan document error. Therefore, even if a plan document error is corrected prior to payout, in many cases it will be unclear at the time of correction whether Section 409A taxes will apply. Payout trigger timing may depend upon subsequent events that are outside both the employer's and the employee's control, or the timing of such events may be driven by business considerations that are more significant than potential Section 409A taxes on the deferred amounts. Therefore, it is important for employers to take advantage of the transition relief available under the Notice for plan document errors that are corrected by December 31, 2010. Any plan document error that is corrected by that date will be treated as retroactively corrected effective on January 1, 2009, so that even if a payout event occurs within the first year following the date the corrective steps are taken, no Section 409A taxes will apply.

Examples

Assume that a severance agreement provides for $200,000 in cash severance benefits that are subject to Section 409A and paid out in a single lump sum upon an involuntary termination and in 12 monthly installments upon any other termination or resignation. This would be an impermissible alternative payout schedule. Further assume that a separation from service occurs on June 15, 2011. If the severance agreement is amended and corrected by December 31, 2010 to provide that in all cases severance benefits will be paid in a single lump sum, no adverse Section 409A tax consequences will apply. However, if the agreement is corrected on January 15, 2011, 50% of the cash severance benefits ($100,000) are subject to Section 409A taxes because the payment event occurred within one year following the date of document correction. If the agreement is not corrected prior to June 15, 2011, 100% of the severance benefits are subject to Section 409A taxes.

Assume that an agreement provides for a $100,000 bonus payment upon the compensation committee's determination of achievement of certain corporate performance goals. The bonus, if earned, will be paid out in 12 monthly installments following the attainment of such goals, unless the employer otherwise determines in its sole discretion to pay out the bonus in a single lump sum, which is impermissible discretion to accelerate the timing of payment. Further assume that the compensation committee determines that the applicable performance goals are met on January 18, 2011. If the bonus agreement is amended and corrected by December 31, 2010 to remove the employer's discretion to accelerate the payment in a lump sum, no adverse Section 409A tax consequences will apply. However, if the agreement is corrected on January 5, 2011, 50% of the bonus ($100,000) is subject to Section 409A taxes because the payment event occurred within one year following the date of document correction. If the agreement is not corrected prior to January 18, 2011, 100% of the bonus is subject to Section 409A taxes.

Recommended next steps

Due to the complexity of the final Section 409A regulations and the extent of informal guidance from IRS officials that followed their issuance, even if an employer may have previously performed an initial Section 409A compliance audit, performing an additional Section 409A compliance audit during 2010 may uncover document compliance errors that were not previously identified and may be corrected by December 31, 2010 without adverse tax consequences. Because it is unlikely that any further Section 409A documentary compliance relief will be forthcoming, employers should not anticipate that there will be further extensions of the Section 409A documentary compliance deadline and, therefore, should consider a comprehensive Section 409A documentary compliance audit of their compensation arrangements during 2010.

The Compensation & Benefits Group is prepared to help you to identify arrangements that are subject to Section 409A, bring them into documentary compliance with its requirements, and make use of available Section 409A correction procedures. If you would like our assistance, please contact one of the attorneys listed above.

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Notes

1 See, *e.g.,* BNA Pension & Benefits Daily on October 23, 2009 *"IRS Official Tells of Future Random Audits On Fringe Benefits, Executive Compensation."*

2 Discounted stock options and discounted stock appreciation rights may be eligible for correction under the operational error corrections guidance in Notice 2008-113.

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