

October 13, 2010

Earlier this year, the IRS issued Notice 2010-6, which provides formal guidance for correction of Internal Revenue Code Section 409A plan document errors and transition relief from adverse tax consequences if such errors are corrected by December 31, 2010. See our prior [Cooley Alert](#). For most plan document corrections that are not implemented until after December 31, 2010, the Notice provides that if payments are triggered within the one year period following the date of correction, 50% of the deferred amount will be subject to adverse Section 409A taxes. However, under the transition relief, any plan document error that is corrected on or before December 31, 2010 will be treated as retroactively corrected effective on January 1, 2009, so that no Section 409A tax consequences will apply with respect to such error, regardless of the timing of subsequent payment triggering events.

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. Waiting until after the December 31, 2010 transition relief expires to correct certain Section 409A document errors thus may result in adverse tax consequences that could have been avoided by taking earlier corrective action.

In order to allow sufficient time to address correction of any 409A document errors before the transition relief expires, employers should now take the following steps:

- Review and revise plan documents.
- Obtain any necessary consents from service providers to document amendments.
- Take Board of Directors or Compensation Committee action to adopt any necessary document amendments no later than December 31, 2010.

Common Section 409A document errors

Some common Section 409A plan document errors that we continue to encounter include the following:

- Impermissible discretion to elect to accelerate or delay the scheduled timing for payment of benefits (e.g., scheduled ongoing benefit payments may instead be accelerated and paid in a lump sum at the employer's discretion).
- No deadline or insufficiently restrictive deadline requirements for return of a release of claims following a payment trigger event as a condition of receiving benefits (i.e., the service provider may effectively elect the taxable year of the benefit payments by controlling the timing of delivery of an effective release of claims).
- Ambiguous provisions governing payment form and timing in relation to occurrence of a payment event (e.g., "employee will be paid one year annual salary in the event of termination of employment").
- Definition of separation from service as a payment trigger that does not conform to Section 409A requirements (e.g., severance pay benefits are triggered even if the individual continues to provide substantial consulting services to the employer after termination of employment).
- Failure to include a mandatory six-month delay provision in employment and severance agreements providing for non-exempt severance benefits to specified employees (e.g., highly paid officers) of publicly traded entities.
- Definitions of change of control in bonus plans that do not conform to Section 409A requirements (e.g., include an initial public offering as a "change of control" event that will trigger bonus payments) where other possible Section 409A exemptions are not

available (e.g., short-term deferral exemption not available due to lack of substantial services requirement).

- Expense reimbursement provisions with a maximum cap that covers moving expenses or other taxable expenses that may be incurred during more than one taxable year (e.g., the maximum moving expenses that may be reimbursable for one taxable year are limited by the amount of moving expenses incurred during a prior year because the maximum cap applies to expenses incurred during both years).
- Alternative payments schedules for the same payment event that do not comply with Section 409A requirements (e.g., severance payments will be made in installments if a termination is due to resignation, but will be made in a single lump sum if due to an involuntary termination).

Two examples of Section 409A plan document errors

Example 1 (severance agreement):

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. Section 409A does not permit such alternative payout schedules. Further assume that a separation from service occurs on June 15, 2011. If the severance benefit 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 adverse Section 409A tax consequences 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 adverse Section 409A tax consequences.

Example 2 (bonus arrangement):

Assume that an agreement provides for a \$100,000 bonus payment upon the Compensation Committee's determination of achievement of certain corporate performance goals, with the bonus to be paid out in 24 monthly installments following the attainment of such goals, unless the Committee otherwise determines, in its sole discretion, to pay out the bonus in a single lump sum. Section 409A does not permit such 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 Committee's discretion to accelerate the payment as 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 (\$50,000) is subject to adverse Section 409A tax consequences 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 adverse Section 409A tax consequences.

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.

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 previously may have conducted an initial Section 409A compliance audit, conducting 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 additional Section 409A documentary compliance relief will be granted, 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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