

Year-End Opportunities to Correct Section 409A Violations and Avoid Potentially Severe Penalties

The combination of Section 409A's complexity and the broad range of compensation arrangements to which it applies has made it all too easy for an employer to end up with Section 409A compliance problems, even when careful attention has been paid to plan drafting and administration. To help manage this risk, employers can take advantage of a number of possible opportunities to self-correct Section 409A violations and avoid potentially severe penalties. Because some of these opportunities are available only if violations are identified and corrected by the end of 2010, undertaking a year-end self-audit of Section 409A-covered plans and agreements can be a useful strategy for minimizing Section 409A compliance risk. Discussed below are available alternatives for correcting various Section 409A violations by the end of 2010 without incurring penalties.

A. Correction of Specified Violations by Year-End 2010 Under IRS Document Correction Program

In Notice 2010-6, the Internal Revenue Service (IRS) established a Section 409A document correction program (the Document Correction Program) that allows self-correction of specified Section 409A "document failures" (i.e., plan or agreement terms that do not comply with Section 409A). In general, the Document Correction Program provides for reduced Section 409A income inclusions and related penalty taxes for document failures that are corrected in accordance with the program.

Pursuant to a transition rule that expires at the end of 2010 (the 2010 Transition Rule), specified document failures may be corrected without any Section 409A income inclusion being required or related penalty taxes being imposed. The document failures for which correction may be made under the 2010 Transition Relief include the following:

- Failing to include, when required, six-month payment delay provisions for specified employees;
- Including impermissible definitions of "separation from service" or "change in control";

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US Treasury Circular 230 Notice

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- Providing a payment period of longer than 90 days following a permissible payment event;
- Including impermissible payment events or alternative payment schedules;
- Providing impermissible discretion to change the time or form of payment; and
- Including impermissible reimbursements or in-kind benefit provisions.

In order to take advantage of the 2010 Transition Relief, a document failure must be corrected by December 31, 2010. In addition, relief is conditioned upon the employer taking steps to identify, and correct, all of the employer's other Section 409A arrangements that have "substantially similar" Section 409A document failures.

B. Correction of Document Failures for New Plans

The Document Correction Program provides special relief for the correction of document failures in new plans (the New Plan Correction Rule). In order to take advantage of the New Plan Correction Rule, the document failure must be corrected by the later of (i) December 31 of the year in which a legally binding right to deferred compensation first arose under the plan; or (ii) the 15th day of the third calendar month following the date on which a legally binding right first arose under the plan. If correction is made within the requisite period, document failures can be corrected without any Section 409A income inclusion or related penalty taxes being imposed. Whether a plan qualifies as a "new plan" under the New Plan Correction Rule is determined by aggregating all plans or arrangements that would be required to be aggregated with that plan under Section 409A if one employee participated in all such plans. Like the 2010 Transition Relief, the relief provided by the New Plan Correction Rule is conditioned upon the employer taking steps to identify, and correct, all of its other Section 409A arrangements that have "substantially similar" Section 409A document failures. The document failures for which favorable correction may be available under the New Plan Correction Rule substantially overlap

with those under the 2010 Transition Rule and include the following:

- Failing to include, when required, the six-month payment delay provision for specified employees;
- Including impermissible definitions of "separation from service" or "change in control";
- Including both permissible and impermissible payment events or alternative payment schedules;
- Providing impermissible discretion to change the time or form of payment; and
- Including impermissible reimbursements or in-kind benefit provisions.

C. Correction of Operational Failures in Year (or Year After) Failure Occurs

In Notice 208-113, the IRS established a Section 409A correction program (the Operational Failure Correction Program) that allows self-correction of specified Section 409A "operational failures" (i.e., failures to comply with Section 409A in operation). In general, the Operational Failure Correction Program provides for reduced Section 409A income inclusions and related penalty taxes for operational failures that are corrected in accordance with the program. Under the program, certain operational failures may be corrected, without any Section 409A income inclusion being required or related penalty taxes being imposed, provided that the correction is made not later than the end of the year in which the operational failure occurs. For service providers who are not "insiders," the same favorable treatment is available for corrections of certain failures made not later than the end of the year following the year in which the operational failure occurs. Operational failures for which favorable correction may be available under the Operational Failure Correction Program include:

- Failing to correctly implement a deferral (e.g., deferring too little or too much);
- Paying an amount before the date scheduled under the terms of the plan and any applicable deferral election; and
- Pricing a stock option below fair market value on the date of grant.

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D. Correction Prior to Calendar Year of Vesting

Under IRS's proposed Section 409A income inclusion regulations, Section 409A violations may be corrected without any Section 409A-required income inclusion or the imposition of related penalty taxes if the correction is made prior to the first calendar year in which any portion of the deferred compensation vests under the applicable plan or arrangement.¹ Thus, where Section 409A deferred compensation remains unvested but could or will become vested during 2011, correction should be made by year-end 2010.

E. Next Steps

Employers interested in taking advantage of the self-correction alternatives described above should act promptly in light of year-end deadlines. Key next steps include indentifying all Section 409A-covered plans and agreements, reviewing their terms and administration to identify any plan document and/or operational failures, assessing the availability of self-correction alternatives, and implementing corrections, as needed. In undertaking this process, special attention should be paid to arrangements that are not typically thought of as involving deferred compensation—such as bonus programs and severance arrangements—but that may nonetheless be subject to Section 409A.

We hope that you find this advisory helpful. If you would like more information, or assistance in addressing or commenting on the issues raised in this advisory, please feel free to contact:

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¹ Proposed Treas. Reg. § 1.409A-4, 73 F.R. 74,380 (Dec. 8, 2008).

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