



COMPENSATION ALERT

FEBRUARY 2010

The IRS has issued IRS Notice 2010-6, which provides employers with procedures to voluntarily correct non-qualified deferred compensation documents that fail to qualify under Section 409A of the Internal Revenue Code of 1986, as amended—enabling them to avoid or limit the significant tax consequences to which employees are subject. The Notice is especially welcome in light of the IRS’s stated intention to target deferred compensation arrangements in its announced, stepped-up audit activities.

Background. Section 409A provides that amounts deferred under a non-qualified deferred compensation plan that does not comply in form and operation with the requirements of Section 409A are currently includible in the income of the employee or service provider. In addition to recognizing income before payment of the deferred compensation, as a result of participating in non-qualified deferred compensation that fails to comply with Section 409A, employees are subject to a 20% penalty tax on the amount included in income, plus interest.

Section 409A was enacted as part of the American Jobs Creation Act of 2004 and became effective for compensation deferred after December 31, 2004. Since January 1, 2009, when the IRS’ final regulations¹ became effective, non-qualified deferred compensation must be in writing and must strictly comply with the requirements of Section 409A and the final regulations.²

The Notice. The Notice establishes a correction program intended to encourage taxpayers to review their non-qualified deferred compensation arrangements and identify provisions that fail to comply with the requirements of Section 409A and the final regulations. By using the relief available under the Notice, they can avoid or limit the taxes and penalties resulting from non-compliance with Section 409A, depending on the type of failure needing correction. The Notice also offers transition relief to correct specified document failures without penalty if the document failure is corrected by December 31, 2010. If the operation failures are the result of document failures, the procedures outlined in IRS Notice 2008-113 must be implemented.

Relief under the Notice only applies for failures that were inadvertent and unintentional. Relief is not available if the federal income tax return for the employer or participating employee is under IRS examination (i.e., audit) with respect to non-qualified deferred compensation for any tax year in which the document failure existed.

The Notice specifies which document failures employers or participating employees can correct under the correction program, including:

- Use of ambiguous or inconsistent plan terms, such as specifying that a payment will be made “as soon as reasonably practicable.”
- Use of definitions that are inconsistent with the defined terms used in Section 409A and the final regulations, such as “separation from service” and “change in control.”
- Use of impermissible payment dates, payment events or schedules.
- Retention of discretion to choose a form of payment or payment schedule.

HERRICK

New York Office

2 Park Avenue
New York, New York 10016
Phone: (212) 592-1400
Fax: (212) 592-1500


Princeton Office

210 Carnegie Center
Princeton, New Jersey 08540
Phone: (609) 452-3800
Fax: (609) 520-9095

Newark Office

One Gateway Center
Newark, New Jersey 07102
Phone: (973) 274-2000
Fax: (973) 274-2500

Attorney Advertising

- 
- Failure to provide for a six-month delay in payment for key employees of publicly traded companies upon separation from service.
 - Use of improper deadlines for making deferral elections.

Reduced Penalties. If, under the terms of a non-qualified deferred compensation arrangement, an impermissible payment event occurs within one year after the correction under the Notice, the employee or service recipient will generally need to include in income 50% of the amount deferred under the arrangement and pay the 20% penalty tax on the amount included (but not the additional interest). In other words, the risk of incurring adverse tax consequences under Section 409A as a result of document failures can be reduced by correcting those failures as soon as possible.

Reporting Requirements. Except for corrections to ambiguous terms or terms inconsistent with the defined terms under Section 409A, an employee participating in a non-qualified deferred compensation plan that is corrected under the Notice must attach a statement to his or her federal income tax return for the year in which the correction occurs. The statement must state, among other things, i) the identity of the non-qualified deferred compensation plan in which the failure occurred; ii) that the plan is eligible for correction under the Notice; iii) that all steps required for correction have taken place; and iv) the amount involved.

What to do now? Employers should carefully review their non-qualified deferred compensation and determine whether the documents comply with the strict requirements of Section 409A and the final regulations. By identifying and correcting document failures as soon as possible, employers can reduce the risk of having to pay any taxes or penalties under Section 409A. As a further incentive to encourage early voluntary correction of non-compliant documents, as noted above, the Notice provides transition relief that would eliminate the requirement to pay even the reduced penalties under the Notice if the correction is made by December 31, 2010.

This Compensation Alert is one in a series of compensation, ERISA and employee benefit-related alerts. To read past alerts, please visit our website, www.herrick.com. For more information on this alert or other compensation or ERISA matters, please contact:

NY [Fred R. Green](mailto:fgreen@herrick.com) at **212.592.5910** or fgreen@herrick.com
NY [Irwin A. Kishner](mailto:ikishner@herrick.com) at **212.592.1435** or ikishner@herrick.com
NJ [Gary S. Young](mailto:gyoung@herrick.com) at **973.274.2035** or gyoung@herrick.com

¹Treasury Regulation §1.409A.

²Prior to January 1, 2009, no adverse tax consequences arise if there is good faith compliance with the requirements of Section 409A and the guidance issued by the IRS.