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## Employee Benefits

### Alert



## 409A Corrections: Year-End Document Review Makes Sense

Earlier this year, the Internal Revenue Service (“IRS”) announced a correction program, IRS Notice 2010-6, for documentary errors in deferred compensation arrangements subject to Internal Revenue Code Section 409A (“409A”). A program for operational errors was announced in late 2008 as Notice 2008-113.

409A establishes strict guidelines that govern the documentation and operation of deferred compensation. 409A covers numerous types of pay arrangements in addition to traditional deferred compensation plans, such as employment agreements, change-in-control arrangements, phantom equity awards, deferred incentive awards, and certain severance agreements. The IRS correction programs are intended to provide some relief from penalties imposed on an employee who is covered by a noncompliant plan or agreement.

More guidance on the IRS’s interpretation of 409A has become available since the original deadline for bringing plans into compliance. The correction programs themselves illustrate IRS views on 409A implementation. Thus, even arrangements previously amended for 409A compliance can benefit from year-end review.

Document review and correction of any errors by the end of 2010 is valuable under Notice 2010-6. Some advantages apply through 2011, as well.

■ Correction During 2010. Certain corrections during 2010 are exempt from income inclusion and penalty taxes that otherwise could be required under Notice 2010-6 for later-year

corrections. Related operational errors also must be corrected in 2010 for this relief.

- Plans Adopted During 2010. For plans adopted in 2010, relief from otherwise-applicable income inclusion and penalty taxes is available if the correction is made during 2010 or, if later, the 15th day of the third month after adoption. Operational failures also must be corrected. This rule applies generally to new plans and is effective beyond 2010.
- Plans “Linked” to a Qualified or Another Nonqualified Plan - 2010 or 2011. “Linked” plans are plans where the benefit under one arrangement affects the amount deferred or payment timing under a second arrangement. Plans amended in 2010 or 2011 to correct errors arising from linked plan status and operation will be treated as having been in documentary compliance since January 1, 2009. Operations must be conformed to the amended documents in accordance with the IRS operational errors correction program.
- “Under IRS Examination” Restrictions - Advantage for 2010 or 2011. Another advantage of prompt correction is that the IRS programs generally are not available to a participant where either the participant’s or the employer’s tax return is under IRS examination for any year in which the 409A error existed. In the employer’s case, a return is under examination for this purpose if the employer has been notified in writing that nonqualified deferred compensation is an issue under consideration. For corrections made by the end of 2011, a more limited definition of “under examination” is applied,

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i.e., the specific document failure must have been identified by the IRS.

- *Amounts Not Vested During 2010.* Employers may be able to make corrections during 2010 outside of the IRS correction process with respect to benefits that remain unvested at the end of 2010. This type of correction can be highly beneficial, as it sometimes can be done through amendment and does not involve information reporting requirements described below. It cannot be used as an indirect method for making late deferral elections or systematically avoiding compliance. This type of correction may be well-suited for change-in-control benefits, severance benefits and other benefits with deferred vesting schedules. This approach is based on proposed income inclusion regulations under 409A. Its availability in a given situation or for future tax years requires consideration of a number of issues.
- *Limiting Post-Correction Exposure.* Additional income taxes, penalties and interest under 409A may be assessed for each year in which an operational or documentary error exists. Correcting errors through amendment or improved administration - even outside of the IRS's formal programs - should reduce the risk of assessments related to those errors for post-correction tax years.

Most of the relief under the IRS correction programs is conditioned on information reporting to the IRS and to affected employees regarding the 409A error. In some cases, all documents with substantially similar errors must be corrected. Other conditions also may apply, depending on the error at issue. Understandably, these requirements are factors that must be balanced against the benefit that comes from using the IRS correction programs.

Whether pursuant to or outside of formal IRS correction programs, periodic review and prompt correction of deferred compensation arrangements go a long way toward enhancing 409A compliance. The IRS programs address many documentary and administrative issues in addition to those described above, and varying correction methods and consequences apply to different categories of errors.

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