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Should You Participate in the Section 409A Document Corrections Program in 2010?

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Section 409A Documentary Compliance Program

Another year-end deadline under Section 409A will occur on December 31, 2010. Despite the passing of the effective date of the final regulations on January 1, 2009, the IRS is giving taxpayers another opportunity, on a much more limited basis than in prior years, to make **certain** corrections to plan documents to avoid Section 409A taxation and penalties. While this opportunity still will be available after 2010, the correction program encourages employers to assure that all plan documents governing nonqualified deferred compensation arrangements contain any required language regarding the timing of payments and deferral elections in accordance with the final Section 409A regulations before January 1, 2011.

Earlier this year, the IRS issued Notice 2010-6, a program that provides guidance on how to voluntarily correct certain documentary failures under Section 409A (the "Document Program"). This program is in addition to the voluntary compliance program offered by the IRS in Notice 2008-113 that gives taxpayers the opportunity to correct certain "operational failures" under Section 409A (the "Operational Program"). Notice 2010-6 allows for certain Section 409A document corrections to be made to existing arrangements with the opportunity for reduced or, in some cases, no penalties. Companies may use the Document Program for taxable years beginning on or after January 1, 2009 and, provided the arrangement is corrected **on or before December 31, 2010**, the arrangement may be treated as having been corrected as of January 1, 2009, which may result in a waiver of any Section 409A penalties. **Therefore, if you have not done so already, we strongly encourage you to perform a documentary audit of all arrangements at your company that are subject to Section 409A. The IRS has already begun Section 409A audits, as described further in our update entitled "Employment Tax Audits Have Begun," and because participation in the Document Program is limited to taxpayers who are not under audit, early participation is encouraged.**

When Does Section 409A Apply?

Examples of nonqualified deferred compensation arrangements that may be subject to Section 409A include:

- Elective deferred compensation plans (e.g., salary and bonus deferral programs)
- Non-elective deferred compensation plans (e.g., SERPs)
- Employment and change-in-control agreements
- Salary continuation plans
- Section 457(f) arrangements (for non-profit organizations or governmental entities)
- Restricted stock units (RSUs) and phantom stock
- Discounted stock options
- Certain stock appreciation rights (SARs)
- Severance plans
- Certain bonus or incentive plans
- Certain split dollar insurance arrangements

As a reminder, a violation of Section 409A can accelerate the participant's inclusion of all income deferred under the arrangement and result in a 20% penalty tax for the participant over and above the income tax owed, as well as interest on such amounts if the tax is not paid in the proper tax year. In addition, these consequences may apply not only to the offending plan or arrangement, but also to similar plans or arrangements subject to Section 409A to which the participant is a party,

The following is based on a summary of legal principles. It is not to be construed as legal advice. Individuals should consult with legal counsel before taking any action based on these principles to ensure their applicability in a given situation.

even if those arrangements comply with Section 409A. Further information regarding Section 409A and its requirements can be found in our prior updates at: http://www.gklaw.com/practice.cfm?action=news&practice_id=26.

What Corrections Can Be Made Under the Documentary Compliance Program?

Generally, the following documentary failures can be corrected under the Document Program:

- Plan terms that are ambiguous (e.g., “as soon as practically possible”) or do not meet the definitional requirements of Section 409A (e.g., for a “separation of service” or “change of control”);
- Discretionary payment periods of 91 days or longer following permissible payment events;
- Payment periods following permissible payment events that depend on the participant taking certain actions or executing certain agreements (such as executing a release of claims or a non-compete);
- Impermissible payment events and payment schedules;
- Impermissible discretion to accelerate payment events;
- Impermissible reimbursements of in-kind benefits;
- Failure to include six-month delay for specified employees of public companies; and
- Impermissible deferral elections.

There are a number of general requirements to participate in the Document Program, including, if applicable, the recognition of income. The specific requirements for a correction are dependent on the type of documentary failure. If a company identifies and corrects a document failure for one employee under the Document Program, then the company must take reasonable steps to identify all other nonqualified deferred compensation arrangements that have a substantially similar document failure and correct the failure for other employees. Furthermore, depending on the type of documentary failure, certain notifications must be made to the IRS, including attaching a statement regarding the documentary failure and correction to the tax return of both the company and the participant, even where no income recognition is required.

What Is the Benefit Of Using the Documentary Compliance Program?

If used, the Document Program offers reduced or, in some cases, no penalties under Section 409A where a nonqualified deferred compensation plan document contained a technical failure under Section 409A as of January 1, 2009.

Generally, the Document Program provides for the following relief:

- If an arrangement is corrected and the correction does not impact the operation of the arrangement for one year afterwards, then all Section 409A penalties can be avoided, provided the correction does not prevent a payment from being made under the original terms of the arrangement and, similarly, does not cause a payment to be made that would not have been made under the original terms of the arrangement; or
- If an arrangement is corrected and the correction does impact the operation of the arrangement within one year, then the Document Program provides for reduced Section 409A penalties (generally 50% of the amount that would otherwise be penalized).

For example, assume a nonqualified deferred compensation plan document contains a “separation from service” definition that is not compliant with Section 409A. On March 1, 2011, the arrangement is corrected under the Document Program. As long as no compensation is paid under the original non-compliant separation from service definition before March 1, 2012 (i.e., one year from March 1, 2011), then the arrangement is deemed compliant with Section 409A and not subject to any penalties, regardless of when a separation from service occurs. However, if there is a separation from service under the original non-compliant definition (but not under the revised, compliant definition) prior to March 1, 2012, then the participant must recognize tax and is penalized on 50% of the deferred compensation amount as opposed to the full amount.

Special Relief in 2010

The Document Program is most effective if used **on or before December 31, 2010**. All documentary corrections made pursuant to the Documentary Program prior to January 1, 2011 are treated as having been made on January 1, 2009. Therefore, even where a documentary correction impacts an arrangement within one year, since the correction is deemed to have been made on January 1, 2009, the one-year look-back period applicable in later years will not apply. Furthermore, if amounts have already been impermissibly paid and the Section 409A violation could have been corrected under the Document Program, then such documentary correction can still be made as long as any impermissibly paid amounts are corrected through the Operational Program.

Other Guidance from Notice 2010-6

The examples and details of the specific corrections that can be made under the Document Program are informative in that they provide examples of what the IRS views as technical failures under Section 409A. For this reason, Notice 2010-6 provides further guidance as to what type of language the IRS is expecting to see in plan documents that will comply with Section 409A. For example, where a plan document uses a “termination of employment” as a payment trigger, but does not define what events constitute a “termination of employment” or does not include a provision that the terms must be interpreted in a manner consistent with Section 409A, the IRS seems to reserve the right to construe such term as “ambiguous” and, in certain cases, as noncompliant. For this reason, it is important that all Section 409A arrangements be revisited, taking into account the examples in Notice 2010-6 for the purpose of assuring compliance.

More to Come: Future Guidance Expected

Despite the voluminous guidance under Section 409A that has been issued so far (e.g. the Final Regulations, the interim income inclusion and reporting rules, the Documentary Program and the

Operational Program), the IRS plans to continue to address certain open issues under Section 409A in future guidance. While it has not made any statements as to timing, the IRS has informally indicated that expects to publish the following items:

- Final Income Inclusion Regulations (governing the calculation of includible income and penalties under 409A).
- Proposed Regulations under Section 409A(b) (relating to certain funding arrangements).
- A Revenue Procedure combining the Operational Program and the Document Program rules.

We will continue to provide updates as this guidance becomes available.

Next Steps

If you have not done so already, review all arrangements at your company that are subject to Section 409A to discover whether you may need to take advantage of the Document Program, including the transitional relief. To see whether you may benefit from participation in the Document Program or if you have any questions about Section 409A in general, please contact Debra Koenig,

Considerations to Using Documentary Corrections Program in 2010

- Corrections under the Document Program in 2010 will not require a look back period, as it will in future years.
- Participation in the Document Program will require reporting the correction on the employer’s and employee’s tax returns in most cases.
- Certain corrections to plan documents may be made outside of the Document Program if the affected amounts are unvested.
- Not all types of document failures can be fixed under the Document Program.

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