



Compensation and Benefits Tax Alert

Subject:

One More Chance - Certain Section 409A Corrections Can Be Made Without Penalty Through December 31, 2010

If you would like to discuss the content of this Compensation and Benefits Tax Alert, please call:

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Summary

Although the general transition relief for compliance with section 409A ended December 31, 2008, employers have one last chance to make penalty-free corrections to nonqualified deferred compensation (“NQDC”) plans that do not comply with section 409A as long as the corrections are made by December 31, 2010. We recommend that employers review their NQDC plans as soon as possible to ensure that this opportunity is not lost.

Background

As most employers now know, amounts deferred under an NQDC plan are currently includible in income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless the (a) plan documentation meets the distribution, anti-acceleration, and election requirements under section 409A, and (b) the plan is operated in accordance with such rules. Noncompliance results in inclusion in income for all amounts deferred under the plan by a participant, a premium interest charge, and an additional 20-percent tax (plus an additional 20-percent tax in California).

Transitional Relief Provision

The transitional relief is set forth in Notice 2010-6, which was issued early in 2010 and provides a means for taxpayers to correct a number of failures to comply with the document requirements under section 409A.

The document correction program under Notice 2010-6 includes a one-year “look-back” period, which means that certain document failures that do not affect a plan’s operation for at least one year after the date of correction can be corrected without adverse consequences, i.e., inclusion of the income or payment of additional tax or premium interest under section 409A. If the correction does affect the plan’s operation within the one-year lookback period, the correction can be made but partial income inclusion and the additional 20-percent tax (but not premium interest) are imposed.

Under this transitional relief, plans that are corrected under Notice 2010-6 on or before December 31, 2010, are treated as having been corrected on January 1, 2009. As a condition of the relief, any payment made before December 31, 2010, that would not have been made under the amended provision, or any payment not made before December 31, 2010, that would have been made under the amended provision, must be treated as an operational failure and corrected on or before December 31, 2010, under Notice 2008-113, the correction program for operational failures of NQDC plans.

Here is an example provided by the Service to illustrate the transitional rule:

Employee A participates in a NQDC plan that provides for a \$100,000 payment upon a separation from service. The plan otherwise complies with section 409A, except that it incorrectly defines “separation from service” to include a transition from employee to independent contractor status (which should be excluded from the definition) and to exclude a reduction in the hours of employment (which should be included).

On July 1, 2009, Employee A became an independent contractor and was paid \$100,000. On April 1, 2010, Employer amended the plan under Notice 2010-6 to correct the definition of “separation from service.”

If the \$100,000 payment is treated as an operational failure and corrected under Notice 2008-113 on or before December 31, 2010, the plan may be treated as corrected under Notice 2010-6, without inclusion of income due to events occurring within one year after the correction.

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