

Nolan Financial Report

Undertaking Voluntary §409A Corrections in 2010 To Avoid Audit Issues Ensuring the Integrity of Nonqualified Deferred Compensation Plans

Introduction

Since 2009, the Internal Revenue Service (IRS) has commenced with audit activity pertaining to §409A Nonqualified Deferred Compensation (NQDC) Plans. This has resulted in notices and information requests being sent to individuals and companies that have been identified as noncompliant. The “Information Document Requests” (IDRs) issued by the IRS request detailed information on §409A plans. The impact of an audit can be severe and the opportunity to ensure compliance may be lost, if not undertaken in advance of an audit.

The IRS also issued Notice 2010-6, on January 5, 2010, that gives taxpayers an opportunity to review, identify and correct certain types of §409A document failures. The notice covers eligibility issues and the corrections that may be made. Notice 2010-6 also has also modified certain provisions of Notice 2008-113 (relating to certain operational failures) and Notice 2008-115 (which provides guidance on reporting and withholding requirements for 2008 and after).

It is important to note that the Document Correction facility is only available if the employer or service provider is not already under IRS examination for the relevant years subject to the review. As such, companies have an opportunity in 2010 to carefully evaluate their §409A documents and correct any provisions that can be remedied. In this edition of Nolan Financial Report (NFR), we will cover, in brief, some of the provisions of Notice 2010-6 and audit issues of which companies should be aware.¹

Brief Background of Code Section §409A

With the passage of the American Jobs Creation Act (AJCA) of 2004, Congress created §409A of the IRC, which applies to NQDC plans and is applicable to all deferrals of compensation from 2005. IRC §409A impacts all NQDC plans as it restricts the timing of deferral elections, limits permissible payment events, restricts changes to the time and form of payments and restricts certain funding vehicles.

Compliance Failure Issues

The failure to comply with §409A can be severe, resulting in the deferred compensation being includable in the employee's income, ordinary federal income taxes and employment taxes, a 20% federal tax penalty and late payment and interest charges. The compliance failure also impacts employers resulting in potential tax liability.

¹ Sources: IRS Notice 2010-6; Fosse, Marc J., *IRS Issues Voluntary Correction Program for Section 409A Plan Document Failures: Time to Find and Fix Problems during IRS Transition Relief Period*, Trucker Hess; Powell, Mary; *Section 409A Audits: Questions, Issues Raised Via Information Document Requests*, Trucker Hess.

Notice 2010-6 Document Correction Opportunity

Notice 2010-6 is a document correction program with a limited window through December 31, 2010. By proactively taking advantage of the correction opportunities offered in this Notice, as well as prior Notices, employers and their employees can avoid damaging consequences, which can wipe out all of the benefits of an NQDC plan.

In brief, Notice 2010-6 provides:

- Clarification that certain language commonly used will not cause a document failure.
- Relief permitting correction of certain document failures without current income inclusion or additional taxes under § 409A, provided, in certain circumstances, that the corrected plan provision does not affect the operation of the plan within one year following the date of correction.
- Relief limiting the amount currently includible in income and the additional taxes under § 409A for certain document failures if correction of the failure affects the operation of the plan within one year following the date of correction.
- Relief permitting correction of certain document failures without current income inclusion or additional taxes under § 409A, if the plan is the service recipient's first plan of that type (disregarding any plans not subject to § 409A or any plans under which all deferred amounts have previously been paid or forfeited) and the failure is corrected within a limited period following adoption of the plan.
- Transition relief permitting corrections of certain document failures without current income inclusion or additional taxes under § 409A, if the document failure is corrected by December 31, 2010, and any operational failures resulting from the document failure are also corrected in accordance with Notice 2008-113, 2008-51 IRB 1305, by December 31, 2010.
- This notice also clarifies certain aspects of Notice 2008-113, which addresses certain failures of nonqualified deferred compensation plans to comply with § 409A in operation (operational failures), including clarification of:
 - The application of the subsequent year correction method to late payments of amounts deferred.
 - The calculation of the amount that must be paid to the service provider as a correction of a late payment of an amount deferred under a plan if the payment would have been made in property, such as shares of stock.
 - The calculation of the amount that must be repaid by the service provider as a correction of an early payment of an amount deferred under a plan if the early payment was made in property, such as shares of stock.

Effective Date

Notice 2010-6 is applicable for taxable years beginning January 1, 2009. The changes made to Notice 2008-113 are effective for taxable years beginning January 1, 2010.

Eligibility Criteria

Notice 2010-6 requires certain eligibility criteria to met, such as:

- The employer must take "commercially reasonable" steps to identify all other NQDC plans that have a document failure
- There should be no pending IRS examination for the relevant correction year
- Document correction is only available for inadvertent or unintentional failures
- Income taxes and/or penalty may have to be paid anyway to complete a particular correction method
- Other information and reporting requirements must be met by the employer

Exclusions

Notice 2010-6 provisions are not available to stock-based plans or failures of the short-term deferral rule. Linked NQDC plans or plans under IRS examination may also be excluded after the transition period.

Transition Relief

For eligible NQDC plans, a plan will be treated as having been corrected on January 1, 2009, and any income inclusion requirement as a condition to be eligible for a correction under the Notice will not apply:

- If the document failure is corrected on or before December 31, 2010; and
- Any payment or non-payment to a taxpayer prior to December 31, 2010 made or not made under a corrected plan are treated as operational errors and are corrected under Notice 2008–113.

Linked NQDC Plans

Notice 2010-6 provides that linked NQDC plans can be corrected until December 31, 2011, by amending the plans to make the time or form of payment under the linked plans identical.

Changes to Notice 2008–113

Notice 2010–6 clarifies certain provisions of Notice 2008– 113, including the following:

- The amount that must be repaid under Notice 2008–113 to a service recipient in the event of an erroneous payment to a service provider is the gross amount of the payment before application of any withholding requirements.
- Failure to pay an amount owed until the calendar year immediately following the year in which it is owed should be treated as an excess deferred amount corrected in the taxable year immediately following the year of the failure.

Changes to Notice 2008–115

If a taxpayer is entitled to relief under Notice 2010-6, Notice 2008-115 is modified to conform to the provisions of Notice 2010-6, including modifications to Notice 2008-113, with respect to the amount required to be include in income by a service provider under §409A and the amount that is required to be reported by the service recipient as an amount includible in income under §409A(a).

Section §409A Audits

IRS Audits entail providing detailed information on the plan under review with the IRS initiating its request via an IDR. In general, an audit would require the following information and answers to key questions listed below.

Complete List of Plans, Programs, Policies, and Agreements

One of the key requirements of an IDR is a request for a list of all plans and arrangements (and the corresponding participants in those plans and/or arrangements) that provide any service provider with a contractual obligation to compensation in one year, but paid in a subsequent year. The IDR states that this list is a request for those plans and arrangements that the company does not consider to be a nonqualified deferred compensation plan subject to code Section §409A. The IDR also asks the basis for not considering those plans subject to code Section §409A. Where the basis is the short-term deferral rule, the company must describe the terms of any relevant substantial risk of forfeiture.

Documents That a Company Would List

The documents that would likely fall into this category are severance plans, bonus plans, certain long-term or short-term incentive plans, employment agreements that contain bonus and/or severance payments, certain stock option plans, and other similar agreements.

Typical Questions a Company Would Be Expected to Address

- Did the Company identify participants who were specified employees for the year?
- Did the Company make any payments of nonqualified deferred compensation during the year to any specified employee upon separation from service? Were any accelerated payments made?

- Did the Company modify any NQDC Plan to comply with §409A? If yes, describe the plan and each modification.
- Has the Company identified any violations of §409A? If so, describe the violation and if amounts were reported on a W-2 or Form 1099. Did the Company participate in any correction program?
- Did the Company undertake any funding of the NQDC plan due to a decline in financial condition?

Conclusion

Due to the complicated provisions of §409A and relatively recent changes made to most NQDC plans, the IRS intends to undertake audits of plans that may be in violation of §409A. The scope of the IDRs reveals the intricacies that Companies have to anticipate in order to withstand IRS scrutiny. The IRS also intends to perform audits in a random manner pertaining to §409A plans. The significant disadvantages of an audit mandate that employers proactively review their §409A NQDC plans to identify and correct any operational and document errors as allowed by the IRS.

Notice 2010-6 gives employers a timely opportunity to address compliance violations before they are audited. With audit activity already under way, participants are also subject to receiving notices facing the burden of demonstrating compliance. Clearly it is important for employers to uncover violations and correct them while they can.

As the IRS undertakes such audit and examination of §409A plans, it is expected more issues will be uncovered and employers will be under a greater burden to demonstrate compliance. Employers should seek the help of qualified counsel to review their §409A plans and documents for compliance.

If you have any questions or concerns about how your company may be impacted or would like additional information, please contact:

Michael E. Nolan
President and CEO
Nolan Financial
Phone: 301-907-9500
Email - nolanm@nolanfinancial.com

William A. Craig
V.P. Business Development
Nolan Financial
Phone: 866-810-6442
Email - craigw@nolanfinancial.com

Associates of Nolan Financial are registered representatives of Lincoln Financial Advisors Corp.

Securities offered through Lincoln Financial Advisors Corp., a broker/dealer. Member SIPC. Insurance offered through Lincoln affiliates and other fine companies. 8219 Leesburg Pike, #200 Vienna, VA 22182.

Lincoln Financial Advisors Corp. and its representatives do not offer legal or tax advice. CRN201004-2040646

Any discussion pertaining to taxes in this communication (including attachments) may be part of a promotion or marketing effort. As provided for in government regulations, advice (if any) related to federal taxes that is contained in this communication (including attachments) is not intended or written to be used, and cannot be used, for the purpose of avoiding penalties under the Internal Revenue code. Individuals should seek advice based on their own particular circumstances from an independent tax advisor.