

409A Second Chances...

I. Background. If you hit a brick wall at midnight on December 31, 2008, with regard to the Section 409A documentary compliance deadline, the IRS is providing a second chance for you to reassess your Section 409A compliance and to bring your deferred compensation documents in line. For those of you not in the know, Section 409A of the Internal Revenue Code requires a nonqualified plan or agreement to reflect the various time and form of payment rules described in that section and in related guidance.

In brief, Section 409A requires that payment of deferred compensation¹ be made upon permitted payment events such as separation from service, change in control, disability, an unforeseeable emergency or death (the first four payment events are defined terms), or that the time of payment be specified in the document. A noncompliant document may result in, among other things, current ordinary income tax plus a 20 percent additional tax imposed on the executive – computed on amounts deferred and vested under the plan. The ordinary and additional taxes apply regardless of whether the deferred amount has actually been paid.

Employers had until December 31, 2008, to amend their nonqualified plans and/or agreements to include Section 409A compliant provisions. Now that this deadline is past, the IRS, recognizing that many drafting errors are inadvertent and unintentional, has created a document correction program. In many cases, the correction requires inclusion of income and compliance with certain information and reporting requirements as a condition of correction.

II. Transition Relief Period. Many of the corrections described in this program require the employee to include a portion of the deferred compensation in income in the year of correction or, if the payment event occurs within one year of the correction, in the year following the year of correction and to pay the additional 409A taxes. If the correction involves one of the corrections described in Section IV, however, and the document is amended by **December 31, 2010**, these requirements do not apply. In the case of nonqualified plans that are linked plans (*i.e.*, the amount deferred under one plan is determined by, or the time and form of payment is affected by, an amount deferred under another plan) and one or both plans fail to satisfy Section 409A, the correction period for de-linking the plans and bringing one or both plans into compliance ends on December 31, 2011. Please note that linked plans are not eligible for relief under this program.

¹ Certain types of compensation are not treated as deferred compensation. Examples include equity compensation that meets Section 409A requirements, compensation paid pursuant to the short-term deferral rule (*e.g.*, annual bonus for 2010 that is paid by March 15, 2011) and compensation paid pursuant to a qualified plan such as a 401(k) plan.

III. What To Do Now. This program is a good opportunity to check with benefits counsel regarding any further corrections and/or clarifications that may be required under a nonqualified plan or agreement to make it Section 409A compliant and to take advantage of the transition relief period to amend these documents. Please keep in mind that Section 409A affects any document that permits deferral of compensation. Examples of deferred compensation plans and agreements affected by Section 409A include, in addition to a typical nonqualified deferred compensation plan, employment agreements, severance agreements, restricted stock unit awards, performance rights awards, annual bonus plans, long-term and short-term incentive plans and supplemental employment retirement programs.

IV. Errors Covered Under The Program. Drafting errors that may be corrected under this program are listed below.² Examples are shown in the table on the following page. References to rows below refer to rows in this table.

- > **Ambiguous Terms.** See Rows A and B.
- > **Non-Compliant Provisions.**
 - *Impermissible Definition of Payment Events.* See Rows C, D and E.
 - *Impermissible Payment Periods Following A Permissible Payment Event.* See Rows F and G.
 - *Correction of Impermissible Payment Events And Payment Schedules.*
 - A combination of impermissible payment events and permissible payment events. See Row H.
 - Only impermissible payment events. See Row I.
 - Impermissible alternative payment schedules. See Row J.
 - Impermissible employer or employee discretion with respect to a payment schedule following a permissible payment event. See Rows K and L.
 - Impermissible subsequent deferral election. See Row M.
 - Impermissible employer discretion to accelerate a payment event. See Row N.
 - Impermissible Reimbursement of In-Kind Benefit Provisions. See Row O.
 - *Failure to Include Six-Month Delay of Payment for Specified Employees.*³ See Row P.
 - *Impermissible Initial Deferral Elections.* See Row Q.
 - *Amendment Period Following The Initial Adoption Of The Plan.* See Row R.

² Equity compensation subject to Section 409A (*e.g.*, a discounted stock option) cannot be corrected under this program.

³ Section 409A requires that in the case of a publicly held company (including a company that is publicly traded on a foreign securities market), deferred compensation payable to a so-called specified employee upon separation from service be made subject to a six-month delay.

COMMON ERRORS AND THEIR CORRECTION ⁴		
Row	Document Language	Brief Explanation of Correction
A.	Payment will be made "as soon as reasonably practicable" after separation from service.	Document need not be corrected. If payment is delayed beyond the later of December 31 ⁵ following separation from service or the 15 th day of the third calendar month following separation from service, the delay will generally result in an operational error.
B.	Payment will be made on termination of employment (instead of upon separation from service) and the document does not include a provision stating that agreement terms will be interpreted to comply with requirements of Section 409A.	Amend document to replace "termination of employment" with "separation from service" or include a reference that agreement terms will be interpreted to comply with Section 409A. In general, however, document need not be corrected unless payment is made on a termination of employment and such termination is not a separation from service for purposes of Section 409A.
C.	Payment will be made upon a separation from service and separation from service is defined to include a transfer from the employer to an affiliate.	Document must be amended before a separation from service occurs either as defined in the plan or as defined in Section 409A. The amendment should define separation from service to comply with Section 409A but the amendment cannot expand or narrow existing definition except to the extent necessary to satisfy Treas. Reg. section 1.409A-3(a)(1). The amendment must be effective immediately. If separation from service either as defined in the plan or in Section 409A occurs within one year of correction, 50 percent of the amount deferred must be included in income under Section 409A(a).
D.	Payment will be made upon a change in control and change in control is defined as an initial public offering of more than 30 percent of the employer's stock.	Document must be amended before a change in control as defined in the plan. The amendment should define change in control to comply with Section 409A but may not expand the definition of change in control. The amendment must be effective immediately. If a change in control as defined in the plan (before the amendment) occurs within one year of correction, 25 percent of the amount deferred must be included in income under Section 409A(a).
E.	Payment will be made upon disability and disability is defined as employee's being unable to continue in employee's position of employment for a period of six months.	Document must be amended before a disability as defined in the plan occurs. The amendment may either remove disability as a payment event or define disability to comply with Section 409A. The amendment must be effective immediately. If correction is made after the occurrence of a disability (as defined in the plan), the same correction method is used and the resulting operational failure may be corrected under IRS Notice 2008-113.
F.	Document provides that payment will be made within 180 days following separation from service (impermissible payment period).	Document may be corrected by an amendment to either remove the impermissible period or set forth a period (<i>e.g.</i> , 90 days) that complies with Section 409A. If amendment is made before separation from service nothing more needs to be done. If amendment is made after a separation from service, the employee must include 50 percent of the deferred amount in income under Section 409A(a).
G.	Document provides that employee will be paid upon signing a release or a non-compete agreement.	Document must be amended to remove ability of employee to delay or accelerate time of payment, <i>e.g.</i> , payment will be made on the 60 th day after separation from service. ⁶ If document provides that payment will be made within a designated period, then amendment must provide that payment will be made on the last day of the payment period.
H.	Document provides that payment will be made on the earlier of an initial public offering (impermissible payment event) or a separation from service (permissible payment event).	Document must be amended before the impermissible payment event occurs (<i>e.g.</i> , initial public offering). The amendment must remove impermissible payment event. The amendment must be effective immediately. If impermissible payment event occurs within one year following date of correction, 50 percent of the amount deferred must be included in income under Section 409A(a).

⁴ In general, relief under this program is available if the error is unintentional, all similar failures are corrected, neither the employee nor the employer's federal tax return is under examination, additional 409A taxes are paid, and certain information and reporting requirements are met.

⁵ The table assumes that the employee and the employer have a calendar year tax year.

⁶ Note that the required period to consider a release under the Age Discrimination in Employment Act (typically 21 days or, in case of certain group terminations, 45 days) and the seven-day revocation period should be taken into account in setting the payment date.

COMMON ERRORS AND THEIR CORRECTION ⁴		
Row	Document Language	Brief Explanation of Correction
I.	Document provides for payment upon a child's enrollment in college (impermissible payment event).	Document must be amended before the impermissible payment event occurs (<i>e.g.</i> , child's enrollment in college) to remove the impermissible payment event and replace with a provision providing for payment on the later of separation from service and the sixth anniversary of the date of correction. The employee must include 50 percent of the amount deferred in income under Section 409A(a).
J.	Document provides for lump sum payment upon an involuntary termination and installment payments on resignation.	Document must be amended before separation from service to provide that the form of payment upon a voluntary separation will be the same form of payment that the pre-correction plan provided for an involuntary separation. The amendment must be effective immediately. If the employee resigns within one year of correction, 50 percent of the amount deferred must be included in income under Section 409A(a).
K.	Document provides for payment in 10 installments upon attaining age 65 unless employer determines in its sole discretion to pay in the form of a lump sum.	Document must be amended to remove employer's discretion with regard to the form of payment. The amendment must be effective immediately. If employee attains age 65 within one year of correction, 50 percent of the amount deferred must be included in income under Section 409A(a).
L.	Document provides for payment upon separation from service but employer may delay payment if certain cash flow targets are not met.	Document must be amended to remove employer's discretion with regard to the time of payment and the delay provision. The amendment must be effective immediately. If employee separates from service within one year of correction, 50 percent of the amount deferred must be included in income under Section 409A(a).
M.	Document permits employee to elect at any time before 30 days before reaching age 65 to defer payment for at least 12 months.	Document must be amended to remove incorrect deferral election. Any incorrect elections must be revoked. If incorrect election is not revoked more than one year before reaching age 65, the amount deferred must be included in income under Section 409A.
N.	Document provides for payment upon separation unless employer in its sole discretion elects to pay the amount before separation.	Document must be amended to remove discretion before such discretion is exercised and becomes irrevocable or before the date a payment is made pursuant to the exercise of discretion.
O.	Document provides for reimbursement of country club dues for five years up to an aggregate of \$100,000 after separation from service.	Document must be amended to provide an annual pro rata limit (<i>e.g.</i> , \$20,000) before separation from service. The amendment must be effective immediately. If employee becomes eligible for reimbursement within one year of correction, 50 percent of the amount deferred must be included in income under Section 409A(a).
P.	Document does not include a six-month delay for specified employees.	Document must be amended before separation from service to provide that amount may not be paid before the later of 18 months following correction or six months after separation. The amendment must be effective immediately. If employee separates from service within one year of correction, 50 percent of the amount deferred must be included in income under Section 409A(a).
Q.	Document permits employee to make election to defer annual (non-performance based) 2010 bonus (payable before March 15, 2011) until June 30, 2010, and employee makes such an election.	In general, document must be amended to remove the ability to make the impermissible election and any amounts that were not paid as a result of the impermissible election must be corrected in accordance with Notice 2008-113.
R.	Amendment period following initial adoption of plan.	In general, document may be amended to remove incorrect provision no later than the later of the last day of the calendar year in which or the 15 th day of third calendar month following the date the legally binding right arises

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