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Non-Qualified Deferred Compensation Plans: Year End Action May Be Required

Earlier this year, the Internal Revenue Service ("IRS") established a new document correction program that permits companies to correct certain documentary violations of Section 409A of the Internal Revenue Code ("Section 409A"). The documentary correction program is set forth in [IRS Notice 2010-6](#) and summarized in our [prior client alert](#). As a result of this new document correction program, certain action may need to be taken with respect to your company's non-qualified deferred compensation plans before year end to ensure that the plans are compliant with or exempt from Section 409A.

Why Prompt Action May be Required

In connection with the new document correction program, the IRS for the first time provided specific examples of plan language that it deems compliant or non-compliant with Section 409A. As a result, many companies that had believed their non-qualified deferred compensation plans were in compliance with Section 409A have learned that their plans may need to be further amended to comply with Section 409A. For example, many companies have learned that certain employment or separation agreements that require the execution of a general release in exchange for severance may violate Section 409A.

Fortunately, the new document correction program permits companies to adopt corrective amendments to their non-qualified deferred compensation plans by the end of 2010. If a company adopts corrective amendments by the end of 2010 (and corrects related operational violations), certain adverse tax consequences may be avoided.

Accordingly, companies are advised to take a fresh look at their non-qualified deferred compensation arrangements to ensure that they are in compliance with or exempt from Section 409A and consider adopting any required corrective amendments and taking other required corrective action by the end of 2010.

Section 409A Generally

Section 409A imposes strict rules for non-qualified deferred compensation arrangements and strict penalties and other adverse tax consequences on participants if the rules are not followed. These penalties include a 20% penalty tax, interest at the federal underpayment rate plus 1% and immediate taxation upon vesting. These adverse tax consequences apply to both non-compliant arrangements as well as any similar arrangements that must be aggregated for purposes of Section 409A, regardless of whether the similar arrangement complies with Section 409A. Companies are subject to certain reporting requirements under Section 409A.

Section 409A applies to both public and private companies and to a broad range of arrangements, including for example traditional deferred compensation plans, excess retirement and savings plans, bonus plans and employment-related agreements.

Section 409A became effective January 1, 2005. To avoid adverse consequences under Section 409A, non-qualified deferred compensation plans were required to have been (1) operated in compliance with or exemption from Section 409A since January 1, 2005 and (2) in documentary compliance with or exempt from Section 409A by December 31, 2008.

Compliance Correction Programs

In December 2008, the IRS established a correction program through which companies could correct certain *operational* violations of Section 409A. The operational correction program is set forth [IRS Notice 2008-113](#) and summarized in our [prior client alert](#).

As noted above, in January 2010, the IRS established a correction program through which companies could correct certain *documentary* violations of Section 409A. The documentary correction program is set forth in [IRS Notice 2010-6](#) and summarized in our [prior client alert](#).

2010 Transitional Relief Available Under the Documentary Correction Program

The document correction program provides special relief for certain documentary failures corrected by December 31, 2010. Certain documentary failures corrected by December 31, 2010 are deemed to have been corrected on January 1, 2009. As long as any impermissible payments or non-payments made before the end of 2010 are treated as operational failures and corrected under the IRS's operational correction program by December 31, 2010, any income inclusion and related penalties that would otherwise apply under the document correction program will be waived. Companies must still report the violation and correction and comply with other reporting requirements under the program.

As noted in our prior client alert, the document correction program also provides relief for newly-adopted plans and very limited transitional relief for certain corrections made in 2011.

Recommended Action

- To the extent that your company has not already done so, in light of the new document correction program, it would be prudent to take a fresh look at your company's non-qualified deferred compensation plans to determine whether any additional amendments are required to ensure that your company's plans are in documentary compliance with or exempt from Section 409A and whether it makes sense to adopt corrective amendments.
- Each plan that may be subject to Section 409A should be reviewed, including for example traditional deferred compensation plans, excess pension and savings plans,

cash or equity incentive plans, international plans in which U.S. employees participate and employment, separation, change of control and consulting agreements.

- Since the end of this year is approaching quickly and certain amendments may require board, committee and/or participant approval or consent, it is important to review your company's non-qualified deferred compensation plans as soon as possible.
- To the extent any additional amendments are required to comply with Section 409A and a determination is made to adopt the corrective amendments, steps should be taken to prepare the amendments and obtain any required approvals and consents before December 31, 2010.
- It would also be prudent to review your company's operational procedures and practices to determine whether any operational violations may have occurred. You may also wish to ask the outside administrators and recordkeepers for your company's plans to confirm that there have been no operational violations of Section 409A.
- To the extent that any operational violations have occurred, your company may wish to consider correcting the operational violation under the IRS' operational correction program.
- If any corrective action is made under the document correction program or operational correction program, your company may need to comply with certain reporting requirements under the document correction program and operational correction program.

Our client alerts are for general informational purposes and should not be regarded as legal advice. If you would like additional information or have any questions, please contact:

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