



SEPTEMBER 2010

## Deadline to Take Advantage of Section 409A Transition Relief Looming

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The Internal Revenue Service (IRS) released Notice 2010-6 (Notice), a correction program for design errors in documents providing for deferred compensation subject to Section 409A of the Internal Revenue Code of 1986, as amended (Section 409A) to comply with the requirements of Section 409A. The Notice includes special transition relief for errors corrected during 2010. To take advantage of this special transition relief, which generally results in the elimination of the correction penalties under the Notice, corrections must be completed by December 31, 2010.

### BACKGROUND

Section 409A is intended to prevent the manipulation of the timing of taxation of deferred compensation under a nonqualified deferred compensation plan or arrangement. Section 409A has a broad reach and can impact various compensation arrangements beyond deferred compensation plans, including employment agreements, severance agreements, bonus plans, and reimbursement arrangements. All arrangements subject to Section 409A were required to be in documentary compliance with Section 409A by December 31, 2008.

If a particular arrangement is subject to Section 409A, failure to comply with the requirements of Section 409A, either in form or operation, can result in significant tax consequences to the employee or service provider. These penalties include immediate taxation of the deferred compensation, a penalty equal to 20 percent of the deferred compensation, and interest. Although penalties are payable by employees or service providers, many employers choose to correct plan errors for purposes of employee relations and litigation avoidance.

### CORRECTIONS FOR CERTAIN DOCUMENT FAILURES

The Notice provides various methods for an employer to bring its documents providing for deferred compensation into compliance with Section 409A. Relief is available under the Notice for many plan document failures, including the following:

- Ambiguous or inconsistent defined terms (e.g., providing that a distribution will be made "as soon as reasonably practicable" following a specified date or event).

- Inclusion of impermissible payment dates or events (e.g., a payment date that varies based on the date of the executive's execution of a noncompete agreement or a release of claims).
- Inclusion of impermissible payment schedules (e.g., multiple forms of payment for the same payment-triggering event).
- Retention of impermissible discretion to choose a form of payment or payment schedule.
- Failure to provide for a six-month delay in payment for key employees of publicly traded companies upon their separation from service.
- Erroneous deadlines for making deferral elections.

Depending on the timing of the correction, full correction under the Notice will often result in the reduction or elimination of Section 409A penalties. Generally, eligible corrections made more than one year before payment could be triggered may be made without penalty. Corrections made within one year of the earliest date on which payment could be triggered, are generally still subject to partial inclusion in income and a Section 409A penalty. Penalties under Section 409A for document failures apply even if no payment was or ever could have been made under the document; the fact that the document was non-compliant is sufficient to result in a violation of Section 409A and a penalty.

#### **TRANSITION RELIEF**

The special transition relief provided under the Notice generally permits the correction of document failures with no penalties or current taxation if the correction is made on or before December 31, 2010. For purposes of Section 409A, the correction will be treated as if it was effective on January 1, 2009, and the document was in compliance by the December 31, 2008 deadline.

If any payments have been made under a document provision corrected through this special transition relief, that payment constitutes an operational failure that must be corrected under Notice 2008-113 to take advantage of the special transition relief under the Notice.

#### **CONCLUSION**

The special transition relief available under the Notice provides employers with an opportunity to bring their deferred compensation arrangements into compliance with Section 409A without penalties. Given the significant savings available to employees and service providers if document failures are corrected before December 31, 2010, employers may wish to perform a self-audit with respect to all of their compensatory arrangements, including nonqualified deferred compensation arrangements, employment agreements and severance agreements, that may be subject to Section 409A prior to year end to determine if correction is required, and if so, to allow sufficient time for any documentary or operational corrections to be completed by December 31, 2010.

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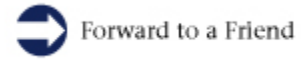
If you have any questions about the voluntary compliance program or Section 409A in general, please contact any of the following attorneys:

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