



Avoiding Injury, Insult, and Loss: Fixing Nonqualified Plan Documents to Protect Executives from the Ravages of Section 409A

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Benefits professionals can save the day for the executives, board members, owners, and other key personnel who have socked away compensation into nonqualified deferred compensation plans that

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contain provisions violating Section 409A's strict language limits. New correction procedures give employers a one-time chance this year to find and fix costly errors that otherwise will directly hurt their most valued players.

Internal Revenue Code (the Code) Section 409A imposes severe penalties on the employees who earn benefits under nonqualified deferred compensation plans (**Deferred Compensation Plans**) that fail to comply with the Code's manifold documentation rules and the hundreds of pages of regulations promulgated to interpret those rules (**Regulations**). The IRS has finally issued guidance on how to correct plan document language that fails to comply with Section 409A and the Regulations.

The new guidance includes a special exemption from the draconian Section 409A penalties if the employer fixes its Deferred Compensation Plans under the correction procedures before the end of this year, 2010. Companies can save their employees with Deferred Compensation Plan benefits the injury of 20% penalty taxes and the loss of advantageous income tax deferrals by reviewing their Deferred Compensation Plans and making corrections this year to bring those plans into compliance. Because Companies typically reserve Deferred Compensation Plans for their power players—executives, board members, owners, and top performers (**Executives**)—benefits and human resources professionals protect themselves when they protect their companies' Deferred Compensation Plans from the ravages of Section 409A penalties.

As a quick refresher, Section 409A imposes penalties for failure directly on the Executives entitled to benefits from a Deferred Compensation Plan. When a Deferred Compensation Plan fails to meet the requirements, the Executive must pay income taxes on all the compensation set aside in the plan plus an additional 20% tax penalty, which is an effective tax rate of 59.6% for many Executives (based on a tax rate of 39.6% for married individuals filing joint returns in 2010 for taxable incomes over \$250,000). This comes as a big shock to an Executive who may not actually receive the deferred compensation for five, 10, or even more years, and who may have scheduled the payment date for a year when he expected to have less income and be in a lower tax bracket. To add insult to injury, the Executive must pay a premium interest rate on the

amount of taxes the Executive would have paid for all the years during which the compensation was deferred under the plan, up to the date the Executive pays the taxes, even if the error occurred in the current year and not in any prior year. (Collectively, these penalties will be referred to herein as “Section 409A Penalties” or “Penalties.”)

New Relief Provided

The IRS published the new set of approved corrections for Deferred Compensation Plans in Notice 2010-6. This notice, which focuses on the correction of plan *document* errors, provides the companion guidance for Notice 2008-113, published in December 2008, which provided correction procedures for *operational* errors. Notice 2010-6 also modifies some of the procedures for fixing operational errors in Notice 2008-113, but those changes are beyond the scope of this article. (Notice 2010-6 also provides for corrections of impermissible initial elective deferrals, but those corrections are not addressed in this article.)

The IRS designed the correction program in the most current notice to encourage Companies and Executives to review their plan documents for compliance with Section 409A and to correct errors promptly. If a Company fixes a provision shortly before an Executive would become entitled to a prohibited distribution, it can reduce the Executive's Section 409A Penalties by 50% to 75%. Generally, if a Company fixes the offending provision at least a year in advance of a prohibited distribution, the Executive can avoid all Penalties and retain the tax deferral benefits provided by the Deferred Compensation Plan. If a Deferred Compensation Plan covers multiple Executives, a correction can reduce the penalties for Executives who would have reached a prohibited distribution event within a one-year period and eliminate the potential penalties for Executives with distribution events arising later. If a particular document error has not yet caused a prohibited distribution or otherwise been applied, Companies that complete all the correction procedures for that error within 2010 can fully protect Executives from the Penalties for that error that would arise after 2010, even if the offending provision would become applicable for some Executives in less than a year after the correction is completed. (Document errors that would cause a prohibited distribution in 2010 or cause a prohibited delay of a distribution that should occur in 2010 would still have to be corrected under the procedures of Notice 2008-113 for operational failures.)

Companies that want to take advantage of the special, one-time relief for 2010 should act quickly. Although a single plan document with only a few errors can be fixed quite quickly, a complete correction procedure may involve multiple plans and multiple Executives, and no Executive can obtain the correction relief until the Company and the Executive have completed all tax reporting and payments applicable to the error. Also, if a similar impermissible provision exists in more than one Deferred Compensation Plan sponsored by the Company and its affiliates, then the impermissible provision must be corrected in every plan, even plans covering different Executives, before any Executive covered by one of the plans receives the protection of Notice 2010-6. Correction of the plan document means the correction must be put in writing in all the necessary documents, be adopted and be effective.

Another incentive to identify and correct plan document errors as soon as possible is the ever-present threat of an IRS audit of the Company's tax filings and each individual Executive's income tax returns. Generally, if the IRS notifies the Company that non-qualified deferred compensation is an issue under consideration in an audit, document request, or proposed tax adjustment, then no Executive will be able to obtain the relief under Notice 2010-6. However, if a Company makes a correction by December 31, 2011, an IRS examination for periods on or before December 31, 2011, will only prevent use of the relief under Notice 2010-6 if the IRS identifies that particular document error, or a substantially similar document error in another Company Deferred Compensation Plan, as an issue in the examination. An individual Executive also loses the ability to correct a document error if the Executive's federal tax return comes under investigation for any taxable year in which the document error existed, unless the document error was completely corrected before the IRS contact.

Companies that correct plan document errors in 2010 also expand the relief they can receive for operational failures under Notice 2008-113. Notice 2010-6 provides that plan documents that are corrected by December 31, 2010, will be deemed by the IRS to have been compliant with Section 409A as of January 1, 2009, and Notice 2008-113 provides relief for operational errors relating to plans with compliant documents.

To obtain the maximum benefits possible under the program, Companies should review all employment agreements and other arrangements that provide for

the deferral of compensation (other than formal, tax-protected qualified retirement plans) for the common document errors that can be corrected under the new program. The following list of corrections available under Notice 2010-6, and the notice itself, also provide useful checklists of provisions that should not be used in Deferred Compensation Plans.

Errors That Cannot Be Corrected

Generally, Notice 2010-6 does not provide relief for the following matters:

- Failures to comply with Section 409A caused by the amount of deferred compensation being determined or affected by another Deferred Compensation Plan or qualified plan.
- Failures to comply with Section 409A caused by the time or form of payment being affected by the payment provisions or amount under another Deferred Compensation Plan or qualified plan.
- Failures with respect to stock rights.
- Intentional failures.
- Any “listed transaction” under Treas. Reg. Section 1.6011-4(b)(2).

Document Corrections Available

Section 409A focuses on limiting the options Executives have to control the timing of the distribution of their deferred compensation. Section 409A restricts permissible distribution triggers to the following six types (**Permissible Triggers**):

1. A specified date (or schedule of dates) set at the time compensation is deferred;
2. Separation from service;
3. A change in control of the Company;
4. An unforeseeable emergency causing severe financial hardship;
5. Disability; or
6. Death.

After the distribution triggers have been set for the Deferred Compensation Plan, Section 409A also strictly limits the circumstances under which these distribution triggers can be changed or the distribution dates postponed. (Distribution dates may never be accelerated.) Congress did not want Executives who could foresee financial trouble for the Company to be able to remain in employment, take a 10% or greater “haircut” of their benefits in exchange for the right to withdraw the reduced benefits from the Company’s

coffers, and wait to see if the Company would survive. Congress also did not want Executives to be able to deliberately choose (or otherwise control) the taxable year in which a distribution occurred after the distribution date (or event) was initially set. Congress also did not want Executives to be able to skirt the rules that lock in the distribution date or event by establishing distribution periods that straddle two tax years (which could allow an Executive to “time” the payment to fall into the more favorable of the two tax years) or to further defer a distribution from the year of the event into a future tax year. Most of the plan document corrections address impermissible provisions that would otherwise permit such behavior.

The following corrections are organized into three major categories, based on the necessary timing of the correction and the level of protection provided from the Section 409A Penalties:

- Corrections providing full protection if made before an impermissible distribution event occurs;
- Corrections that must be made a year in advance of an impermissible distribution event to receive full protection; and
- Corrections providing only partial protection from Section 409A Penalties.

Errors for Which Full Correction Is Available Before Distribution Event

The following errors may be completely corrected, thereby fully protecting affected Executives from the Section 409A Penalties, as long as the correction is made before any impermissible distribution event occurs.

Payment Periods: “As Soon As Practicable” and Other Nonspecific Language

Deferred Compensation Plans that do not provide for a specific payment date or payment within a specified period following a distribution event can be problematic. If a payment date is absolutely flexible or gives an Executive discretion to set the distribution date with little regard to the timing of the distribution event, then the Executive can skirt the Section 409A limitations and demand payment in a tax year after the tax year of the distribution event. Notice 2010-6 addresses these possibilities when a plan document provides for payment “as soon as practicable” following a distribution event.

According to the Notice, the distribution event will be treated as the payment date as long as the payment

is made within the same year as the distribution event or by March 15 of the following year (the 2½ month grace period). If the Company pays the Executive later than the end of the grace period, that will create an operational failure, unless the payment fits within one of the exceptions under the Section 409A regulations.

If a Company abuses the provision by making a practice of paying deferred compensation after the year of the distribution event (and the 2½ month grace period), then all the Company's plans containing the "as soon as practicable" language or any similar language can be treated by the IRS as if those plans failed to include the required payment dates and have document failures. Thus, if the IRS finds a pattern or practice of abusing the payment date requirements, it can impose the Section 409A Penalties on all the Executives with plans that have the vague payment timing language.

A very conservative approach in the face of this guidance would be to adopt an omnibus amendment that purports to apply to all the current Deferred Compensation plans to provide for payment within a specified period (for example, payment within 30 days of the occurrence of a distribution event). This approach has the advantage of giving the Executives the benefit of the Notice's protection for any plans the Company fails to discover and amend while decreasing the chances that one or a few payments to Executives outside the permissible payment periods will constitute a "practice" that could cause all plans to be considered to be violative of Section 409A. However, if the Company sponsors plans that require the signature of the Executive, as well as the Company, to amend, this type of omnibus action may not be effective for such plans. Unfortunately, Notice 2010-6 does not indicate how many payments outside of a permissible payment period would create a practice or pattern. Thus, it is possible that an IRS auditor could find that an Executive with a single Deferred Compensation Plan with annual distribution events who received more than one late payment constitutes a "pattern or practice" of abusive late payments. Such a finding could cause all the Company's other Executives who have vague payment timing language in their plans, even if those plans are completely separate from the offending plan, to be subject to the Section 409A Penalties.

Ambiguous Terms

If a Deferred Compensation Plan provides for a distribution event that is not defined or has an

ambiguous definition that may or may not comply with the Section 409A requirements, the plan will meet the document requirements of Notice 2010-6 if the plan also contains a provision requiring the distribution event to be interpreted to comply with Section 409A. However, the Company's plans lose the protective benefit of the Notice if at any time on or after January 1, 2009, the Company interprets the distribution event language in a way that would violate Section 409A. Such an interpretation violating Section 409A will also taint all the Company's plans with "substantially similar language." The protection can also be lost if a court interprets the plan language regarding the distribution event in a way that violates Section 409A (but such interpretation may or may not extend to other plans of the Company, depending on the court's jurisdiction).

Definition of "Disabled"

Deferred compensation plans often provide a built-in safety for early distribution if the Executive becomes disabled and will not be able to continue employment. The disability trigger differs from most other triggers in that the Company may add a disability trigger even after the plan has been established and the Executive has obtained a legal right to the compensation. However, Section 409A requires a Deferred Compensation plan to use a very specific definition of "disabled." [See Code Section 409A(a)(2)(C).]

Notice 2010-6 permits correction of a plan provision permitting a distribution related to the Executive's illness or incapacity that results in the Executive's inability to perform his duties to the Company if the provision does not use the required language to define such an event. The Company may either remove the distribution trigger entirely or modify the event language to match the Section 409A definition of "disabled." Either amendment must be effective immediately.

Notice 2010-6 permits a Company to make the corrective amendment before a non-409A-type of disability occurs that would trigger a payment under the Deferred Compensation Plan. Unlike the corrections under the Notice in relation to other types of improper definitions, a Company may also correct the plan *after* an improper "disability" has triggered a distribution from the plan if any amount that is paid or payable under the bad definition is eligible for correction as an operational error under Notice 2008-113. Thus, the Company will need to correct the document language under Notice 2010-6 and then correct the

distribution under Notice 2008-113. For the purposes of Notice 2008-113, the Company will then be permitted to treat the plan as if the disability provisions had always been in compliance (and that the payment error was simply operational in nature).

Note that, if an Executive becomes disabled in a way that meets both the Deferred Compensation Plan's distribution trigger and constitutes a disability under Section 409A, then the Company must distribute the benefits to the Executive, even if the plan's definition of "disabled" includes some impermissible terms. This distribution will not need to be corrected under Notice 2008-113 (since it was, in fact, compliant with Section 409A), but the plan will still need to be corrected to eliminate the impermissible aspects of the definition of "disability." If the plan document goes uncorrected, all the Executives with benefits under the plan (including the one who received the bona fide disability distribution) could be subject to the Section 409A Penalties because of the failure of the plan document to comply with the law.

Impermissible Payment Periods

When a Deferred Compensation Plan provides for a distribution upon one of the Permissible Triggers, the Regulations require the plan to provide that the distribution date is one of the following:

1. The date the event occurs,
2. Another specific date that is determinable once the event occurs, or
3. A date occurring during a specified period that is determinable once the event occurs.

The plan cannot permit the Executive or the Company any discretion in choosing the distribution date or period once the agreement is in place; otherwise, the Executive could use this discretion to change the taxable year in which he receives the income by moving the actual distribution date into the following year.

Payment Periods of Longer Than 90 Days. If the Deferred Compensation Plan provides that the payment following a distribution event will be made during a specified period that is determinable once the event occurs, the designated period must either be (1) within a single taxable year of the Executive or (2) no longer than a 90-day period. Because the second option potentially spans two taxable years, the Executive cannot be permitted to have any discretion as to the taxable year during which the distribution

will be made. Otherwise, the Executive could violate Section 409A by timing his distribution to occur in the more favorable of two tax years.

If a Deferred Compensation Plan violates the Regulations by setting a designated distribution period longer than 90 days but shorter than 366 days, then the Company can fix the plan document under Notice 2010-6 by amending the plan. The amendment may either remove the designated payment period or provide for a designated payment period that meets the regulatory requirements. If an Executive becomes entitled to payment under the impermissible payment schedule before the plan is corrected, the plan can still be corrected, in which case the affected Executive will face reduced Section 409A Penalties (only half the payment amount will be subject to the 409A Penalties) and the other Executives will be fully protected by the correction.

Distribution Timing Based on Executing an Agreement. Severance agreements typically include a requirement that an employee sign a noncompete agreement, a nonsolicitation agreement, or a release of claims (or an agreement combining such commitments and waivers) that protects the Company from actions an employee might take after the termination of his employment. While some severance agreements are exempt from the limitations of Section 409A, others are not. Deferred Compensation Plans and severance agreements covered by Section 409A cannot require an Executive, once he is entitled to actually receive payment of deferred compensation, to sign a noncompete agreement, a nonsolicitation agreement, a release of claims, or a similar document before receiving payment. Such a condition precedent would permit the Executive to manipulate the timing of the distribution (and the taxable year of such income) by refusing to sign the subsidiary agreement until a subsequent tax year. Also, if state law permits the Executive to revoke such an agreement within a certain number of days after it is signed, then the Company will usually write the plan or agreement so that payment is not due until the revocation period has expired. Therefore, an Executive who terminates employment in November or December but who does not want to include the deferred compensation in income in that year could manipulate the year of payment by signing the subsidiary agreement late enough in the tax year so that the revocation period expires in the following year.

To obtain the relief under Notice 2010-6, the Company must correct the provision before the occurrence of a distribution event with such a condition.

If the distribution condition (prior to amendment) required the Executive to sign the subsidiary agreement within a period of 90 days or less after the distribution event (which is a designated distribution period allowed under the Regulations), then the Company must amend the plan to provide that (1) the payment will be made on the last day of the designated period if the subsidiary agreement is signed; and (2) if the subsidiary agreement is not signed by the date necessary to permit distribution by the last day of the period (including any revocation period, if applicable), the benefit will be forfeited.

Corrections That Must Be Made a Year in Advance to Receive Full Protection

The following corrections usually provide the Executive with full protection from the Penalties if the correction is made at least a year before an event occurs that would have led to a distribution under the Deferred Compensation Plan's terms before the plan document was corrected. However, these provisions encourage Companies and Executives to review and correct plans as quickly as possible by subjecting Executives for whom an impermissible distribution event occurs within a one-year period after the correction is made (and who potentially could have foreseen such an event when making the correction) to some, albeit reduced, 409A Penalties. Executives experiencing an impermissible event within one year of the correction must suffer the following Reduced Penalties:

- Include in income a certain percentage (the amount of which depends on the specific correction) of the deferred compensation that would have been payable prior to correction (Includible Percentage); plus
- Pay the 20 percent penalty tax on that income.

However, the Executive is not required to pay the premium interest charge on the tax. The Reduced Penalties apply in the year in which the event occurs.

Definitions Related to Termination of Employment

The following errors may be corrected by amendment. In each case, the corrective amendment must be effective immediately. If the event described in an impermissible trigger occurs for an Executive within one year following the date of correction, the Executive must include the Includible Percentage in income in the year the impermissible event occurs, and the

Company must report the income on the Executive's W-2 Form in Box 1 and Box 12 using Code Z.

Definition of "Separation from Service." Section 409A requires Executives to establish at the time they begin deferring income when that income will be paid out, and Congress intended to prevent Executives from changing the time of payment at their own discretion either to further push off taxation or to cash out early if the Company's financial health took a turn for the worse. If a Deferred Compensation Plan provides for payment of deferred compensation when the Executive terminates employment, the Executive could try to bend this rule by changing his employment status so that he appears to terminate his employment even though he continues to work and draw a paycheck. For example, the Executive could arrange to quit his job with one Company subsidiary and simultaneously begin employment for another Company subsidiary. For this reason, Section 409A only permits certain types of terminations of employment to be used as distribution triggers in Deferred Compensation Plans. The IRS uses the term "separation from service" to describe those conditions that qualify as a distribution trigger. A separation of service does not include a reduction to part-time employment or similar reduction in work hours, a change from an employee to an independent contractor, or a change in employment from one subsidiary of a Company to another subsidiary.

If a Deferred Compensation Plan's terms permit the Executive to receive a distribution based on a change in employment status that does not qualify as a separation from service, the Company can correct the plan document by removing the offending distribution trigger before any such impermissible event actually arises. The correcting amendment must be effective immediately, and the plan cannot be amended to add new payment triggers.

Executive's Includible Percentage: 50%

Definition of "Change in Control." A Deferred Compensation Plan may provide for a distribution on certain changes in ownership or control of the Company. Generally, the permissible triggers are change in effective control of the Company, change in the ownership of the Company, or change in the ownership of a substantial portion of the Company's assets. The trigger event cannot be the sale of specifically identified assets (such as a specified piece of property) or a specified type of assets. If an Executive's plan is based on employment with a parent corporation, a

change in control provision cannot be based upon the sale of a specified subsidiary because such a sale is treated as the sale of a specified asset. The plan cannot use the requirement of a public offering of securities, the securing of financing, or similar events as a change in control event to trigger distribution.

A plan using one or more of the permissible types of triggers could violate Section 409A if it does not meet the specific regulatory requirements for the applicable trigger. For example, plans that permit distribution upon a change in the ownership of a substantial portion of the Company's assets must specify the percentage of Company assets that must be sold to trigger the distribution, and the percentage cannot be lower than 40%. If a plan uses a lower threshold than 40%, the plan violates Section 409A. A plan could also violate Section 409A if, in addition to the permissible trigger, it includes in impermissible trigger, such as a change in ownership due to an initial public offering.

This correction applies if a Deferred Compensation Plan permits payment on the sale of stock or assets of a corporation or a change in the effective control of the corporation. Notice 2010-6 permits correction of the change in control provision as long as the correction is made before one of the impermissible change in control events named in the plan occurs.

Executive's Includible Percentage: 25%

Other Impermissible Distribution Events

Plans Containing Both Impermissible Events and at Least One Permissible Event. If a Deferred Compensation Plan containing impermissible distribution triggers also contains at least one permissible distribution trigger, then the Executive will obtain full protection against the Penalties if the Company amends the plan to remove all impermissible distribution events before an impermissible event would apply to the deferred amount for that Executive. If the plan permits the Executive to elect the distribution trigger(s), then the correction must be made before the Executive elects an impermissible distribution trigger. Even if the Executive does elect an impermissible trigger, that election does not count for purposes of the correction until the plan makes the election irrevocable.

If an impermissible trigger applies to the deferred compensation before the corrective amendment can be made, the correction may still be completed before the date any impermissible payment event occurs by amending the plan to remove the impermissible triggers. Such amendment must be effective immediately.

Executive's Includible Percentage: 50%

Year of Income Inclusion: Year of Impermissible Event

Plans Containing Only Impermissible Events. If a Deferred Compensation Plan does not contain any permitted distribution triggers, then the Company may correct the plan only if none of the impermissible events has occurred. The Company corrects the plan by removing all the impermissible distribution events. Because the plan does not contain any permitted distribution triggers, Notice 2010-6 provides the following trigger, which the Company must insert by amendment: Distribution shall occur upon the later of (1) the Executive's separation from service or (2) the sixth anniversary of the date of correction. In this case, separation from service only means termination of employment, retirement, or death. There is no complete protection from the Penalties, but Reduced Penalties can apply.

Executive's Includible Percentage: 50%

Year of Income Inclusion: Year of Correction

Impermissible Alternative Payment Schedules

For the following two corrections, if the Executive separates from service within one year following the date of correction, the Executive must include the Includible Percentage in income in the year of separation.

Executive's Includible Percentage: 50%

Differing Payment Schedules Based on Voluntary/Involuntary Termination. A Deferred Compensation Plan cannot provide for different times or forms of payment for a voluntary and an involuntary termination of employment. A Company can correct such a provision by amending the plan before a separation from service occurs that would apply one of the alternative times or forms of payment. The corrective amendment must make the payments for a voluntary termination match the provisions for an involuntary termination, and the amendment must be effective immediately. (If the six-month delay rule applies to the Executive. (See "Failure to Require 'Six-Month Delay' of Distribution" below), then the rule must be applied to the plan's termination provisions.)

Other Differing Payment Schedules. If a Deferred Compensation Plan provides for different times or forms of payment based on factors other than whether

a termination is voluntary/involuntary, the Company is permitted to correct the plan by removing certain payment alternatives before a payment event occurs that would apply one of the alternative times or forms of payment. Generally, the rules for determining which of two alternative payment terms should be removed leave the later possible payment date in the plan. First, when comparing two payment alternatives, the payment that remains must be the one resulting in the latest final payment date. If the alternatives would have the same final payment date, then the alternative that remains must be the one with the latest commencement date. If the commencement dates are the same, the alternative that remains must be the one generally expected to result in later payment dates overall. The amendment must be effective immediately.

Impermissible Discretion to Affect Distribution Schedules

Discretion to Change Time or Form of Payment.

A Deferred Compensation Plan cannot permit the Executive or the Company to change the time or form of payment, because the Executive, either directly or indirectly through the Company, could then accelerate or defer the distribution into another taxable year or choose a form of payment (such as Company stock) with different tax consequences. However, if a plan's terms permit such discretion, the Company may not be required to fix the plan to avoid the Penalties. If the plan has default payment provisions that would apply in the absence of a discretionary change, the Executive and Company generally can avoid a Section 409A violation as long as neither exercises the discretionary power. Even if the Executive or Company changes the time or form of payment, the harm can be undone if the party that made the change revokes the change at least one year before the distribution event occurs.

However, this special protection will be lost if another Executive with a substantially similar provision in his Deferred Compensation Plan changes his time or form of payment (or the Company does so) and does not revoke the change at least a year before the distribution event. In that case, the first Executive will be protected from the Penalties only if the Company takes commercially reasonable steps to identify and correct all its plans with substantially similar provisions (whether discretion has been exercised or not).

Notice 2010-6 permits correction of a Deferred Compensation Plan with such a "discretion" provision if the Company amends the plan before the date of any

payment subject to the discretion provision. If the plan has default payment terms, then the Company only needs to remove the provision granting discretion to change those terms. For a plan without default payment terms, the Company must also add a provision applying the time and form of payment with the latest final payment date from among all the plan's options. If two provisions in the plan could potentially be effective, the Company must apply the rules for choosing between alternative payment schedules, discussed in the section above titled "Other Differing Payment Schedules."

Executive's Includible Percentage: 50%

Year of Income Inclusion: Year Separation of Service Occurs (for voluntary separation); Year Discretion Provision Triggered

Discretion to Accelerate Distribution Events.

With only certain special exceptions provided in the Regulations, a Deferred Compensation Plan cannot permit the Company the discretion to ignore the distribution events listed in the plan and make a distribution of the deferred compensation to the Executive before a distribution event occurs. If a plan provision would permit the Company such discretion, the plan can be corrected if the Company amends the plan to remove such discretion before (1) the Company uses its power to accelerate a distribution and the discretion becomes irrevocable and (2) the distribution is made. (Alternatively, the Company can correct with an amendment limiting such discretion to those specific instances permitted in the Regulations. [See Treas. Reg. § 1.409A-3(j)(4).])

Corrections Always Requiring Some Penalties

Failure to Require "Six-Month Delay" of Distribution.

Section 409A requires that any distributions from a Deferred Compensation Plan triggered by a separation from service by certain key Executives of publicly traded Companies be delayed six months after the separation from service. A Deferred Compensation Plan that fails to include such a provision can be corrected under Notice 2010-6 before such a distribution trigger occurs.

To make the correction, the Company must amend the plan to add the necessary delayed-payment provision and to include an additional provision that an amount subject to the delayed-payment rules may not be paid before the later of (1) 18 months following the

date of correction or (2) 6 months following the date of the distribution event.

Executive's Includible Percentage: 50%

Year of Income Inclusion: Year Separation of Service Occurs

Exception from Penalties for Correction in Plan's Initial Year

Notice 2010-6 provides a special exception for corrections made to a new Deferred Compensation Plan that would allow an Executive to avoid any of the Section 409A Penalties even if the Executive has *already received* a prohibited distribution from the plan (or already deferred a distribution that should have been made). The Company must make the correction(s) permitted in Notice 2010-6 and correct the prohibited distribution as an operational failure under Notice 2008-113. The plan document correction must be made by the end of the calendar year in which the first legally binding right to deferred compensation arose under the plan. (An alternative deadline, March 15 of the subsequent year, applies if the legally binding right arises late in the calendar year, but only if the period ending on the 15th day of the third month following the date the first legally binding right arises is later than the end of the calendar year.) The Company is permitted until the end of the calendar year in which the document error is corrected to correct the operational failure under Notice 2008-113.

To determine whether the Deferred Compensation Plan is a new plan, the Company must examine all its Deferred Compensation Plans of the same category and use the date of the first legally binding right to deferred compensation that arises under any of those plans. Notice 2010-6 uses the same nine categories of plans used in the plan aggregation rules in the Regulations, which can be generally broken down into the following types of plans:

1. Account balance plans permitting Executive deferral elections;
2. Other account balance plans, including those providing for matching contributions;
3. Nonaccount balance plans;
4. Separation pay plans;
5. Plans providing in-kind benefits or expense reimbursements;
6. Split-dollar life insurance arrangements;
7. Plans providing for the deferral of modified foreign earned income;
8. Stock right plans; and
9. Plans providing for all other types of deferred compensation.

The Company and the Executive may disregard any Deferred Compensation Plan that already paid out or forfeited all its benefits if the Company did not have any obligations remaining to pay benefits at the time the legally binding right in the new plan arose. The Company and the Executive may also disregard any plan not subject to Section 409A, including grandfathered plans exempt from Section 409A.

Conclusion

Notice 2010-6 rewards Executives and Companies that act quickly to review all their employment agreements, severance agreements, and other arrangements and plans that defer compensation for compliance with Section 409A. Those who perform a comprehensive review and who follow up when they find errors in one plan to identify similar errors in other plans will provide the greatest protection to the greatest number of their Executives. And even a focused review of just a Company's largest plans, by assets deferred or individuals covered, can potentially save Executives large sums in avoided penalty taxes.

Benefits professionals and advisers who review the plans in time to complete the corrections in 2010 can protect the C-suite bosses from all potential Section 409A document penalties and improve their ability to fix any operational error that can be corrected under Notice 2008-113. However, remember that certain document errors cannot be fixed unless the Company amends the plan *before* certain events and distributions occur. So act promptly to survey plan documents and to complete corrections before an unexpected event triggers a distribution, because events such as terminations of employment can occur at any time, even before the 2010 and 2011 deadlines, and strip away the additional protections available during the special relief periods. ■