DOT YOUR "I"S AND CROSS YOUR "T"S: IT'S ONCE AGAIN TIME TO REVIEW AND FIX DEFERRED COMPENSATION PLANS

January 15, 2010

To Our Clients and Friends:

On January 5, 2010, the IRS issued Notice 2010-6 which, among other things, (i) "clarifies" that certain commonly used terms in nonqualified deferred compensation plans do not cause the plans to violate §409A and (ii) expands the voluntary corrections program to cover certain "inadvertent" and "unintentional" documentation violations under §409A.

While the new guidance provides welcome relief with respect to a number of possible documentation failures, the IRS also identified as problematic plan provisions that employers may have thought complied with §409A. Accordingly, and to make the most out of the new relief, companies should review and correct their plan documents under Notice 2010-6 by no later than **December 31, 2010**.

OPERATIONAL FAILURES MUST BE CORRECTED

Notice 2010-6 does not provide relief from operational failures to comply with §409A. Thus, operating a plan in a manner that violates §409A will result in adverse tax consequences – even if the terms of the plan are corrected in accordance with Notice 2010-6. However, relief from operational failures continues to be available under Notice 2008-113, which the IRS promulgated in December 2008. For additional information regarding Notice 2008-113, please see our Client Update of January 22, 2009, "IRS Revises §409A Corrections Program (But it's No Panacea)," available at http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=b7a6f220-8137-4a39-bec4-15f3272e3aff.

A LITTLE FLEXIBILITY DOESN'T HURT

"As Soon As Practicable." Notice 2010-6 "clarifies" that, contrary to previous statements made by IRS authorities, a plan will generally not violate §409A simply because it provides for payment "as soon as practicable" following a separation from service, fixed date, change of control, death, disability or unforeseeable emergency (such events are referred to as "permissible payment events").

Note, however, that payment must be made by the later of the end of the year in which the payment event occurs or 2 ½ months following the payment event (the "grace period") in order to avoid an *operational* violation. Moreover, if an employer habitually pays after the

grace period expires, any plan of that employer providing for payment "as soon as practicable" following a permissible payment event will *not* be treated as being in *documentary* compliance with §409A. To avoid inadvertent document failures, plans providing for the payment of deferred compensation should be qualified to provide that payment will in all events be made during the grace period.

Undefined Permissible Payment Events. Notice 2010-6 also "clarifies" that a plan will not generally be treated as violating §409A simply because the meaning of a properly selected permissible payment event (such as separation from service/termination of employment, change in control or disability) is ambiguous. For example, a plan that provides for payment upon "termination of employment," without expressly defining the term or a caveat that the term is to be interpreted within the meaning of §409A, will generally be deemed to be in documentary compliance, even though the term "termination of employment" could be interpreted in a manner that violates §409A. (For §409A purposes, a termination of employment requires a substantial reduction in the level of services provided by an employee. The words "termination of employment," without further definition, could be interpreted to include other events, such as an employee's retirement, even though he or she continues to provide substantial consulting services following retirement.)

Any payment that is made pursuant to the vague plan term, but that does not meet the requirements of §409A, will be treated as an operational failure that may be corrected in accordance with Notice 2008-113. However, to take advantage of the operational correction program, the plan must *also* be amended to properly define the permissible payment event to fall within the meaning of §409A. Again, to avoid inadvertent violations, consider amending your plans so that all payment events are either adequately defined within the plan or are to be interpreted within the meaning of §409A.

Note that the rule described above does *not* apply – and the plan will not be deemed to meet the written plan requirements of §409A – if the payment event (i) is expressly defined in the plan in a manner that violates §409A (although the plan may be corrected as provided below), (ii) has, with respect to *any* plan of the employer, been consistently interpreted by the employer since January 1, 2009 in a way that violates §409A, (iii) has been interpreted by a court to require payment in violation of §409A, or (iv) has been intentionally used by the employer to make payments that do not comply with §409A.

FIXING DOCUMENTATION FAILURES

Effect Of Correction. If a plan is properly and timely corrected under Notice 2010-6 as described below, the plan will generally be treated as meeting the written plan requirements of §409A both after the correction is made *as well as* for all prior years. Note that, if document failures had previously been reported, employers and employees may need to amend prior returns to reflect the correction.

General Eligibility Requirements. The following conditions must be satisfied to take advantage of the available corrections under Notice 2010-6, as described below:

- The company must take commercially reasonable steps to identify all other plans (whether or not such other plans are aggregated under §409A's plan aggregation rules) with substantially similar document failures and correct such failures in accordance with Notice 2010-6.

- Neither the employee nor the employer may be under examination by the IRS at the time of the correction. For these purposes, a non-individual employer will only be considered to be under examination if the examination specifically cites non-qualified deferred compensation as an issue for consideration. Moreover, a non-individual employer under examination before December 31, 2011 will be eligible to make corrections under Notice 2010-6, unless the particular document failure has been identified as an issue in the examination.

- The document failure must be "inadvertent and unintentional." (Notice 2010-6 does not provide any guidance as to what an "inadvertent and unintentional" failure is; without further guidance, we believe this should include plan provisions that an employer reasonably thought complied with §409A but did not, in fact, comply.)

- As noted in the chart attached to this Client Update, with respect to some corrections effected after 2010, an employee may be required to include in income under §409A an amount equal to 25% or 50% of the deferred compensation. If an amount is includable, the 20% penalty tax applies to the includable amount, but *not* the special §409A interest tax. (If a plan is properly and timely corrected by December 31, 2010, no amount would be includible in income under Notice 2010-6.)

- The employer must notify the IRS that it utilized the corrections program and provide the IRS with specified information about the plans and documentation failures involved and the corrective measures taken, as well as the names and social security numbers of the employees involved.

- The corrections under Notice 2010-6 are not available to fix options and stock appreciation rights.

New Problems Identified. As noted above, the IRS also identified as problematic plan provisions that employers may have thought complied with §409A. One notable example involves the payment of severance "within" 90 days of an employee's separation from service, if the employee is required to sign a release as a condition to receiving the severance.

The regulations under §409A permit payment within a designated period of not more than 90 days, so long as the employee does not have a right to designate the year of the payment. With Notice 2010-6, the IRS is now on record as stating that an actual payment date must be fixed (outside of the release delivery period) in such circumstances and appears to be saying that a plan may not permit the employee to have any discretion as to when payment occurs, even if the designated period does not transcend two years.

Corrections that must be completed by December 31, 2011. There are two types of document failures that must be corrected by December 31, 2011.

Linked Plans. One type of failure involves so-called "linked plans," where the time and form of payment under one plan is affected by the time and form of payment under another plan. Notice 2010-6 gives an example of a non-account balance plan which provides payments in 10 annual installments beginning from the earlier of separation from service or a change in control. The amount payable under the non-account balance plan is offset by amounts payable under an account balance plan that provides for lump sum payment. The IRS states that the offset – that is, the linkage between the two plans – could change when amounts are payable to the plans' participant and (therefore) the linkage causes the plans to violate §409A's written plan requirements. Notice 2010-6 requires *both* plans to be amended by no later than December 31, 2011, so that the plans have identical payment schedules with the payment schedule providing for the latest payments governing.

Timing Based On Payments To Employer. The other document failure that must be corrected by December 31, 2011 applies to a payment schedule based on when amounts are received by the employer. A payment schedule determined by reference to the timing of payments received by the employer meets the requirements of a specified date or fixed schedule of payments under §409A provided, among other things, (i) there is an objective, nondiscretionary method of identifying the payments to the employer that are used to determine the amounts payable to the service provider and (ii) the payment schedule provides an objective, nondiscretionary schedule under which the payments will be made to the employee. If a plan fails to provide either of these two prongs, the plan must be corrected by December 31, 2011 to add the missing provisions.

Other Corrections. The other corrections available under Notice 2010-6 do not need to be completed by a specific date. **However, as previously noted, corrections made by December 31, 2010 are afforded more favorable tax treatment.** That is because, with respect to some corrections effected after 2010, an employee may be required to include amounts in income under §409A and be subject to the 20% penalty tax (but not the §409A interest tax).

There is also a special rule for employers who first establish a non-qualified deferred compensation plan that is not aggregated with any other plans of the employer under §409A's plan aggregation rules. Under this special rule, no participant under the new plan would be required to recognize income under Notice 2010-6 if the corrections available under the notice are completed by the later of the end of the year or 2 ½ months following the date the first legally binding right under the new plan arises.

The chart attached to this Client Update shows: (i) the document failure that may be corrected under Notice 2010-6, (ii) the means of correction, (iii) when the correction must be effected, and (iv) whether any amount is required to be included in income.

WHAT SHOULD YOU DO NOW? (CUE THE JAWS THEME MUSIC ON YOUR IPOD)

Just when you thought it was safe to put down your plan documents, the IRS tells you to pick them up and review them again for §409A compliance. In this respect, Notice 2010-6, though burdensome, can also be viewed as a planning opportunity—another chance to review your documents to ensure that they meet the written plan requirements of §409A, especially in light of any guidance that has been issued since you last completed your §409A review in 2008. If they do not meet those requirements, you should consider whether any failures may be corrected under Notice 2010-6. You should begin this review as soon as possible, because you may only recognize the full benefit of Notice 2010-6 if you complete plan corrections by December 31, 2010.

This memorandum was not intended or written to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer under U.S. federal tax law.

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Notice 2010-6 Corrections Chart

Document Failure	Correction	By When?	Income Inclusion?
Impermissible definition of "separation from service."	Properly define "separation from service."	Before a separation from service occurs.	If separation from service occurs within a year of the correction, and payment would have been required under the "bad" definition, the employee is taxed on 50% of the amount of the deferred compensation.
Impermissible definition of "change in control." Note that this correction does not to apply to a payment event that is a public offering or financing.	Properly define "change in control."	Before a change in control occurs.	If a change in control occurs within a year of the correction, and payment would have been required under the "bad" definition, the employee is taxed on 25% of the amount of the deferred compensation.
Impermissible definition of "disability."	Either (i) properly define "disability" or (ii) remove disability as a payment event (note that a §409A disability may be added as a payment event at any time).	The plan may be corrected at any time (note that payment on account of a disability that is not within the meaning of §409A will result in an operational failure).	N/A
Payment periods of longer than 90 days but fewer than 366 days following a permissible payment event (note that whether this is a §409A violation depends on the terms of the plan).	Either (i) remove the payment period or (ii) limit the period to 90 days.	Before a payment event occurs, but . . .	. . . may also correct after the payment event occurs, but the employee is taxed on 50% of the amount of the deferred compensation.

Document Failure	Correction	By When?	Income Inclusion?
Payment period following permissible payment event conditioned on employee action (such as conditioning severance on the employee signing a release within 90 days of termination).	Remove the ability of the employee to determine payment date. If there is a designated payment period, the amended plan must provide for payment on the last day of such period. Otherwise, payment must either be on the 60th or 90th day following the payment event.	Before a payment event occurs.	N/A
Plan with permissible and impermissible payment events.	Remove the impermissible events.	Before the impermissible event has been elected as a payment event, but . . .	. . . may also correct after the impermissible event has been elected and before the event occurs, but the employee is taxed on 50% of the amount of the deferred compensation.
Plan only pays upon impermissible events.	Remove impermissible events and provide for payment on the later of (i) separation from service and (ii) the 6th anniversary of the correction.	Before the impermissible event occurs.	N/A

Document Failure	Correction	By When?	Income Inclusion?
Impermissible alternative payment schedules.	If different payment schedules apply to voluntary and involuntary terminations of employment, the time and form of payment upon voluntary termination must be revised to be the same as the time and form of payment for involuntary termination. For other types of alternative payment schedules, payment schedules must be aligned, with the schedule resulting in the latest payments governing.	Before event occurs.	If a payment event occurs within a year of the correction, and payment would have been required under the "bad" alternative schedule, the employee is taxed on 50% of the amount of the deferred compensation.
Impermissible discretion with respect to payment schedule.	Remove discretion so that either (i) the default plan rules apply, if there were default plan rules prior to the correction or (ii) if there were no default plan rules, the payment schedule under the pre-corrected plan resulting in the latest payments govern.	Before payment event occurs.	If a payment event occurs within a year of the correction, the employee is taxed on 50% of the amount of the deferred compensation.
Impermissible discretion to accelerate.	Remove discretion to accelerate.	Before election to accelerate or acceleration occurs.	N/A

Document Failure	Correction	By When?	Income Inclusion?
Impermissible reimbursement or in-kind benefit (for example, amounts reimbursed in one year affect the amounts reimbursable in a subsequent year).	Provide for reimbursement schedule that complies with §409A, provided that the amount of eligible reimbursements must be allocated *pro rata* to the number of years the reimbursements are available to the employee. If the reimbursements are available over the employees lifetime, the period of reimbursement is determined based on the employee's life expectancy. If the reimbursements are available until the occurrence of an event, the relevant period must be estimated, but in no event be less than three years.	Before payment event occurs.	If a payment event occurs within a year of the correction, the employee is taxed on 50% of the amount of the deferred compensation.
Failure to include 6 - month delay for specified employees.	Provide for payment upon separation from service for specified employee to be no earlier than (i) 18 months following correction or (ii) 6 months following separation from service.	Before separation from service.	If separation from service occurs within a year of the correction, the employee is taxed on 50% of the amount of the deferred compensation.

Document Failure	Correction	By When?	Income Inclusion?
Impermissible initial election (note there is no plan violation with respect to an employee to whom the impermissible election does not apply).	Remove ability to make impermissible election and revoke any impermissible elections.	By December 31 of the 2nd year following the applicable deadline for making an initial election under §409A. If the initial election happens to have been made by the applicable deadline, but thereafter the "bad" plan terms are fixed and the election is revoked, then there is no operational failure. However, if the initial election is made after the applicable deadline, and thereafter the "bad" plan is fixed and the election is revoked, the improper election must be fixed under Notice 2008-113 as an operational failure.	N/A