



## Avoid Tax Penalties by Correcting Employment, Severance and Deferred Compensation Arrangements in 2010

Employment, Labor & Benefits Practice Group

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### **PRACTICE AREAS**

Business Law

Employee Benefits

Nonqualified deferred compensation arrangements are required to comply, in writing, with the highly technical rules of Internal Revenue Code Section 409A ("Section 409A") effective as of January 1, 2009. A "deferred compensation arrangement" is any arrangement with an employee or independent contractor that could result in compensation being paid in a year following the year in which the compensation is earned. Thus, the term may include traditional deferred compensation plans, as well as employment agreements, independent contractor agreements, bonus arrangements, severance plans, stock incentive plans and management service contracts.

Failure to comply with the rules of Section 409A could result in the employee having to recognize all amounts "deferred" under the arrangement as current income, plus interest and a 20% penalty. The employer could also be subject to penalties and interest for not withholding sufficient income and employment taxes.

The IRS recently published guidance that permits an employer to correct a Section 409A failure in the document that sets forth the terms of the arrangement. The IRS previously published guidance that permits an employer to correct a failure to comply with Section 409A in the operation of an otherwise compliant plan. Corrections made during 2010 avoid significant penalties. After 2010, the correction procedure will continue to be available but, penalties may apply.

We recommend that all employers have their deferred compensation arrangements, including employment agreements, independent contractor agreements, bonus arrangements, etc., reviewed for compliance with Section 409A during 2010, so that any errors might qualify for penalty-free correction.

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