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Employee Benefits & Executive Compensation Update

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Recent Developments in Employee Benefits and Executive Compensation

This newsletter briefly discusses several recent developments in employee benefits and executive compensation that may be of interest. For more details on any item reported herein, please contact any member of Blank Rome's Employee Benefits and Executive Compensation group.

Section 409A Correction Program for Non-Compliant Documents

The IRS has announced a correction program (Notice 2010-6) that permits employers with deferred compensation programs subject to section 409A of the Internal Revenue Code to correct certain *document* failures and limit potential 409A exposure for their employees. This is in addition to a correction program announced in late 2008 (Notice 2008-113) that addresses *operational* failures of non-qualified deferred compensation plans.

In order to be eligible for the correction program: (1) the employee's 1040 must not be under IRS audit; (2) the employer's deferred compensation plans must not be under IRS audit; (3) the 409A document failure must be unintentional; (4) the employer must take steps to identify and correct other documents or arrangements with similar failures; (5) the employee may have to recognize as taxable income up to 50% of the amount subject to the correction (the amount that must be recognized depends on the nature of the failure and when it is corrected), *including payment of the 20% excise tax under 409A with respect to such income;* (6) certain information filings must be made with the IRS; and (7) the correction must be made before the occurrence of a payment event that gives rise to the operation of the incorrect provision.

As a general matter, Notice 2006-10 appears to confirm the concept that, except under very limited circumstances, there is no way to retroactively correct a payment that was made pursuant to non-409A compliant plan provisions. Such payment is subject to the 409A penalties in full.

In lieu of complying with the seven requirements discussed above, all 409A penalties may be avoided in connection with the document failures described below if the document is corrected before January 1, 2011 and the employer has operated the plan since January 1, 2009 in accordance with the document as amended. This provides a limited opportunity to bring documents into compliance without penalty to the employee.

The correction program is limited to the following plan defects:

- Describing a payment date as "as soon as reasonably practicable" following a permissible 409A triggering event, rather than using a fixed date following the triggering event.
- Failure to define an otherwise permissible triggering event or ambiguously defining an otherwise permissible triggering event.

- Use of an incorrect definition of an otherwise permissible triggering event (i.e, an incorrect definition of "separation from service", "change in control" or "disability").
- Use of an impermissible payment period (e.g., payment tied to the actual signing of a release agreement, rather than tied to the end of the consideration period).
- Use of an impermissible payment event or payment schedule.
- Failure to include six-month delay rule for specified employees.
- Use of impermissible initial and subsequent deferral elections.

The correction program is not available for discounted stock options.

Government Shows Interest in Having DC Plans Provide Lifetime Benefit Options

Retirement income "sufficiency and security" is a high priority on the Government's 2010 Regulatory Agenda. The Department of Labor and the IRS have announced that they will shortly be issuing a Request for Information regarding how defined contribution plans may provide for lifetime payment options. Perhaps with this in mind, the IRS released Private Letter Ruling 200951039 that clarifies some of the legal requirements surrounding lifetime income options in defined contribution plans. In the PLR, the IRS addressed a novel variable annuity product that allows a plan participant to receive a stream of income for life (or the joint life of the participant and a beneficiary) in two phases.

During Phase 1, which runs for a minimum of five (5) years, each periodic payment is calculated as the product of the account value and an annuity factor, adjusted to reflect investment performance. During Phase 1, the participant has the option to start or stop the periodic payments, to lengthen or shorten the initial phase, to pay additional premiums into the group annuity, to request a partial lump-sum withdrawal, to surrender the group annuity for its surrender value, or to change the joint annuitant. At the conclusion of Phase 1, the participant is no longer able to make such changes.

If a participant dies during Phase 1, a death benefit equal to the account value is provided. The beneficiary may elect to receive the amount in a single sum or in a variety of life annuities that satisfy the IRC § 401(a)(9) minimum distribution requirements.

During the Phase 2, periodic payments in the form of contingent annuity payments are provided. Even though payments may increase or decrease based on the investment return during Phase 2, investment experience cannot exhaust the value of the group annuity, which continues for the life of the participant (or joint lives of the participant and beneficiary).

If a participant dies during Phase 2, continued payments are provided in the form elected by the participant.

The IRS ruled as follows:

- Minimum required distributions during Phase 1 should be determined under the rules applicable to defined contribution plans, and during Phase 2 under the rules applicable to defined benefit plans.
- Notice requirements, including QJSA, must be satisfied at the beginning of Phase 1 even though during Phase 1 the employee may change the Phase 2 joint annuitant and, by taking withdrawals, change the amount of the Phase 2 payments.
- The annuity payments made during Phase 2 could be considered payments under a QJSA, notwithstanding that the payment amounts would vary with investment performance.

IRS Reviews When a Bonus is Deductible.

The IRS has released through Chief Counsel Advice 200949040, a review of requirements that determine when a liability arising from bonus compensation may be deductible for Federal income tax purposes. The CCA rejects a company's assertion that it had "fixed" a portion of the amount of its bonus liability for purposes of the "all events test" prior to the end of the taxable year for which the bonus was payable and, therefore, a bonus relating to a particular year of employment could not be deducted until the year of payment.

The company, an accrual basis taxpayer, sponsored a bonus plan. The plan provided that an employee's entitlement to a bonus for a year was conditioned upon employment on the date in the next year when the bonus was paid. The company "supplemented" the bonus plan by obligating itself to pay 90% of the amount accrued in the first 2½ months of the next year. Any amounts not paid as bonuses would be paid to a charity as a charitable contribution. Because the amount of the bonuses actually paid exceeded the 90% threshold, the company paid no amount to charities.

Treasury regulations provide that under the accrual method of accounting, a liability is incurred, and is generally taken into account for federal income tax purposes, in the taxable year in which (1) all the events have occurred that establish the fact of the liability, (2) the amount of the liability can be determined with reasonable accuracy, and (3) economic performance has occurred with respect to the liability. For liabilities arising from services, economic performance occurs as the services are rendered. If the board of an accrual basis corporate taxpayer authorizes a charitable contribution during any taxable year, and payment of the contribution is made after the close of such taxable year and within 2½ months following the close of such taxable year, then it may elect to treat the contribution as paid and deductible during such taxable year.

The company asserted that the combination of the obligation arising from the bonus plan and the obligation to contribute any amounts not paid to employees to charity, "fixed" its liability during the first year. The CCA rejects the company's argument, reasoning that the charitable and the bonus deductions are governed by separate sections of the tax law, constitute two different types of liabilities and are subject to different timing rules. The CCA reasons that the obligation to pay the bonuses did not become "fixed" with regard to an employee until he or she satisfied the employment condition on the payment date. Even though the bonuses were based on the company's performance during the year relating to the bonus, the CCA reasons that economic performance did not occur until the date that the bonuses were paid because services had to be rendered to the date of payment. Accordingly, the CCA concludes that the bonuses were deductible for the year the bonuses were paid.

Department of Labor Extends Period for Small Employers to Make Contributions

The Department of Labor has amended its plan asset regulations to provide a seven-business-day safe harbor for the transfer of employee contributions and employee loan repayments for contributors to small plans. The safe harbor applies only to plans with fewer than 100 participants as of the beginning of the plan year. The safe harbor applies on a plan by plan basis and therefore does not apply to an employer that has fewer than 100 employees to the extent the employer contributes to a multiple or multi-employer plan that has more than 100 participants.

The regulations confirm that employee contributions and repayments may be transferred to the plan later than the seven day safe harbor deadline but no later than the date on which the contributions and repayments can reasonably be segregated from the employer's general assets.

The regulations confirm the continued applicability of DOL Field Assistance Bulletin 2003-2, which explains that if a multiemployer plan maintains a reasonable process for the expeditious and cost-effective receipt of contributions, such process may be taken into account in determining when employee contributions can reasonably be segregated from the employer's general assets.

The regulations also confirm the continued applicability of the 90-day deadline for welfare plans.

In no event may participant contributions and loan repayments to a retirement plan be transferred to the plan later than the 15th business day of the month following the month in which the participant contribution or loan repayment is withheld or received by the employer.

New Forms

The Department of Labor has issued new COBRA notices that address the extension of the COBRA premium subsidy. These notices may be accessed at www.dol.gov/ebsa/COBRAmodelnotice.html. The IRS has issued new model distribution notices (sometimes called the "Direct Rollover Notice" or "402(f) Notice") which may be accessed at http://www.irs.gov/irb/2009-39_IRB/ar14.html.

IRS Issues Significant HEART Act Guidance

The IRS has issued Notice 2010-15, which provides significant guidance under the HEART Act. The HEART Act is essentially an expansion of the 1994 legislation known as "USERRA" which protects the reemployment rights of employees who leave civilian jobs for military service. For qualified plan purposes, if the individual returns to employment within a specified period and meets other requirements of USERRA, the employee must receive qualified plan benefits that he or she would have received but for the absence during military service.

With respect to qualified plans, the HEART Act provides that (1) some USERRA rights are extended to individuals (or their beneficiaries) who do not return to employment because they die during military service; (2) employers *may* treat individuals who die or become disabled during military service as having returned to employment on the day before death or disability (in which case they would be entitled to all of the benefits required to be restored by USERRA); (3) differential wage payments may be used as the basis for making contributions under a qualified plan; (4) an employee who is in military service may be treated as having a severance from employment; and (5) distributions are permitted to members of the reserves who are called up to active duty and such distributions are not subject to the 10% early withdrawal penalty. Notice 2010-15:

- Clarifies how to determine the death benefits that must be provided by the plan.
- Explains the differences between the restorative benefits that may be provided with respect to deceased individuals and those that may be provided with respect to disabled individuals.
- Explains how to calculate employer-provided benefits that are contingent on employee contributions.
- Clarifies that the inclusion of differential wage payments as plan compensation is elective and that failure to include it will not be considered discriminatory.

Treasury and IRS Issue Final Employee Stock Purchase Plan Regulations

Treasury and the IRS have issued final regulations under Section 423 of the Internal Revenue Code relating to employee stock purchase plans. Such plans allow employees to purchase employer stock at discounts of up to 15%. Overall, the final regulations followed the 2004 proposed regulations with the following of note: (1) the final regulations confirm that employers may provide for different offerings under an ESPP and that they have flexibility in determining the terms and conditions that apply to each; (2) the final regulations clarify that the grant date is last day of the offering period (i.e., the "Purchase Date") because that is the first date the maximum number of shares an individual may purchase becomes fixed; (3) the final regulations clarify how the $25,000 accrual limitation works for options that remain outstanding for multiple calendar years; and (4) the final regulations further expand on which changes would render the ESPP a new plan requiring shareholder approval.

The final regulations also provide that the IRS reporting requirements are further delayed until January 2011, but there is no delay to the the employee information requirements. ■

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