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First Quarter 2010

NOTICE 2010-6

As you know, nonqualified deferred compensation plan documents were required to be in compliance with Section 409A of the Internal Revenue Code and the regulations issued thereunder (“Section 409A”), by January 1, 2009. If a plan thereafter contains an impermissible provision, then even if the provision is never used, all vested amounts will immediately become taxable to each plan participant and each participant will be subject to a 20% additional tax plus interest and penalties.

In early January 2010, the IRS issued Notice 2010-6 (the “Notice”), containing much anticipated guidance providing relief for certain document failures under Section 409A. The Notice gives deferred compensation plan sponsors the opportunity to make document corrections necessary to comply with Section 409A through the end of 2010 without penalty. In addition, the Notice provides for procedures to make document corrections beyond 2010, though in these cases individual participants may be required to pay additional taxes and penalties.

Note that distribution and deferral elections made under defective plan provisions may constitute operational failures and, as

such, would be subject to the operational correction provisions of Notice 2008-113.

Here is a summary of the 2010 transitional rules as well as the rules that will continue beyond 2010 for correcting defective plan documents.

General Requirements for Correction

There are several general requirements that must be satisfied for an employer to be eligible to make corrections under the Notice:

Unintentional Failures Only. Failures must be inadvertent and unintentional.

All Substantially Similar Failures Must be Corrected. The employer must take “commercially reasonable” steps to identify and correct all other plans and arrangements subject to Section 409A with the same or substantially similar failures.

GENERAL REQUIREMENTS

- Failure must be unintentional
- All substantially similar failures must be corrected
- Employer and employee must not be under IRS examination
- Any applicable 409A tax must be paid
- Employer and any affected employee must report to IRS

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Employer and Employee Not Under IRS

Examination. Neither the employer's nor the employee's federal income tax return can be under "examination" by the IRS with respect to nonqualified deferred compensation for any taxable year in which the document failure existed. An *individual* will be considered under examination if his or her federal income tax return is under examination for that taxable year. Any other type of taxpayer (e.g., corporation) will be considered under examination if it received written notification which specifically cited nonqualified deferred compensation as an issue under consideration by the IRS. If an employer is under examination for periods prior to January 1, 2012 and a document is corrected prior to that date, the employer will only be treated as under examination if the IRS has identified a specific document failure that did not comply with Section 409A as of January 1, 2009.

Payment of All Section 409A Correction Taxes.

If required by a specific correction method, the employee must include in income the applicable percentage (either 50 percent or 25 percent) of the deferred amount subject to correction and pay all federal taxes, including the additional 20 percent tax on the amount included in income. The premium interest tax is waived. Together, the income tax and penalty tax is referred to hereinafter as the Applicable Section 409A Income and Correction Taxes.

Reporting Requirements. The Notice requires that a statement be attached to the employer's federal income tax return and provided to each affected employee for attachment to the employee's federal income tax return for the year of the failure. The statement must contain the identification of the plan involved, information regarding the failure, the specific authority under the Notice for the correction, and information identifying the affected employees.

SIX KINDS OF PERMISSIBLE CORRECTIONS

The Notice generally provides for six kinds of corrections.

CHANGES ARE PERMITTED TO CORRECT:

- Impermissible definitions of payment events
- Impermissible payment periods
- Impermissible payment events or impermissible discretion
- Failure to include six-month payment delay
- Impermissible initial deferral elections
- Impermissible provisions after the initial adoption of a plan

Correction of Impermissible Definitions of Payment Events.

Permissible payment events under Section 409A include: (1) a separation from service, (2) death, (3) disability, (4) change in control, (5) unforeseeable emergency, or (6) a specified date. These payment events are defined in the Section 409A final regulations, and a plan's use of a variation could result in a Section 409A violation.

The Notice permits an employer to correct an impermissible definition of separation from service or change in control provided that the correction occurs before the date of the payment event. In addition, if there is a distribution under the plan within one year after the correction date, an affected employee must pay the Applicable Section 409A Income and Correction Taxes.

If the definition of "disability" needs to be corrected, the correction may be made before or after the disability event.

Any operational failure that occurred due to a defective definition must also be corrected.

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Correction of Impermissible Payment Periods.

Plans may provide for a payment period that is limited to one taxable year, or a period that is no longer than 90 days following a payment event and that does not permit an employee to elect the year of payment. The Notice permits an employer to amend a plan provision that:

- contains a payment period longer than 90 days after a payment event, or
- conditions payment on an employee's action during a payment period (for example, the execution by the employee of a claims release).

In general, these impermissible payment periods may be corrected without adverse tax consequences before the date of the related, permissible payment event. In addition, payment periods in excess of 90 days may be corrected within a reasonable time after the payment event, provided that the employee includes the Applicable Section 409A Income and Correction Taxes on his or her tax return.

Correction of Impermissible Payment Events or Impermissible Discretion.

A plan may provide for a different time or form of payment for each permissible payment event and allow for an alternative distribution schedule if a specific payment event occurs before or after a specified date. (For example, the plan pays a lump sum if separation from service occurs before age 65, and pays in 10 annual installments if separation from service occurs on or after age 65.) The Notice provides relief for plans with impermissible payment events or payment schedules, and for plans that permit certain employer or employee discretion to change the time or form of payment. In these cases, a plan may be corrected before the payment event (or exercise of discretion) covered by the correction:

- by removing or replacing (if required) any impermissible payment event or form of payment, or

- by removing the right to exercise discretion (or revoking the exercise of such discretion).

In addition, if the operation of the plan is affected by the correction within one year of the correction date, an affected employee must include the Applicable Section 409A Income and Correction Taxes on his or her tax return, except under certain limited circumstances.

Correction of Failure to Include Six-Month Delay.

Distributions made to a "specified employee" of a publicly traded company as a result of a separation from service may not be made for at least six months after the separation. The Notice provides relief for a plan that fails to include a provision requiring the six-month delay of payment. The plan may be amended to add the six-month delay provision prior to a specified employee's separation, so long as the plan is further amended to provide that the payment of amounts subject to the six-month delay may not be paid before *the later of* 18 months after the correction date or six months following the separation. In addition, if a specified employee has a separation within one year of the correction, the employee must include the Applicable Section 409A Income and Correction Taxes on his or her tax return.

Correction of Impermissible Initial Deferral Elections.

A plan must specify the conditions under which an initial deferral election may be made to defer compensation. The Notice allows employers to correct the plan by removing an impermissible deferral election provision without Section 409A tax consequences if the provision has not been used by the employee or the employer. If the provision has been used to make an impermissible deferral election, the employer may correct the plan *no later than* the end of the second taxable year after the year in which the deadline for making

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the deferral election occurred. The correction must involve both:

- amending the plan document to remove the impermissible deferral election provision, and
- correcting under Notice 2008-113 any amounts not paid as a result of an impermissible deferral election.

Initial Adoption of New Plan. The Notice provides a transition period for document corrections made shortly after the adoption of a new plan, but applies the aggregation rules under the Final Regulations for purposes of determining when the plan was first adopted. Under this relief, only plan provisions that are eligible for correction under the Notice may be corrected. Corrections must be made by the end of the year in which the first legally binding right to deferred compensation under the plan (and all other plans of the employer required to be aggregated with it under Section 409A) arose or, if later, by the 15th day of the third month following such date. If the plan is properly corrected under the Notice, and any operational failures occurring under the corrected provision are corrected under Notice 2008-113 by the end of the year in which the document is corrected, the document correction may be made without regard to any requirement that amounts be includible in income (and applicable penalty taxes) if certain events occur within one year of the correction. Because of the plan aggregation rules, this provision will be of limited use for many large employers that already maintain plans that will be aggregated with a new plan.

ADDITIONAL GUIDANCE

“As soon as practicable.” A plan provision that provides that distributions be made “as soon as practicable” (or other similar language) does not result in a document failure under Section 409A. The

Notice provides that for purposes of Section 409A, the permissible payment event is treated as the payment date. This means, if the payment is made by *the later of* the end of the employee’s taxable year in which the permissible payment event occurs or the fifteenth day of the third calendar month following the permissible payment event, there is no operational or document failure under Section 409A.

Use of Section 409A Savings Clauses. The Notice confirms the effectiveness of a plan provision requiring that an otherwise ambiguous or undefined term be interpreted to comply with Section 409A.

Payment Dependent Upon Execution of a Release. As noted above, the use of a designated payment period no longer than 90 days is permissible following a payment event, if the employee is not permitted to elect the year of payment. The Notice clarifies that a plan provision conditioning payment upon the execution of a claims release by the employee will constitute impermissible employee discretion under Section 409A because the employee could theoretically determine the year of payment based upon when he or she executed the release.

MODIFICATIONS TO NOTICE 2008-113: OPERATIONAL CORRECTIONS

The Notice includes several modifications to Notice 2008-113. Most notably, the Notice confirms that the procedure for correcting excess deferrals also applies to a failure to pay deferred amounts in the appropriate tax year.

The Notice also modifies the Operational Correction Program to provide rules for determining the amount of an employee’s required repayment to the employer, and for determining certain amounts that were erroneously paid or deferred.

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CONCLUSION

The Notice provides welcome guidance on correcting Section 409A document failures. Under the Notice, employers and employees may be able to avoid, or at least limit, the penalties that could otherwise be imposed for a Section 409A document failure. In light of the significant advantages to making corrections in 2010, employers should consider evaluating (or reevaluating) their plans and agreements for compliance with Section 409A and, if necessary, making corrections in accordance with the Notice.



RESTORING AMERICAN FINANCIAL STABILITY ACT OF 2010

In March 2010, the Senate Banking Committee unveiled a new draft of comprehensive financial services regulatory reform legislation, entitled Restoring American Financial Stability Act of 2010. This massive piece of legislation contains executive compensation provisions requiring:

- a shareholder advisory vote to approve a listed corporation's compensation of executives,
- the members of a listed corporation's compensation committee be independent and to act independently in its hiring of, and relationships with, compensation consultants, legal counsel, and other advisors,
- disclosure of information showing the relationship between executive compensation paid and the financial performance of the company,
- recovery of erroneously awarded compensation as a result of a restatement in accounting,
- disclosure of whether employees or members of the board of directors may purchase financial instruments to hedge or offset decreases in the market value of a company's equity securities, and

- with respect to bank holding companies, the Federal Reserve's Board of Governors is directed to prohibit any compensation plan that provides an employee, director, or shareholder with "excessive" compensation or which could lead to a "material financial loss."



HEALTH CARE LEGISLATION —SOME TAX PROVISIONS

The Health Care and Education Reconciliation Act (H.R. 4872) will impose a new 3.8 percent tax on all unearned income for individuals earning more than \$200,000 per year and married couples earning more than \$250,000 per year beginning in 2013.

The Joint Committee on Taxation reports that when this tax is combined with the 0.9 percent surtax on high-income taxpayers' share of their Hospital Insurance (HI) payroll taxes, the new taxes would raise \$210.2 billion over the 2010-2019 period.

In addition to that provision, the bill includes a \$13 billion revenue raiser from limiting tax-free employee contributions to health flexible spending arrangements to \$2,500 per year, again beginning in 2013.

The Patient Protection and Affordable Care Act limits tax deductions for medical expenses unless they exceed 10 percent of adjusted gross income. Current law allows deductions once medical expenses exceed 7.5 percent of AGI. Individuals who are at least 65 years old would be allowed to continue to use the 7.5 percent threshold for medical expense deductions through 2016. The change will raise \$15.2 billion over 10 years, reports the Joint Committee on Taxation.



RATE INFORMATION

Moody's Long-Term Corporate Bond Yields

	2/26/2010	HIGH—PAST 12 MONTHS	LOW—PAST 12 MONTHS	FEBRUARY AVERAGE	JANUARY AVERAGE
Average—all risk ratings	5.75%	6.85%	5.61%	5.86%	5.76%

U.S. Consumer Price Index

	JANUARY 2010 INDEX LEVEL	% CHANGE FROM	
		DECEMBER '09	JANUARY '09
All items	216.687	0.3	2.6
Core	220.086	—	1.6

Prime Rates (U.S. Effective Date: 12/16/2008)

	LATEST	WEEK AGO	52-WEEK	
			HIGH	LOW
U.S.	3.25	3.25	3.25	3.25

London Interbank Offered Rate, or Libor (March 12, 2010)

	LATEST	WEEK AGO	52-WEEK	
			HIGH	LOW
One month	0.23	0.22906	0.55625	0.22813
Three month	0.25719	0.25363	1.31563	0.24875
Six month	0.39781	0.39	1.90188	0.3825
One year	0.86838	0.85063	2.22688	0.83406

Source for CPI, prime rate, and LIBOR: http://online.wsj.com/mdc/public/page/2_3020-moneyrate.html (accessed March 15, 2010).

The information incorporated into this presentation has been taken from sources, which we believe to be reliable, but there is no guarantee as to its accuracy.

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