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Executive Compensation

In this article, the authors provide an overview of Notice 2010-6, which provides “reasonable solutions” on how to fix Section 409A plan document failures. In addition to discussing the various types of corrections available and summarizing substantive guidance provided in the notice, the authors identify significant advantages to making corrections in 2010 under the notice’s special transition rules.

Overview of Document Correction Guidance Under Section 409A

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Section 409A of the Internal Revenue Code (“Section 409A”) changed the world of nonqualified deferred compensation by imposing strict operational and documentation rules on these plans for the first time. Moreover, Section 409A imposes draconian tax penalties on plan participants for any operational or document failure.

Previously, the IRS and Treasury Department had provided limited relief for unintentional operational failures under Section 409A (the “Operational Correc-

tion Program”),¹ but had not issued any guidance on how to correct plan document failures. Fortunately, the IRS and Treasury Department recently provided welcome news to taxpayers (and practitioners) by issuing IRS Notice 2010-6 (Jan. 5, 2010) (the “Notice”). The Notice provides reasonable solutions on how to fix many (but not all) plan document problems, as well as other guidance on Section 409A issues. Taxpayers using the Notice may be able to avoid, or at least significantly limit, the tax penalties that could otherwise be imposed for a Section 409A document failure.

This article outlines the general requirements for corrections under the Notice, provides an overview of the various types of document corrections available, and identifies the advantages for corrections made in 2010 and 2011 under the special transition rules. In addition, it summarizes certain substantive issues under Section 409A and modifications to the Operational Correction Program addressed in the Notice.

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¹ I.R.S. Notice 2008-113, 2008-51 I.R.B. 1305.

In general, the Notice provides strong incentives for an employer² to identify and correct document failures as soon as possible. In particular, the Notice provides more favorable treatment for corrections made by Dec. 31, 2010. As a result, immediate action to use the relief in the Notice may help employers and employees³ avoid costly tax consequences under Section 409A.

I. Background

Section 409A was added to the tax code as part of the American Jobs Creation Act of 2004 in reaction to certain perceived abuses in the executive deferred compensation area. In particular, Section 409A was intended to limit the ability of employees to control the timing (and thus taxation) of deferred compensation payments. Section 409A applies very broadly, potentially impacting many types of arrangements in addition to nonqualified retirement plans, including certain severance, equity compensation, and bonus arrangements. Since its enactment, employers have struggled to comply with complex rules that generally apply to deferred amounts under various types of compensation arrangements to the extent earned or vested after 2004.

The final regulations under Section 409A (the “Final Regulations”)⁴ required all nonqualified deferred compensation plans and arrangements to be operated in strict compliance with the Final Regulations, and amended to reflect certain rules regarding deferral elections and distributions, by the end of the transition period that ended on Dec. 31, 2008.⁵

Generally, a plan or arrangement subject to Section 409A must be in writing, must specify the amounts being deferred (or formula), the time and form of payment (including the six-month delay for payments to “specified employees” of public companies on account of separation from service), and the conditions under which initial or subsequent deferral elections may be made, and must not permit any impermissible acceleration of payment.⁶ If a violation occurs with respect to an employee’s benefits under a plan subject to Section 409A, generally all vested amounts under the plan and all similar plans are taxed to the employee immediately. The employee is also subject to a 20 percent additional tax on the amount of compensation included in income plus possible additional taxes based on interest calculations from the time of deferral or vesting.⁷

II. Transition Relief

Under a special transition rule, plan document failures that are eligible for correction under the Notice may be corrected by Dec. 31, 2010, and be treated as having been corrected on Jan. 1, 2009—the first day that plans were required to be in documentary compli-

² All references in this article to “employer” are intended to also include any other “service recipient,” as that term is defined under Section 409A and related guidance.

³ All references in this article to “employee” are intended to also include any other “service provider,” as that term is defined under Section 409A and related guidance.

⁴ 72 Fed. Reg. 19,234 (April 17, 2007).

⁵ I.R.S. Notice 2007-86, 2007-46 I.R.B. 990.

⁶ Treas. Reg. § 1.409A-1(c)(3).

⁷ I.R.C. § 409A(a)(1)(B)(i); I.R.S. Notice 2008-115, 2008-52 I.R.B. 1367.

ance (and full operational compliance) with the Final Regulations. Under the transition rule, any requirement in the Notice of income inclusion and the additional 20 percent tax under Section 409A as a condition of the relief do not apply, so long as certain operational corrections are completed. Generally, any payment made before Dec. 31, 2010, that would not have been made under the corrected provision, or any payment not made before Dec. 31, 2010, that would have been made under the corrected provision, must be treated as an operational failure and corrected under the Operational Correction Program by that date.

Document failures due to a linked plan design generally may not be corrected under the Notice.⁸ Under a special transition rule, such a failure may, however, be corrected to comply with Section 409A on or before Dec. 31, 2011. Generally, the Notice requires that the time and form of payment under the two linked plans be made identical, and includes additional requirements regarding how the correction must be made.

The Notice also includes transition relief for corrections made by Dec. 31, 2011, of payment schedules determined by the timing of payments received by the employer and, as noted below, in certain cases where the employer is under an IRS audit for periods beginning on or before Dec. 31, 2011.

III. General Requirements for Correction

Similar to the Operational Correction Program, there are several general requirements that must be satisfied (in addition to the more specific requirements described in IV, below) for an employer to be eligible to make corrections under the Notice. Generally, the relief for document failures will not apply *unless* the following requirements are satisfied:

- *Only Unintentional Failures.* The failures must be inadvertent and unintentional.

- *All 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 (not just those plans covering the same employees as the plan in question) with the same or substantially similar failures.

- *Not Under Examination.* Neither the employer’s nor the employee’s federal income tax return was under “examination” with respect to nonqualified deferred compensation for any taxable year in which the failure existed. For purposes of corrections made before 2012, a transition rule provides that an employer will only be treated as under examination with respect to any specific document failure that has been identified by the examining agent(s) as an issue, including any substantially similar document failures identified in other plans.

- *Payment of All 409A Correction Taxes.* If required by a specific correction method, the employee must include in income the applicable percentage (e.g., 50 percent or 25 percent) of the deferred amount with respect to the correction and pay all federal taxes, including the

⁸ The Notice describes “linked plans” ineligible for relief as those in which the amount deferred is determined by, or the time or form of payment is affected by, the amount deferred under, or the payment provisions of, one or more other nonqualified deferred compensation plans or one or more tax-qualified plans.

additional 20 percent tax on the amount included in income (excluding the premium interest tax) (collectively, the “409A Correction Taxes”).⁹

■ **Reporting Requirements.** The employer must satisfy certain information and reporting requirements with respect to each failure for the year of the correction and, if applicable, for the year of any required income inclusion. Generally, 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 his or her respective federal income tax return. This statement must contain information similar to that under the Operational Correction Program (i.e., the plan(s) involved, information regarding the failure, the specific authority for the correction, and other information identifying the affected employees).

Consistent with the written plan requirement in the Final Regulations,¹⁰ the plan aggregation rules in the Final Regulations do not apply for purposes of the document correction guidance in the Notice. This means that any amounts required to be included in income and subject to the 409A Correction Taxes are calculated on a plan-by-plan basis without regard to the rules under the Final Regulations that require all plans of the same type to be treated as one plan.¹¹ Also note that the relief in the Notice does not apply to failures involving stock rights (as defined in the Final Regulations). Further, if two or more document failures are corrected under the Notice with respect to the same deferred amount, special rules apply in determining the applicable percentage or the amount that must be included as a condition of correction.

IV. Permissible Corrections

The issues eligible for correction under the Notice are summarized and organized in six categories below.

Impermissible Definitions of Payment Events. Section 409A generally requires a plan to provide that payments will be made on a specified date or upon any of five events: (1) a separation from service (“SFS”), (2) death, (3) disability, (4) change in control, or (5) unforeseeable emergency. Several of these payment events are specifically defined in the Final Regulations, and a plan’s use of a variation on these definitions often will result in a Section 409A violation. Generally, the Notice permits an employer to replace an impermissible definition of SFS, change in control, or disability with a Section 409A-compliant definition, provided that such correction occurs before the date the payment event to be corrected occurs (or after the event in the case of a correction involving an impermissible disability definition, provided that any corresponding operational failure is also corrected). Further, if the correction of SFS or change in control affects a distribution under the plan within one year after the correction date, an affected employee must include in income the applicable percentage (i.e., 50 percent for SFS, and 25 percent for change in control) of the deferred amount and must pay the 409A Correction Taxes.

⁹ The determination of the deferred amount under a plan subject to Section 409A is made in accordance with I.R.S. Notice 2008-115, 2008-52 I.R.B. 1367, or, as applicable, the proposed regulations under § 1.409A-4, issued on Dec. 8, 2008 (73 Fed. Reg. 74,380).

¹⁰ Treas. Reg. § 1.409A-1(c)(3)(viii).

¹¹ Treas. Reg. § 1.409A-1(c)(2).

Impermissible Payment Periods. The Final Regulations permit plans to provide for a payment period that is expressly 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. For example, a plan provision for payment within 90 days of a SFS generally will be treated as providing for a compliant specified payment date. The Notice permits an employer to amend a plan provision that (1) contains a payment period longer than 90 days after a payment event, or (2) conditions payment on the employee’s action during a payment period (e.g., a requirement to execute and submit a release). Generally, these impermissible payment periods may be corrected without adverse tax consequences before the date of the related, permissible payment event. Further, payment periods in excess of 90 days may be corrected within a reasonable time after the payment event, provided that the employee includes in income 50 percent of the applicable deferred amount and pays the 409A Correction Taxes.

Other Impermissible Payment Events or Impermissible Discretion. The Final Regulations generally permit a plan to 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. The Notice provides relief for plans with impermissible payment events or payment schedules (including impermissible reimbursement provisions), and for plans that permit certain employer or employee discretion to change the time or form of payment. Generally, a plan may be corrected before the date of a payment event (or exercise of discretion) covered by the correction (1) by removing or replacing (if required) any impermissible payment event or form of payment, or (2) by removing the right to exercise the impermissible discretion (or revoking the exercise of such discretion). However, if the operation of the plan is affected by the correction within one year of the correction date, an affected employee must include in income 50 percent of the deferred amount and pay the 409A Correction Taxes, except under certain limited circumstances.

Failure to Include Six-Month Delay. Generally, distributions made to a “specified employee” (as defined in the Final Regulations) of a publicly traded company as a result of a SFS may not be made for at least six months after the SFS. Relief is available under the Notice 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 before a specified employee’s SFS, 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 SFS. In addition, if a specified employee has a SFS within one year of the correction, the employee must include in income for the year of the SFS 50 percent of the deferred amount and pay the 409A Correction Taxes.

Impermissible Initial Deferral Elections. Generally, a plan must specify the conditions under which an initial deferral election may be made to defer compensation. The Notice provides relief for employers to amend a plan provision that allows an employee to make an impermissible initial deferral election. An employer generally may remove an impermissible deferral election pro-

vision without Section 409A tax consequences if the provision has not been “applied” by the employee or the employer. If the provision has been applied 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 applicable deadline for making the deferral election occurred. Importantly, this correction must involve both (1) amending the plan document to remove the impermissible deferral election provision, and (2) correcting under the Operational Correction Program 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 an employer’s adoption of a new plan, but applies the aggregation rules under the Final Regulations¹² for purposes of determining when the plan was first adopted. Under this relief, plan provisions that are otherwise eligible for correction under the Notice may be corrected 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 applicable requirements in the Notice, and any operational failures occurring under the corrected provision are corrected under the Operational Correction Program 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 subject to the 409A Correction Taxes) if certain events occur within one year of the correction. Because of the plan aggregation rules, this provision may be of limited use for many large employers who maintain various types of plans.

V. Substantive Guidance

In addition to the specific correction procedures and transition relief, the Notice includes certain substantive guidance regarding whether certain provisions result in Section 409A failures. In some cases, the Notice helpfully clarifies that certain ambiguous plan terms will not result in plan document failures so long as the terms are otherwise operated in compliance with Section 409A. The Notice also identifies issues that constitute document failures that must be corrected under the Notice, including certain issues that have not previously been discussed in the Final Regulations or other guidance under Section 409A.

Notable examples of substantive guidance provided in the Notice include the following:

Payments “As Soon as Practicable” Following Payment Event. The Notice provides that a plan provision providing for payment “as soon as practicable” following a permissible payment event does not, by itself, result in a document failure. In such cases, the date of the payment event is treated as the payment date, meaning that the payment must be made by the end of the year in which the payment event occurs (or the 15th day of the third month following the event, if later).

Payments Upon Termination of Employment (or Other Ambiguous Terms). Some plans provide for payment upon a

participant’s “termination of employment,” the employer’s “acquisition,” or upon some other payment event that is undefined and/or ambiguous. The Notice states that terms such as these could be interpreted to mean only events that constitute a permissible payment event (i.e., a Section 409A “SFS” or “change in control”), or alternatively, to include events that do not constitute a permissible payment event (or exclude events that must be included in the payment event’s definition). Generally, the Notice provides that the presence of such ambiguous terms does not result in a document failure. To be eligible for relief, the plan provision must not, however, have been interpreted by the employer after 2008 such that a “pattern or practice” of the application of a noncompliant interpretation has been established. Moreover, any payment (or failure to make a payment) pursuant to such a plan provision that is not compliant with Section 409A may be corrected under the Operational Correction Program, provided that the plan is properly amended by the end of the year during which the operational failure is corrected.

Use of 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 Period Dependent Upon Execution of a Release. As noted above, the Final Regulations generally permit the use of a designated payment period following a permissible payment event that is no longer than 90 days following a payment event, so long as the employee is not permitted to elect the year of payment. After the issuance of the Final Regulations, IRS and Treasury personnel informally indicated that a plan provision conditioning payment upon an action by the employee, such as the execution of a release, might constitute impermissible employee discretion because the employee could theoretically determine the year of payment based upon when he or she executed the release. Unfortunately, the Notice indicates that the inclusion of such a provision constitutes a Section 409A failure unless corrected pursuant to the Notice.

Payments Upon Initial Public Offering. In several instances, the Notice uses as an example of an impermissible payment provision a payment upon an initial public offering (IPO) of the employer’s stock. On first blush, this appears to conflict with the Final Regulations, which provide that a specified time or fixed schedule may be based upon the lapse of a substantial risk of forfeiture and which include as an example the vesting and payment of amounts upon an IPO.¹³ It is possible that the examples in the Notice involve vested amounts that are not subject to a substantial risk of forfeiture. However, this is not specified in the Notice and may create some confusion regarding permissible payment events.

Calculation of Hours on Weekly Basis. Under the Final Regulations, whether a SFS occurs depends in part on whether it is reasonably anticipated that the level of future services provided by an employee will decrease to 20 percent or less of the average level of services performed over the immediately preceding 36-month period. In addition, a rebuttable presumption may apply if actual performance is 20 percent or less, or 50 percent or more, of the services performed over the preceding 36-month period. A common issue that has arisen in ap-

¹² Treas. Reg. § 1.409A-1(c)(2).

¹³ Treas. Reg. § 1.409A-3(i)(1)(i).

plying these rules is the appropriate time period over which the post-change and pre-change service should be determined. The Notice includes several examples under which service for these purposes is calculated on a weekly basis. Although these examples are certainly not determinative, they may indicate how the IRS intends to analyze this issue.

VI. Modifications to the Operational Corrections Program

The Notice also includes several modifications to the Operational Correction Program. Most notably, the Notice confirms that the correction procedure under Section V.D.2(a) of the Operational Correction Program (i.e., excess deferrals corrected in following year) covers a failure involving deferred amounts that are not paid during the year in which the payment date occurs (or, if applicable, the 15th day of the third month after a permissible payment event). The Notice also modifies the Operational Correction Program to provide rules for

determining the amount of an employee's required re-payment to the employer, and for determining the amount erroneously paid or deferred if such amount was denominated in the form of stock or other property.

VII. Conclusion

The Notice is a very good first effort at providing employers with guidance on how to fix document failures in plans subject to Section 409A. Taxpayers using the Notice may be able to avoid, or at least significantly 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 for compliance with the Section 409A document requirements and, if necessary, making corrections in accordance with the Notice. And hopefully, like other correction programs, the IRS and Treasury will expand the relief available under the Notice as additional issues arise.