

IRS Establishes Internal Revenue Code Section 409A Document Correction Program

The Internal Revenue Service (the “IRS”) recently released Notice 2010-6¹, which sets forth guidance for amending noncompliant provisions of plan documents (“document failures”) in order to bring nonqualified deferred compensation plans into compliance with Section 409A of the Internal Revenue Code of 1986, as amended (“Section 409A”). This notice:

- (i) clarifies that certain common ambiguous plan terms will not be deemed to constitute document failures,
- (ii) provides procedures for correcting certain document failures without current income inclusion or penalty taxes or with reduced current income inclusion and reduced penalty taxes, and
- (iii) provides transition relief designed to encourage prompt correction of document failures (generally, by the end of 2010).

Notice 2010-6 provides a new opportunity for an employer or other service recipient to correct document failures while avoiding or mitigating adverse tax consequences. Because of transition relief allowing corrections to be made by December 31, 2010 without current income inclusion or penalties and because the relief under Notice 2010-6 is not available if the federal tax return of the service recipient or service provider is under examination, it is desirable for service recipients to begin the process of reviewing their nonqualified deferred compensation plans to determine whether any further documentary corrections are desirable and to make those corrections promptly but in any event by December 31, 2010.

I. Background

Nonqualified deferred compensation plans must comply with Section 409A in both form and operation. If there is a failure to comply, the employee or other service provider covered by the noncompliant plan would generally be required to include in income for federal income tax purposes all amounts deferred under the plan to the extent not subject to a substantial risk of forfeiture and not previously included in income. Such employee or other service provider would also be subject to a 20% penalty tax on the amounts so includible in income as well as an additional penalty tax calculated as the underpayment interest (determined at a premium interest rate) that would have been due if the deferred amounts had been includible in income when first deferred or, if later, when first no longer subject to a substantial risk of forfeiture.

All nonqualified deferred compensation plans were required to be in documentary compliance with Section 409A by December 31, 2008. After that deadline passed, the adverse tax consequences described above generally would (in the absence of relief from the IRS) have applied by reason of a document failure even if there were in practice no payments made (or failures to make payments) in contravention of the requirements of Section 409A and even if the plan were in fact amended before any operational failure had occurred.

On December 3, 2008, the IRS issued Notice 2008-113² setting forth guidance for correcting certain operational failures under Section 409A with no or reduced current income inclusion and penalties. Given the numerous interpretative issues under Section 409A and the broad range of plans, programs and arrangements

¹ 2010-3 I.R.B. 275.

² 2008-51 I.R.B. 1305.

potentially affected by the section, practitioners have long been urging the IRS to establish a program for correcting document failures. The IRS has now responded by issuing Notice 2010-6.

II. Ambiguous Plan Terms

Notice 2010-6 provides that a plan provision requiring payment “as soon as reasonably practicable” following a permissible payment event (or similar formulations) will not be considered a document failure, provided the service recipient does not have a pattern or practice of making payments beyond the period prescribed by Section 409A. If a payment under a plan having such a provision is not made by the end of the service provider’s taxable year in which the permissible payment event occurs or, if later, the fifteenth day of the third month following the permissible payment event, the failure to pay will constitute an operational failure (unless an exception is applicable under the Section 409A regulations). Such operational failure may be eligible for correction under Notice 2008-113.

In addition, under Notice 2010-6, if a plan provision designates a payment event (such as “termination of employment” or “acquisition of the employer”) but does not define the payment event or has an ambiguous definition of the payment event, such that the provision could reasonably be interpreted as complying with Section 409A but could also be reasonably interpreted to be noncompliant, such provision will not be considered a document failure. However, such relief would not be available if:

- (i) there has been a pattern or practice of interpreting the plan provision on or after January 1, 2009 contrary to the requirements of Section 409A,
- (ii) a court of competent jurisdiction has interpreted the plan provision,
- (iii) the definition of the payment event explicitly includes events that would not be a permissible payment event under Section 409A or explicitly excludes events that are required for the payment event to be such a permissible payment event, or
- (iv) the service recipient has intentionally used the ambiguous plan provision.

If a payment is made (or fails to be made) under a plan qualifying for this relief in contravention of the requirements of Section 409A, that payment (or failure) may be treated as an operational failure eligible for relief under Notice 2008-113, provided the plan is amended (either by explicitly defining the term to comply with Section 409A or adding a provision requiring that terms be interpreted to comply with the requirements of Section 409A) before the end of the service provider’s taxable year during which the operational failure is corrected.

An otherwise ambiguous plan provision would not be ambiguous for this purpose, and the plan would be in documentary compliance, if the plan contained a provision requiring that terms be interpreted to comply with the requirements of Section 409A.

III. General Conditions To Be Eligible For Relief

Notice 2010-6 specifies certain conditions that must be met to qualify for the relief described in the Notice, including the following:

- (i) commercially reasonable steps must be taken by the service recipient to identify and correct all other nonqualified deferred compensation plans with a substantially similar document failure,

- (ii) the federal income tax return of the service provider must not be under examination and the federal tax return of the service recipient must not be under examination with respect to nonqualified deferred compensation (subject to a transition rule for corrections on or before December 31, 2011 pursuant to which a non-individual service recipient would only be treated as being under examination with respect to any specific document failure that has been identified as an issue in the examination),
- (iii) the document failure must be inadvertent and unintentional,
- (iv) the document failure must not be directly or indirectly related to any listed transaction,
- (v) the service provider must include in income the amounts required under the Section 409A correction program and pay the taxes on such amount, including the 20% penalty tax prescribed by Section 409A (but not the additional premium interest penalty tax),
- (vi) the service recipient must satisfy certain information and reporting requirements prescribed by Notice 2010-6 (which would essentially require the service recipient to attach a statement in prescribed form to its federal income tax return and furnish a statement to each affected service provider, who must also attach the statement to his or her federal income tax return),
- (vii) the document failure may not be related to certain linked nonqualified deferred compensation plans (i.e., where the amount, time or form of payment under one nonqualified deferred compensation plan is affected by the amount deferred or payment provisions under another nonqualified deferred compensation plan or qualified plan), but subject to transition relief if the nonqualified plans are amended on or before December 31, 2011 to make the time or form of payment under the plans identical using the narrower, longer payment schedule, with any resulting operational failures being corrected under Notice 2008-113 on or before December 31, 2011, and
- (viii) the document failure may not apply to a stock right.

Because the IRS has begun auditing companies for compliance with Section 409A, the condition set forth in (ii) above creates a heightened incentive to promptly review nonqualified deferred compensation plans to determine whether there are any document failures that should be corrected under Notice 2010-6.

IV. Permissible Corrections

Notice 2010-6 specifically allows the correction of several specific types of document failures:

- (1) Impermissible definitions of “separation from service”, “change in control event” or “disability”,
- (2) Impermissible payment periods longer than 90 days (but not longer than 365 days) following a permissible payment event,
- (3) Impermissible payment periods following a payment event dependent on the service provider completing certain employment-related actions (such as payments conditioned on execution of a release of claims or a noncompetition or nonsolicitation agreement),

- (4) Plans with both permissible and impermissible payment events or only impermissible payment events (impermissible payment events would include, for example, providing for payment upon an initial public offering not otherwise a change of control under Section 409A or enrollment of a child in college),
- (5) Impermissible alternative payment schedules upon the occurrence of a single type of permissible payment event (for example, providing for a lump sum severance payment if the employee is involuntarily terminated but severance payments in installments if the employee leaves voluntarily),
- (6) Impermissible service provider or service recipient discretion with respect to payment schedule following a permissible payment event (such as employer discretion to delay payment if certain cash flow targets are not met), including impermissible subsequent deferral elections,
- (7) Impermissible service recipient discretion to accelerate payment events (such as discretion to terminate the plan and pay out all amounts deferred under circumstances not permitted under the Section 409A regulations),
- (8) Impermissible reimbursement or in-kind benefit provisions,
- (9) Failure to include six-month delay of payment for specified employees, and
- (10) Impermissible initial deferral elections (such as applying the election deadline for performance-based compensation to a bonus that does not qualify as performance-based).

Each of these types of corrections is discussed in detail in the Notice. In many cases, the correction must be made before the occurrence of an event that would result in payment under the corrected provision but not under the pre-correction provision or that would result in payment under the pre-correction provision but not under the corrected provision. The tax consequences under the correction provisions of the Notice often differ depending upon whether or not such an event occurs within one-year following the correction. Typically, where the event does not occur within such one-year period, the correction may be made without any amount being included in income and without any tax penalties, but where the event does occur within such one-year period, the employee or other service provider is typically required to include in income a percentage (most commonly, 50%) of the deferred amounts under the plan and pay the 20% penalty on the amount so included in income (but no premium interest penalty tax).

There is also a special correction procedure applicable to new plans that allows a document failure that is otherwise eligible for correction under the Notice to be corrected without current income inclusion or tax penalties if the correction is made no later than the later of the end of the calendar year in which, or the 15th day of the third calendar month following, the date the first legally binding right to the deferred compensation arose under the plan or any other plan aggregated with that plan. Where the correction results in there having been a payment or a failure to pay that would not have occurred if the corrected provisions had always been in place, such payment or failure is considered an operational failure which must be corrected in accordance with Notice 2008-113 by the end of the calendar year in which the document failure is corrected in order to avoid any current income inclusion or tax penalties if an event occurs within one year following the correction.

The Notice formally reflects the IRS position that a plan provision that conditions payment on the execution of a release would give impermissible control over the timing of payment to the service provider, resulting in a document failure, unless corrected by a plan amendment that eliminates such control (for example,

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by requiring payment at the end of a designated period following the permissible payment event provided the employee has executed the release and not revoked it by the end of such period, with a forfeiture occurring if the employee fails to complete this action by the end of such period).

V. Transition Relief

Notice 2010-6 includes a transition rule providing that, with respect to the types of document failures eligible for correction under the Notice, if a plan is brought into documentary compliance by December 31, 2010 in accordance with the Notice, it will be treated as having been corrected on January 1, 2009 for purposes of the relief provided in Notice 2010-6 and any income inclusion or penalty taxes otherwise required as a condition for the relief will not apply. However, any payment made before December 31, 2010 that would not have been made under the amended provision (or any payment not made before December 31, 2010 that would have been made under the amended provision) is treated as an operational failure and must be corrected under Notice 2008-113 on or before December 31, 2010.

Under another transition rule, if a nonqualified deferred compensation plan contains a payment provision that would satisfy the requirement for a fixed schedule of payments but for the absence of an objective, nondiscretionary method of identifying the payments to the service recipient from which the payments to the service provider are to be determined or an objective, nondiscretionary payment schedule, the plan will not be treated as failing to provide a fixed schedule of payments if the plan is amended to comply no later than December 31, 2011 and any payments that were made before the amendment which would not have been made if the amended plan had been in effect since January 1, 2009 or any failure to make a payment that would have been due before the amendment if the amended plan had always been in effect must be treated as an operational failure and corrected under Notice 2008-113 on or before December 31, 2011.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to contact Michael Macris at 212.701.3409 or mmacris@cahill.com; or Glenn Waldrip at 212.701.3110 or gwaldrip@cahill.com.

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