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IRS Issues Document Corrections Program for Deferred Compensation Plans Under Code Section 409A

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On January 5, 2010, the Internal Revenue Service (IRS) issued Notice 2010-6 (Notice), which establishes a document correction program for nonqualified deferred compensation programs under section 409A of the Internal Revenue Code (Section 409A). Previously, the IRS had only permitted correction of operational failures, specifically excepting document errors from such correction. The Notice is a significant piece of guidance that fills the hole left by prior guidance. Affected taxpayers now have the opportunity to voluntarily correct both operational failures under Section 409A *and* failures to comply with the document requirements under Section 409A, potentially saving immediate and punitive taxes that can be triggered by innocent errors in arrangements covered by Section 409A.

Importantly, the Notice provides a relatively generous initial timeline to correct document errors, setting the transitional deadline for fixing document failures at December 31, 2010, which is extremely valuable in that it substantially limits the income inclusion and additional taxes that might otherwise apply.

The Notice does, however, include some potential traps for the unwary. One of the most significant pitfalls is that while the Notice does permit the correction of many document failures without current tax consequences or the imposition of additional taxes under Section 409A, the Notice also includes a number of instances in which an employee may face a negative tax result upon the occurrence of subsequent events. Under several of the correction procedures, various scenarios can result in an employee having to include up to 50% of the amount deferred under the plan in income, and to pay both federal income taxes as well as the additional 20% penalty tax under Section 409A on such amount. Another administrative concern with making corrections under the Notice is that, as with prior correction guidance issued to correct Section 409A failures, most of the correction procedures set forth in the Notice require that both the employer[1] and all affected employees[2] comply with notice and reporting requirements.

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[1] While this LawFlash refers only to "employers," the Notice applies to all "service recipients," as defined under Section 409A.

[2] While this LawFlash refers only to "employees," the Notice applies to all "service providers," as defined under Section 409A.

In light of the favorable transition rules and the expectation that the IRS intends to increase audit activity under Section 409A, it is important for employers to review nonqualified deferred compensation plan arrangements to determine if correction may be necessary and, if so, take quick action to meet the more advantageous correction principles applicable before December 31, 2010.

Background

Section 409A generally provides that all amounts deferred under a nonqualified deferred compensation plan are currently includible in gross income to the extent they are not subject to a substantial risk of forfeiture unless the plan meets specified restrictions, including, for example, restrictions as to the timing of deferral elections and permissible distributions. Section 409A applies to a wide variety of compensatory arrangements in addition to traditional deferred compensation plans, including a number of arrangements not intuitively viewed as deferred compensation arrangements (e.g., severance and change-in-control arrangements, equity compensation plans, discounted stock options, and stay or sign-on bonuses). Failure to comply with the requirements of Section 409A generally results in automatic taxation of all amounts deferred under the plan (whether or not actually paid or available), and such amounts are subject to an additional 20% federal penalty tax (and potentially a similar state tax) plus an interest charge, bringing the effective tax rate on the amounts involved to well over 50%. The costs of a failure to comply with Section 409A are potentially enormous and can be disproportionate to the magnitude of the error.

Section 409A generally became effective as of January 1, 2005, but was subject to transition relief provisions that expired effective January 1, 2009. For more information on that issue, please see Morgan Lewis's September 16, 2008 LawFlash "Deadline for Compliance with Section 409A Approaching," available at http://www.morganlewis.com/pubs/EB_Section409ADeadline_LF_16sept08.pdf. For a discussion of the requirements of the final regulations under Section 409A, please see our December 18, 2008 LawFlash on that topic, "Executive Compensation and Equity Compensation Plans Year-End Checklist; 409A Documentary Compliance Period Ends December 31, 2008," available at http://www.morganlewis.com/pubs/EB_ExecCompYearEnd_LF_18dec08.pdf. On December 3, 2008, the Treasury Department and the IRS issued Notice 2008-113, which gives taxpayers a limited ability to correct certain operational failures under Section 409A. For more information on that issue, please see Morgan Lewis's February 11, 2009 LawFlash, "2009 Offers Section 409A Correction Opportunities," available at http://www.morganlewis.com/pubs/EB_409ACorrectionOpportunities_11feb09.pdf.

Transition Relief

One of the most favorable provisions of the Notice is the ability to correct document failures during a transition period on or before December 31, 2010 or December 31, 2011 without subjecting the deferred amount to tax under Section 409A. If a plan document failure is corrected under the Notice on or before December 31, 2010, the plan may be treated as having been corrected on January 1, 2009 (the transition relief expiration date), and no income inclusion under Section 409A will be required as a condition of the relief. However, as part of the correction, any operational failures arising out of the retroactive amendment to the plan (e.g., payments made in 2009 or 2010 that should not have been made under the corrected plan) must be corrected on or before December 31, 2010 under Notice 2008-113.

The transitional rules also permit correction of certain document failures on or before December 31, 2011, including correction of (i) impermissible provisions linking nonqualified deferred compensation plans, (ii) payment schedules determined by the timing of payments received by the employer, and (iii) errors impacting employers under examination for returns covering periods beginning on or before December 31, 2011.

The opportunity to correct documentary mistakes under this more beneficial regime, i.e., without facing negative tax consequences, will expire at the end of 2010 or, as noted, in some instances at the end of 2011. In order to take advantage of the transition period, all correction steps must be completed by December 31, 2010, or December 31, 2011, as applicable. **Prompt attention is required to first determine if correction is necessary, then if needed, to complete all necessary correction steps.** It should be noted that complete correction, even under the transition rules, requires compliance with the notice and reporting requirements set forth in the Notice.

Eligibility Requirements

The rules for correction under the Notice are detailed, and in some cases complex. The Notice is clear that the relief is available only for document failures that are inadvertent and unintentional. The relief is not available for document failures that are directly or indirectly related to participation in an abusive tax-avoidance transaction. The Notice provides that correction is not available for a document failure unless the employer identifies all other nonqualified deferred compensation plans that have a similar document failure and all such failures are corrected in a manner consistent with the Notice.

Except as provided under the transition rules, the Notice does not generally provide relief for document failures due to plans linked to qualified plans or other nonqualified deferred compensation plans. In addition, the relief does not apply to a stock right.

Issues Addressed Under the Notice

The Notice generally addresses the following issues, each of which is discussed in greater detail below:

- Application of Section 409A to certain ambiguous plan terms
- Correction of faulty distribution provisions
    - Correction of impermissible definitions of otherwise permissible payment events
    - Correction of impermissible payment periods following a permissible payment event
    - Correction of impermissible payment events and payment Schedules
    - Correction of failure to include six-month delay of payment for specified employees
- Correction of provisions providing for impermissible initial deferral elections
- Amendment period following an employer's initial adoption of a plan
- Information and reporting requirements

The Notice also (i) modifies Notice 2008-113 to clarify the application of certain correction methods and the calculation of certain amounts if payment would have been made in shares of stock, and (ii) modifies Notice 2008-115 to conform the reporting requirements under Notice 2008-115 with the tax consequences and reporting requirements under the Notice.

Application of Section 409A to Certain Ambiguous Plan Terms

The Notice provides clarification that a plan provision that sets forth a permissible payment event under Section 409A, but that requires payment "as soon as reasonably practicable" following such permissible payment date (or includes substantially similar language), will generally not cause a document failure under Section 409A so long as the plan operationally complies with Section 409A. Therefore, if payment is made by the later of (i) the end of the employee's tax year in which the payment event occurs or (ii) two and a half months following the payment event, the failure to pay will not constitute an operational failure under Section 409A. Assuming the plan complies with the payment requirements of Section 409A in operation, the plan does not need to be amended to remove a provision that requires payment "as soon as reasonably practicable" following such permissible payment date (or that includes substantially similar language).

The Notice provides that if a plan does not define a payment event or has an ambiguous definition of the payment event, the plan generally can be amended at any time to either (i) add language requiring that the plan terms be interpreted as necessary to comply with Section 409A or (ii) set forth explicit definitions that comply with Section 409A. If the deferred compensation is paid in a manner that is not compliant with Section 409A, the payment (or failure to make a payment) may be treated as an operational failure. If the facts and circumstances indicate that the employer has intentionally used ambiguous terms for a payment event, the plan is not eligible for relief under the Notice.

It is important to note that the Notice provides instances where a term will be deemed to be no longer ambiguous, and notes that in such event, this provision of the Notice will no longer be applicable to such term.

Correction of Faulty Distribution Provisions

The Notice provides a procedure for correcting faulty distribution provisions resulting from (i) an impermissible definition of otherwise permissible payment events, (ii) an impermissible payment period following a permissible payment event, (iii) an impermissible payment event and payment schedule, and (iv) a failure to include the six-month delay for specified employees. While the Notice generally requires a plan amendment to correct the listed document failures, in many instances the Notice also imposes adverse tax consequences upon the occurrence of certain events.

Most commonly, if the previous and incorrect distribution event occurs within one year after the plan correction to fix the event under these provisions of the Notice, each affected employee must include a stated percentage (generally 50%) of the amount deferred under the plan that was corrected under this Notice in income for purposes of Section 409A. Including such amounts in income for purposes of Section 409A will require the employee to pay federal income taxes, as well as the additional 20% penalty tax under Section 409A, on such amount (but not the additional premium interest tax) for the year in which the event occurred. The tax consequences imposed by the Notice must be paid in order to complete correction.

Correction of Impermissible Definitions of Otherwise Permissible Payment Events

The Notice provides relief for plans that contain impermissible definitions of the following otherwise permissible payment events: (i) separation from service, (ii) change in control, and (iii) disability. With respect to a plan including an impermissible definition of separation from service and/or a change in control, the plan must be amended before the event meeting the impermissible definition occurs. To avoid confusion, if the plan includes an impermissible definition of change in control but requires a "double trigger" for payment (e.g., the plan pays upon a separation from service following a change in control event), no correction is needed, so long as separation from service is defined in accordance with Section 409A.

If the definition of separation from service is corrected and within one year of the correction an event occurs that is not a separation from service under Section 409A but would have required payment under the plan prior to its correction, or that is a separation from service under Section 409A but would not have required payment under the plan prior to its correction, the affected employee must pay taxes under Section 409A for the year in which the separation from service occurred on 50% of the amount deferred under the plan to which the pre-amendment plan provisions applied. The same rule applies if the definition of change in control is corrected, and within one year of the correction, an event occurs that is not a change in control under Section 409A but would have required payment under the plan prior to its correction, except that the amount included in income is reduced to 25% (instead of 50%).

With respect to a plan with an impermissible definition of disability, the plan may be amended to remove the payment event or define the payment event as a Section 409A disability. The plan may be corrected in the same manner after an event occurs that is not a Section 409A disability but is a payment event under the plan if the amount can be, and is, corrected under Notice 2008-113.

Correction of Impermissible Payment Periods Following a Permissible Payment Event

Under the Notice, a plan that correctly provides that payment will be made following a permissible payment event but then improperly provides that such payment (i) may be made or commenced during a period of time later than 90 days and earlier than 366 days following the payment event, or (ii) is conditioned on an employment-related action of the employee (e.g., the execution of a release of claims), may be amended to comply with Section 409A.

A plan that includes an impermissible payment period may be amended to remove the payment period or, alternatively, provide for payment within a designated period, or upon a specified date, following the payment event that complies with Section 409A. For example, a plan with an impermissible payment period may be amended to provide that payment will be made within 90 days following a permissible payment event, provided that the employee does not have the right to designate the taxable year of payment.

The Notice provides fewer leniencies in amending a plan that conditions payment upon the employee completing an employment-related action (e.g., the execution of a release of claims). In this instance, the only permissible correction is to either (i) remove the condition or (ii) remove the employer's ability to delay or accelerate the timing of payment based on the employee's actions by setting a fixed payment

date, subject to certain conditions regarding the timing of the fixed payment date as set forth in the Notice.

For example, a plan provides for payment within 90 days of an employee's separation from service, but not until the employee executes and submits a release of claims. The Notice states that the payment provisions do not comply with Section 409A but may be amended to either (i) remove the release requirement or (ii) provide that payment shall be made on the 90th day following the employee's separation from service, provided the employee has executed a release of claims and the revocation period has expired before the 90th day. The amendment may not otherwise change the time or form of payment.

With respect to a failure involving an improper payment period following a permissible payment event, if the plan is not amended before the occurrence of the permissible payment event, but complies with Section 409A in operation and is amended within a reasonable time after the occurrence of the payment event, the plan will not be treated as failing to comply with Section 409A so long as the affected employee pays taxes under Section 409A for the year in which the event occurred on 50% of the amount deferred under the plan to which the pre-amendment plan provisions applied. The Notice does not provide for amendments to be made after the fact with respect to correcting a plan which conditions payment upon the employee completing an employment-related action (e.g., the execution of a release of claims).

Correction of Impermissible Payment Events and Payment Schedules

The Notice permits plans to be amended to correct failures resulting from provisions providing for (i) payment upon both permissible and impermissible payment events, (ii) payment upon impermissible payment events only, (iii) impermissible alternative payment schedules, (iv) impermissible discretion with respect to a payment schedule following a permissible payment event (including impermissible subsequent deferral elections), (v) impermissible employer discretion to accelerate payment events, and (vi) impermissible reimbursement or in-kind benefit provisions. In each instance the Notice generally requires that the plan be amended to remove the provision that is not compliant with Section 409A and/or replace the provision with a provision that is both compliant with Section 409A and meets any additional requirements imposed by the Notice.

Under certain correction events, the Notice limits the employer's options for amending the payment provisions. For example, to correct a plan that provides for payments **only** upon impermissible payment events, the Notice requires the plan to be amended to provide for payment upon the later of the employee's separation from service or the sixth anniversary of the date of correction. Even though Section 409A provides other acceptable payment events that could have been originally included in the plan (e.g., death, change in control), the Notice limits the permissible payment event that may be included upon correction to the later of the employee's separation from service or the sixth anniversary of the date of correction.

Additionally, to correct a plan which includes impermissible alternative payment schedules, the Notice sets forth specific requirement for determining which impermissible alternative form of payment must be removed, and which are the appropriate remaining forms of payment.

Any amendment made to the plan in accordance with this provision of the Notice must be effective prior to the event that would trigger an impermissible payment under Section 409A. An exception exists for plans permitting impermissible subsequent deferral elections. If a plan provides a default time or form of payment that would be in effect if the employee or employer did not exercise discretion to change the time or form of payment or alternatively, if the employee or employer revoked any exercised discretion more than one year before the payment event occurs, then no amounts will be included in income under Section 409A, regardless of whether an amendment was in place prior to the occurrence of the payment date.

As described above, the Notice imposes certain requirements on any correction undertaken with respect to a plan that provides for payments only upon impermissible payment events. In addition to limiting the payment provisions that may be incorporated into the plan by an amendment, the Notice also imposes adverse tax consequences on all employees participating in the plan, regardless of whether a triggering payment event occurs for each employee. This means that all affected employees must pay taxes under Section 409A for the year in which the *correction* occurred. The taxable amount will equal 50% of the amount deferred under the plan to which the pre-amendment plan provisions applied.

For all other failures described in this provision of the Notice, if within one year of the correction an event occurs that would require payment under the pre-amendment provisions of the plan, and such payment would not comply with Section 409A, the affected employee must pay taxes under Section 409A for the year in which the event occurred on 50% of the amount deferred under the plan to which the pre-amendment plan provisions applied.

Correction of Failure to Include Six-Month Delay of Payment for Specified Employees

A plan that fails to include the requisite provision providing for a six-month delay of payment for a specified employee may be corrected by amending the plan to incorporate the six-month delay, and to further provide that any amount payable under the plan that is subject to the six-month delay may not be paid before the **later** of (i) 18 months following the date of correction or (ii) six months following the date of the payment event. Any amendment made to the plan in accordance with the Notice must be effective prior to the event that would trigger an impermissible payment under Section 409A. If, within one year of the correction, an event occurs that results in the corrected plan provisions being applied to avoid a payment that would have been due under the pre-amendment plan provision, the affected employee must pay taxes under Section 409A for the year in which the event occurred on 50% of the amount deferred under the plan to which the pre-amendment plan provisions applied.

Correction of Provisions Providing for Impermissible Initial Deferral Elections

The Notice allows correction of a plan that provides for an initial election to defer compensation that does not comply with Section 409A. The plan may be corrected by amending the plan to remove the ability to make the impermissible initial deferral election, provided that any amounts that were not paid during one or more of the employee's taxable years due to an impermissible deferral election are treated as operational failures and corrected under Notice 2008-113. Correction must be made no later than the end of the employee's second taxable year immediately following the taxable year during which the deadline for making an initial deferral election occurs.

It should be noted that a plan that provides for an initial election to defer compensation that does not comply with Section 409A will not result in a failure so long as the provision has not been applied with respect to an employee. However, if either the employee or the employer does make an initial deferral election under a plan that provides for an initial election to defer compensation that does not comply with Section 409A, but all action is actually completed on or before the date required under Section 409A for an initial deferral (e.g., December 31 of the plan year preceding the plan year in which the election will be effective), the initial deferral election will be treated as having been made in accordance with Section 409A.

Amendment Period Following an Employer's Initial Adoption of a Plan

The Notice provides a grace period for corrections made under a new plan, taking into consideration the Plan aggregation rules under Section 409A and disregarding those plans identified in the Notice. A document failure can be corrected so long as it is corrected no later than the later of (i) the end of the calendar year in which the date on which the first legally binding right to deferred compensation arose under the newly adopted plan or (ii) the 15th day of the third calendar month following such date.

If the plan is properly corrected, including correction under Notice 2008-113 of operational failures that may have occurred under the noncorrected plan, the applicable section of the Notice may be applied without any requirement that an amount be includible in income if an event occurs within one year following the date of correction.

Information and Reporting Requirements

The Notice requires compliance with the notice and reporting requirements for almost all of the corrections allowed under the Notice. However, there are no notice or reporting requirements for corrections made with respect to "certain ambiguous plan terms."

The notice and reporting requirements require that the employer attach a statement to its original federal income tax return for both (i) the taxable year in which a correction is made and (ii) if an employee is required to include an amount in income during the subsequent taxable year, the subsequent taxable year. The statement must contain certain information mandated by the Notice. This information includes the name and taxpayer indentification number of each employee affected by the failure, the identification of the nonqualified deferred compensation plan affected by the failure, and information regarding the amount involved in each failure and whether such amount is taxable. The employer must also provide a statement to each affected employee that contains the information outlined above but only to the extent such information relates to a deferred amount of that employee.

The employee must attach a copy of the statement to its original federal income tax return for both (i) the taxable year in which a correction is made and (ii) the taxable year subsequent to the taxable year in which a correction is made, if the employee is required to include an amount in income during such subsequent year. As with prior guidance under Notice 2008-113, the onerous notice and reporting requirements may create significant incentives for taxpayers to consider alternative solutions outside the parameters of the Notice wherever possible.

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