

January 7, 2010

## At Last! A Correction Program for 409A Plan Documents

The IRS has issued Notice 2010-6 that offers employers an opportunity to correct documents that are not compliant with Internal Revenue Code Section 409A. Section 409A imposes strict rules on nonqualified deferred compensation plans and other deferred compensation arrangements. Deferred compensation plans were required to be in documentary compliance with Section 409A by December 31, 2008. The IRS previously provided an opportunity to correct certain 409A *operational* failures under Notice 2008-113; however, until the issuance of Notice 2010-6, there was no method for correcting *document* failures.

A failure to comply with Section 409A normally would result in a tax imposed on each affected participant based on the entire value of his or her account under the plan and all similar plans, plus a 20% penalty and interest. Correcting under this new guidance can avoid or reduce these drastic consequences. The relief is especially welcome and timely, as the IRS has recently begun auditing for 409A compliance.

According to Notice 2010-6, the new correction program is intended to encourage taxpayers to review their nonqualified deferred compensation plans to identify provisions that fail to comply with the requirements of Section 409A, and to correct those plan provisions promptly. Early correction is important not only because the relief is generally not available once the taxpayer is under audit, but also because some of the relief under the Notice is time sensitive. For example, assume a plan provides for payment upon a change in control that does not meet the 409A definition of change in control. If the change in control has not yet occurred, the employer can amend the definition of "change in control" to be 409A-compliant, with the amendment effective immediately. However, if a change in control as defined before the amendment occurs within one year after the correction, 25% of the deferred compensation that would have been paid under the pre-amendment definition must be included in income – even though the payment isn't made because the corrected definition applies. Similar rules apply for many of the other corrections, often with 50% includible in income.

Under a special transition rule, taxpayers can avoid 409A income inclusion otherwise required for the correction relief, such as the type described above due to the impermissible event occurring within one year after the correction, if the document failure is corrected by **December 31, 2010**. However, if an improper payment was made (or should have been made, if the amended definition applied) by December 31, 2010, there is also an operational failure that must be corrected under Notice 2008-113. That correction may independently require income inclusion. Special deadlines also apply to linked nonqualified deferred compensation and to new plans.

Only certain types of document failures are eligible for relief under Notice 2010-6. Some of the plan provisions that may be 409A violations and eligible for correction are:

- An otherwise permissible payment event such as "termination of employment," "disability," "separation from service," "change in control," or "acquisition" that is not defined in the document, or is improperly defined.
- A payment period that is more than 90 days following a permissible payment event, or a payment period that is dependent upon the participant executing a noncompetition or nonsolicitation agreement or a release of claims.
- An impermissible payment event, such as an initial public offering (that does not otherwise

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constitute a change in control as defined in the 409A regulations) or enrollment of a child in college.

- Impermissible alternative payment schedules that apply depending on which payment trigger occurs, for example, a lump sum if the participant has an involuntary separation from service versus ten annual installments if the participant has a voluntary separation from service.
- Employer or participant discretion to change the time or form of a payment that is due, such as the discretion to pay in a lump sum or annual installments, discretion to delay payments if certain cash flow targets are not met, or discretion to make subsequent deferral elections.
- Employer discretion to accelerate payments events, such as discretion to pay before the participant separates from service even though the plan provides for payment upon separation from service.
- Impermissible reimbursements, like country club dues, after separation from service.
- Failing to include the six-month delay for payments to “specified employees.”
- Provisions that don’t comply with 409A’s initial deferral election timing rules, such as applying the election deadline for performance-based compensation to a bonus that does not qualify as performance-based compensation.

The Notice also clarifies whether there is a 409A violation where the plan has an ambiguous term such as providing for payment “as soon as reasonably practicable” after separation from service.

If you have any questions about the 409A correction programs, or any other aspect of your company’s employee benefit plans or executive compensation arrangements, please contact a member of our [Benefits Law Group](#).



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