

IRS Launches Self-Correction Program For §409A Document Failures

Under final IRS regulations, all nonqualified deferred compensation arrangements subject to §409A generally were required to have compliant plan documents in place not later than December 31, 2008. This raised concern among taxpayers and practitioners because of the complexity of the rules under §409A and the number of issues that remained - and remain - unresolved. Many urged the IRS to establish a procedure that would allow correction of unintentional documentary violations without incurring the draconian tax penalties that would otherwise apply.

That procedure is now outlined in Notice 2010-6. In many respects the new document correction procedure has been designed to work in tandem with the procedure for correcting §409A operational failures that was established in December 2008 under Notice 2008-113. You can read our summary of the correction program for operational failures by clicking on the following link. [IRS Issues Year End Guidance Under Section 409A.](#)

Notice 2010-6 includes a generous transition rule that permits any of the documentary failures covered by the Notice to be corrected by December 31, 2010 without any tax penalties, so long as any operational failures corresponding to or resulting from the documentary correction are also corrected by December 31, 2010 under Notice 2008-113. Documents corrected under this transition rule are treated as if they had been compliant since January 1, 2009. **This opportunity should encourage employers to re-examine their nonqualified deferred compensation documents in the next few months and determine whether those documents include any of the failures for which correction is available.**

The Notice also includes a transition period through December 31, 2011 to correct (i) impermissible provisions that link payments under two or more nonqualified deferred compensation plans but do not provide identical times or forms of payment, (ii) payment schedules that are impermissibly based on the timing of payments received by the service recipient (e.g., the employer), and (iii) documentary errors that affect service recipients (e.g., employers) being audited for tax returns covering tax years beginning on or before December 31, 2011. As to this last group, the correction program generally is unavailable if a federal income tax return of the service recipient (e.g., employer) or the service provider (e.g., employee) is under audit for any taxable year in which the document failure existed. The transition rule essentially waives this disqualification through 2011.

Like the correction program for §409A operational failures, the new correction program for documentary failures requires participating service recipients (e.g., employers) and service providers (e.g., employees) to include with their federal income tax returns detailed information about the violation and its correction. **It is important for taxpayers to remember that the IRS will not treat any operational or documentary correction as effective unless these notice requirements are satisfied.**

In a number of cases, only partial relief will be available under Notice 2010-6. The correction procedures for several of the documentary failures, for example, require inclusion in taxable income of up to 50% of the amount deferred under the flawed plan provision, together with payment of the 20% penalty tax on that amount, if an event occurs within one year after the correction that would otherwise have triggered an impermissible payment under the faulty plan provision. Thus, well meaning taxpayers may not know immediately whether they have eluded tax penalties entirely.

The Notice clarifies that certain ambiguous plan provisions do not violate §409A unless they have been applied in an impermissible way. A plan provision requiring payment "as soon as reasonably practicable" after a permissible payment event (e.g., separation from service), for example, is not a §409A documentary failure unless the service recipient has a pattern or practice of making impermissibly late payments. An isolated payment outside regulatory timeframes, as distinguished from a pattern or practice, would be treated as an operational failure, but would not cause the plan provision itself to be treated as non-compliant. In the case of a permissible payment event (e.g., termination of

employment) that is undefined or defined ambiguously by the plan, however, such an operational failure may also require that the plan be amended to eliminate the ambiguity as part of the correction.

Here is a brief description of some of the documentary failures covered by the new correction program:

- Impermissible definitions of otherwise permissible payment events, such as "separation from service," "change in control" and "disability." A plan with an impermissible "change in control" definition that requires a "double trigger" for payment, however, would not need to be amended, so long as the "separation from service" definition is compliant, because separation from service - not change in control - would be treated as the payment event.
- Impermissible payment periods following a permissible payment event. These would include payment periods that are longer than permitted by regulations or that are contingent on some action by the service provider, such as execution of a noncompetition agreement or a release of claims. Examples in the Notice offer detailed guidance for drafting compliant plan provisions that condition payment on execution of a release of claims.
- Impermissible payment events and payment schedules. These include plan provisions that (i) allow impermissible service recipient or service provider discretion to establish or modify a payment schedule after a permissible payment event, (ii) allow impermissible service recipient discretion to accelerate payment events, or (iii) provide impermissible reimbursements or in-kind benefits.
- Failure to include a 6-month delay for specified employees following separation from service. The correction in this case prohibits any payment to a specified employee within 18 months after the date of correction that is based on separation from service.
- Impermissible initial deferral elections.

Finally, if a documentary failure covered by the Notice is corrected within a limited period after a new plan is first put into effect, the remedial provisions of the Notice may be applied without the need to include any deferred amount in the service provider's taxable income if a triggering event occurs within one year after the date of correction (see above). Whether a plan qualifies as "new" is determined by taking into account any other plans with which it would be aggregated under the §409A regulations, whether or not the affected service provider participates in any of those other plans.

If you have questions or would like additional information about the tax rules for nonqualified deferred compensation under §409A, or the available correction procedures for violations, please feel free to contact Brian Dougherty at 215-587-5919 or bdougherty@postschell.com

To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments or enclosures) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein. In addition, we do not impose on any person or entity to whom this is addressed any limitation on disclosure of the tax treatment or tax structure of any transaction discussed herein (including in any attachments or enclosures).

Disclaimer: this E-Flash does not offer specific legal advice, nor does it create an attorney-client relationship. You should not reach any legal conclusions based on the information contained in this E-Flash without first seeking the advice of counsel.

© Copyright 2009 Post & Schell, P.C. All rights reserved
"POST & SCHELL" and the Post & Schell Logo are registered trademarks of Post & Schell, P.C.
[About Us](#) | [Our Attorneys](#) | [Practice Areas](#) | [Publications](#) | [Offices](#)