Section 409A Violations: Corrections of Document Failures

Recent Guidance on Procedures for Voluntary Correction of Certain Document Failures in Nonqualified Deferred Compensation Plans – Correction During 2010 Strongly Encouraged

SUMMARY

The Internal Revenue Service (the “IRS”) issued IRS Notice 2010-6 (the “Notice”), providing procedures for employers\(^1\) to voluntarily correct certain shortcomings in their documentation of nonqualified deferred compensation plans that are subject to Section 409A of the Internal Revenue Code (“Section 409A”). The Notice is effective for taxable years beginning on or after January 1, 2009, and generally provides:

- special relief permitting corrections of certain document failures without current income inclusion or additional taxes under Section 409A if the document failure is corrected by December 31, 2010 (December 31, 2011 for certain “linked plans”), and any operational failures resulting from the document failure are also corrected in accordance with IRS Notice 2008-113 by December 31, 2010 (December 31, 2011 for linked plans)
- relief for certain new plans, permitting corrections of document failures without current income inclusion or additional taxes under Section 409A if the document failure is corrected by the end of the calendar year of adoption (or in some cases somewhat later)\(^2\) and any operational failures resulting from the document failure are also corrected in accordance with IRS Notice 2008-113 by that time
- relief permitting correction of certain document failures without current income inclusion or additional taxes under Section 409A if the correction does not affect plan operation within the following 12 months (and limits on current income inclusion if plan operation is affected within that 12-month period)
- clarification that certain ambiguous language commonly included in plan documents will not necessarily cause a document failure
- clarification of certain aspects of IRS Notice 2008-113 (which addresses operational failures of nonqualified deferred compensation under Section 409A)
BACKGROUND

All nonqualified deferred compensation plans are required to be in documentary and operational compliance with Section 409A as of January 1, 2009 or their later inception. If a plan is not in documentary and operational compliance, amounts deferred under the plan are currently includible in income and subject to significant additional taxes as they “vest” for purposes of Section 409A. Because the tax penalties under Section 409A can be very significant, and the employees who bear them usually have no control over employer compliance, the IRS has been receptive to requests for remedial programs. IRS Notice 2008-113 set out procedures for the correction of some operational failures but not document failures. Notice 2010-6 now provides correction procedures for certain types of plan document failures, mostly relating to the time and form of payment. These new procedures require information reporting to the IRS and to affected employees, and can operate to eliminate or reduce tax penalties for non-compliance.

LIMITATIONS ON RELIEF UNDER THE NOTICE

Correction under the Notice is not available with respect to:

- **Returns that are Under IRS Examination:** neither the employee’s nor employer’s federal income tax return can be under audit for any year in which the document failure existed; in the employer’s case, however, this restriction only applies if the employer also receives written notification specifically citing nonqualified deferred compensation as an issue under consideration.

- **Failures that are Intentional:** the failure to comply must be “unintentional and inadvertent.”

- **Stock Rights,** i.e., stock options or stock appreciation rights (although Notice 2008-113 provides certain relief for operational failures resulting from the grant of discounted stock rights).

- **Listed Transactions:** the document failure may not be directly or indirectly related to participation in any “listed transaction” under Treas. Reg. § 1.6011-4(b)(2).

The Notice also makes the timing of many permitted corrections critical:

- **The Most Generous Relief is Provided for Documentary Failures that are Corrected by December 31, 2010 or Within the Calendar Year that a Plan is First Implemented.** Corrections made during 2010 may be treated as having been corrected on January 1, 2009 for purposes of the corrective procedures under the Notice, and may thus avoid the 12-month post-correction “probation” period (see below), which would be deemed to have expired as of January 1, 2010 – provided that any payments or distributions made before December 31, 2010 that would not have been made under the corrected provisions (or that would have been made under the amended provisions) are corrected as operational failures pursuant to Notice 2008-113 by December 31, 2010. Newly adopted plans with document and operational failures may, subject to certain limitations, generally be corrected during the calendar year of adoption.

- **Linked Plans.** Special provision is made for so-called “linked plans,” that is, plans that operate together, e.g., through an offset mechanism, and under which amounts payable and the time or method of payment can shift as the benefits between the plans shift, if such plans fail to comply due to different payment provisions. The prescribed correction is to make the time and form of payment identical under the arrangements, generally opting for the longest deferral or payout. These linked plan failures may be corrected by December 31, 2011, and any amounts paid (or failed to have been paid) under one or more of the linked plans in a
manner that is not consistent with the amended provisions, had those provisions been in effect as of January 1, 2009, would be treated as operational failures under Notice 2008-113 to be corrected by December 31, 2011. 4

- **Corrections Must Usually Occur Before the Payment Event.** Generally, document corrections are effective to eliminate or reduce penalties for employees only if made before a payment event under the plan occurs for the employee. Important exceptions include linked plan corrections, correction of “back-to-back” payment provisions and the correction of non-compliant “disability” definitions, which, in each case, still require corrective action under Notice 2008-113.

- **Some Tax Penalties May Apply if Distributions or Other Events Occur Within 12 Months of Correction.** In certain cases where the correction results in a material plan change (e.g., the plan had no permissible payment event and is corrected to include one), or where the correction alters what would have occurred under the plan in the 12 months following the correction (e.g., where a distribution is made under a corrected provision but would not have been made under the old provision or a distribution is not made under the corrected plan but would have been made absent the correction) amounts deferred under the plan are subject to partial inclusion in current income ranging from 25% to 50% (with the corresponding 20% additional tax, but not the additional tax based on the underpayment interest component, also imposed). This effectively imposes a toll charge on the correction equal to a 5-10% additional tax on the total amount deferred and could prove problematic, as employers and employees remain exposed to unfavorable tax consequences for a year following the corrective amendment. The reduced tax penalty appears to be how the IRS has chosen to penalize those who have not diligently complied with Section 409A from the start but later make the effort to get it right.

### TYPES OF FAILURES ELIGIBLE FOR RELIEF AND CORRECTION PROCEDURES

The Notice categorizes a limited number of documentary failures eligible for correction and provides corresponding correction procedures and relief. Consequently, employers must first identify the type of documentary failure before determining whether relief is permitted, and if permitted, the appropriate corrective action.

**Errors Eligible for Correction** include where:

- The plan uses permissible payment events but does not define them by reference to Section 409A or uses an ambiguous definition (e.g., “termination of employment” instead of “separation from service” or “acquisition” rather than the Section 409A change in control definition). In a helpful statement, the IRS concludes that if the plan contains a provision requiring that the ambiguous or undefined term be interpreted to comply with Section 409A, and if there is no pattern or practice of a specific, non-compliant interpretation of the term, then the term is not deemed ambiguous and the plan is compliant.

- The plan’s definition of an otherwise permissible payment event (such as “termination of service,” “change in control event” or “disability”) is overly broad, e.g., separation from service includes a transfer from a parent to a subsidiary.

- The plan provides for an impermissible payment period following a permissible payment event, including payment periods longer than 90 days, or permits an employee to delay or accelerate a payment based on actions such as the employee’s execution of a release of claims or restrictive covenant agreement.
  - The IRS has made clear its view that the employee’s ability to time a payment through the execution of a release, non-compete or similar condition can be a problem under Section 409A. The prescribed correction is to remove employee control by fixing a payment date that allows sufficient time for the condition to be satisfied.
The Notice also helpfully clarifies that a plan provision stating that payment will be made “as soon as practicable” after a payment event will not be considered a document failure, although a late payment would be an operational violation and a pattern of late payments would give rise to a document failure.

The plan contains certain impermissible payment events and payment schedules, including impermissible employer or employee discretion with respect to a payment schedule following a permissible payment event (including subsequent deferral elections) or discretion to accelerate payment or impermissible alternative payment schedules.

The correction prescribed by the Notice appears to adopt, in these circumstances, a bias toward longer deferral rather than accelerated payout.

Impermissible reimbursement or in-kind benefit provisions.

Failure to include the six-month delay for specified employees, to the extent required by Section 409A. The prescribed correction mandates a minimum payment delay of 18 months from the correction date.

Impermissible initial deferral elections (although corrective measures may be limited).

Correction Procedures. Eligibility for relief under the Notice is conditioned on adherence to certain procedural requirements. These include:

Plan Amendment. Documentary failures eligible for correction under the Notice are, in most cases, remedied by amending the plan. Amendments correcting documentary failures must be effective immediately.

Correction of Plans With “Substantially Similar” Document Failures. Relief is available with respect to a plan for which a document failure has been corrected only if the employer has taken commercially reasonable steps to identify and correct all of its other nonqualified deferred compensation plans with document failures that are substantially similar to the failure initially identified and corrected.

Amounts Included in Income as a Condition of Correction. If the provision of the Notice under which a correction is made requires the employee to include a deferred amount in income under Section 409A, relief is conditioned upon the employee’s inclusion of such amount in the appropriate tax return and payment of all applicable taxes, which will be treated, for all subsequent periods, as an amount previously included in income for purposes of Section 409A.

Information and Reporting Requirements. The Notice follows the requirements of Notice 2008-113 and requires extensive reporting of the correction. An employer seeking relief under the Notice must attach to its timely-filed federal income tax return for the year in which correction is made, a statement (and supply affected employees with a similar statement for attachment to their returns) that, among other things:

- Identifies each employee affected by the document failure,
- Identifies the plan and reporting of the amount involved in the failure, as well as the amount reported by the employer as includible in the employee’s income, and
- States that the failure is eligible for correction under the Notice, citing the applicable Notice provision and asserting that the employer has taken all required actions and otherwise met all requirements for such correction as of the last day of the employer’s taxable year in which the correction is made and also as of the last day of any subsequent taxable year during which the amount is required by Section 409A to be included in the employee’s income as part of the correction.
MODIFICATIONS TO NOTICE 2008-113 AND NOTICE 2008-115

The Notice generally does not affect the operation of Notice 2008-113 unless expressly provided. Notice 2010-6 adds provisions to Notice 2008-113, which are intended to clarify the application of the subsequent year correction method to late payments of deferred amounts, and the calculation of the amount that must be paid to, or repaid by, the employee as a correction of a late or early payment of a deferred amount, if the payment would have been made in property, such as shares of stock. In addition, Notice 2008-115 is modified as required to conform to the income inclusion requirements of Notice 2010-6.

* * *

In general, relief provided by the Notice is limited, and when available, comes at the cost of extensive information and reporting requirements, and in many cases, continued exposure to negative tax treatment for 12 months after the correction date. Nevertheless, it provides significant incentives to correcting possible documentation issues prior to December 31, 2010 through the elimination or significant reduction in the Section 409A additional taxes. In this regard, the proposed Section 409A income inclusion regulations also should be available to mitigate the costs of document correction under the Notice, as the proposed regulations provide that tax is not imposed under Section 409A for any taxable year for which payments or benefits remain unvested (i.e., subject to a substantial risk of forfeiture) and that correction while an amount is unvested will comply with Section 409 (subject to anti-abuse rules).

* * *

ENDNOTES

1 For convenience, we refer to “employers” as shorthand for “service recipients” and “employees” as shorthand for “service providers” (the terms used in the regulations and other guidance), which includes directors and certain other individuals as well.

2 Specifically, such document failures may be corrected no later than the later of (i) the end of the calendar year in which the date the first legally binding right to deferred compensation arose under the newly adopted plan and all other plans with which it must be aggregated under Section 409A or (ii) the 15th day of the third calendar month following such date.

3 Also see note 2, above.

4 Similar corrective provisions also apply to “back-to-back” arrangements that fail to comply with Section 409A because the distribution schedule is improperly determined based on the timing of payments received by the employer.

5 Consistent with the Section 409A regulations, however, Notice 2010-6, provides that the Section 409A plan aggregation rules do not apply to plan documentation requirements.

6 Published in the Federal Register on December 8, 2008 (Vol. 73, No. 236, pages 74380-74403).
ABOUT SULLIVAN & CROMWELL LLP
Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance and corporate transactions, significant litigation and corporate investigations, and complex regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 700 lawyers on four continents, with four offices in the U.S., including its headquarters in New York, three offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP
This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future related publications from Jennifer Rish (+1-212-558-3715; rishj@sullcrom.com) or Alison Alifano (+1-212-558-4896; alifanoa@sullcrom.com) in our New York office.

CONTACTS

New York
Matthew M. Friestedt +1-212-558-3370 friestedtm@sullcrom.com
Michael A. Katz +1-212-558-3160 katzma@sullcrom.com
Lawrence A. Pasini +1-212-558-4672 pasinili@sullcrom.com
Max J. Schwartz +1-212-558-3936 schwartzma@sullcrom.com
J. Michael Snypes, Jr. +1-212-558-7295 snypesjm@sullcrom.com
Marc R. Trevino +1-212-558-4239 trevinom@sullcrom.com

Washington, D.C.
Rebecca S. Coccaro +1-202-956-7690 coccaror@sullcrom.com