



Legal Alert: The Latest 409A Release – A Document Correction Program

1/12/2010

On January 5, 2010, the IRS released Notice 2010-6 (the "Notice"), which prescribes methods for correction of certain documentary failures to comply with §409A of the Internal Revenue Code ("§409A"). Section 409A is the Internal Revenue Code section that prescribes requirements that must be met by most nonqualified deferred compensation arrangements, and further provides that, if the requirements are not met, the deferred compensation will be included in income – and subject to an additional 20% tax – whether or not paid when it is no longer subject to "substantial risk of forfeiture."

The IRS had previously provided, in Notice 2008-113, a correction procedure for various operational defects in nonqualified deferred compensation arrangements. However, there has been no comparable program under which employers could remedy document defects and avoid the sanctions for failure to comply with §409A. With the deadline for documentary compliance generally having passed a year ago, a correction program is particularly welcome.

The Notice first provides clarification of a number of issues that may arise in the application of §409A to a nonqualified deferred compensation arrangement. For example, the Notice provides that document language requiring a payment to be made "as soon as reasonably practicable" following a permissible distribution event (or similar language) will not cause the document to fail to satisfy §409A, unless the service recipient has a pattern of making payments later than would be "timely" under §409A, so long as payment is made by the later of (i) the last day of the service provider's taxable year in which the distribution event occurs, or (ii) the fifteenth day of the third month following the distribution event.

Similarly, the Notice provides that if a plan or arrangement contains a distribution event that is not defined, or that is insufficiently defined, so that it may or may not be a §409A permissible distribution event (e.g., providing for a payment upon a "termination of employment," without further defining "termination of employment"), the language will not cause a violation of the §409A document requirements so long as (i) the service recipient doesn't have a pattern or practice of interpreting the language (whether in the subject plan or any other plan or arrangement) in a noncompliant manner, and (ii) no court has interpreted the language so as to resolve the ambiguity. Furthermore, if the ambiguous language is applied in such a way that it does not comply with §409A, the resulting failure may be corrected under Notice 2008-113 as an operational failure so long as the ambiguous language was not intentionally used in order to avoid the requirements of §409A.

Next, the Notice provides relief for, and allows correction of, certain specified §409A document defects. In this regard, the Notice allows most defects to be amended before the occurrence of a noncompliance event. For example, if a plan permits a distribution on the occurrence of a change in employment status that would not qualify as a "separation from service" for §409A purposes, the plan provision may be amended before the occurrence of such a "nonqualifying" change in employment status, provided that (i) the amendment is effective immediately, and (ii) in the event that, within one year following the date of amendment, such a "nonqualifying" event occurs that would have triggered a distribution absent the amendment, then 50% of the amounts deferred under the plan are included in the service provider's income (as a §409A inclusion, subject to the 20% penalty) for the year within which the nonqualifying event occurs. Along the same lines, if an arrangement provides for a distribution on the occurrence of a transaction that would not qualify under §409A as a "change in control" (a "noncomplying transaction"), the arrangement may be corrected if done before the occurrence of such a transaction by limiting payments to those transactions that do constitute a §409A "change in control." Again, the amendment must be effective immediately, and if, within one year following the date of amendment, a noncomplying transaction were to occur, 25% of the amounts deferred under the arrangement must be included in the service provider's income (again, as §409A income) for the year in which the transaction occurs.

There are numerous other situations in which corrections are permitted under the Notice, on a basis similar to those described above, except that inclusion of deferrals in income is not always a condition of correction, and, depending upon the circumstances, the corrections are subject to varying time deadlines.

Finally, the Notice provides transitional relief under which (i) corrections permitted under the Notice may be made by December 31, 2010, and (ii) certain categories of corrections may be made by December 31, 2011, provided that, in either case, any impermissible payments that had already been made (or required payments that had not been made) are also corrected pursuant to Notice 2008-113 by the relevant correction deadline.

If you have any questions regarding this Alert, or would like additional details concerning Notice 2010-6 or other matters involving your deferred compensation arrangements, you can contact the author of this Alert, Jeffrey Ashendorf, 212-453-5926, jashendorf@fordharrison.com, or any member of Ford & Harrison's Employee Benefits practice group.