

Welcome Relief! IRS Issues Section 409A Correction Program

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For several years now companies and their advisors have been frustrated by the lack of guidance under Section 409A of the Internal Revenue Code for certain common plan provisions and the inability to correct a document that is found to have provisions that violate Section 409A. The IRS has recently issued Notice 2010-6, which provides helpful and practical guidance on how Section 409A applies to certain common plan provisions and for the first time provides a procedure to correct plan document errors.

Application of Section 409A to Common Plan Provisions

The Notice provides guidance on how Section 409A applies to two common plan provisions. It was previously unclear whether these provisions violated Section 409A.

- If a plan provides for payment "as soon as administratively practicable" or under some other ambiguous timing rule after a permissible payment event, then the payment timing will not violate Section 409A if payment is made by the later of the end of the service providers tax year or the 15th day of the third month after the payment event occurs.
- If a plan provides for payment upon an event that could be interpreted as a permissible payment event under Section 409A but could also be interpreted to not comply with Section 409A, such as a termination of employment (a "separation from service" under Section 409A) or an acquisition (a "change in control" under Section 409A), then the provision may or may not violate Section 409A depending on how the provision has been interpreted historically. Such a provision may be corrected by adding a Section 409A definition or a clause that the plan will be interpreted in accordance with Section 409A.

Correction of Plan Document Failures

The Notice includes procedures to correct plan document provisions that violate Section 409A. Under the Notice the service recipient self-corrects the document failures. The procedure does not require submission of the proposed correction to the IRS. The Notice may require a portion of the deferred amount be taxable under Section 409A as the cost of correcting the plan document. The general rule for many of the corrections in the Notice is that, if the improper provision would have triggered a payment within one year after the correction, a portion of the deferred amount (typically 25% or 50% depending on

the correction) must be included in taxable income and subjected to the Section 409A 20% additional tax, even though the deferred amount is not paid under the corrected provision. If no payments would have been made until more than a year after the correction is made, no taxes are owed until actual payment. The intent of this approach is to encourage employers to self-audit and self-correct their own arrangements before any problems arise. The Notice provides corrections for the following plan document failures:

- An improper definition of separation from service, change in control or disability.
- A payment provision that allows for payment during a window more than 90 days after the payment event.
- A payment provision that times the payment based on the time the employee takes some employment-related action, such as signing a release or non-compete.
- Inclusion of both permissible and impermissible payment events.
- Inclusion of only impermissible payment events. Unlike the general rule described above where Section 409A penalty taxes only apply if the impermissible event occurs within one year after the correction, if a plan includes only impermissible payment events and is corrected under the Notice, 50% of the deferred amount must be included as taxable income subject to Section 409A penalty taxes for the year of the correction even if the impermissible payment events are never triggered.
- Providing for alternative payment schedules based on a single payment event, impermissible discretion, or impermissible reimbursements or in-kind benefits.
- Failure to include the six-month delay for specified employees of publicly traded companies.
- Providing for improper deferral elections.

Transition Relief

If plan document failures are corrected under the Notice by December 31, 2010, then the plan document will be treated as complying with Section 409A on January 1, 2009, without requiring any of the deferred amounts be taxed under Section 409A as described above. Essentially, the IRS has extended the Section 409A compliance period to December 31, 2010. This gives companies an additional opportunity to review their arrangements that may raise Section 409A issues and determine if there are failures that can be corrected under the Notice or ambiguous provisions that can be clarified under the guidance provided in the Notice.

Tax Reporting Requirement

The Notice requires that service recipients attach certain information regarding corrections under the Notice to their tax returns and provide certain information to the service provider. The service provider must then attach that information to the individual's tax return.

Conclusion

Notice 2010-6 provides a tremendous opportunity for companies to clarify ambiguous terms in their arrangements that are subject to Section 409A and to correct any plans that contain errors. If you would like to discuss how the Notice may affect any of your arrangements please contact any member of the employee benefits group at Warner Norcross & Judd LLP.