

Legal Updates & News

Legal Updates

IRS Releases Notice 2010-6, Offering Opportunities to Avoid or Reduce Adverse Tax Consequences with the Correction of Inadvertent Documentary Violations of Section 409A

January 2010

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On January 5, 2010, the Internal Revenue Service issued Notice 2010-6 [<http://www.irs.gov/pub/irs-drop/n-10-06.pdf>], offering opportunities for companies to correct non-compliant deferred compensation documents and avoid certain penalties that would otherwise apply under Internal Revenue Code Section 409A.

Background

As discussed in a previous Morrison & Foerster alert [<http://www.mofo.com/news/updates/files/12270.html>], nonqualified deferred compensation arrangements in violation of Section 409A cause acceleration of income recognition, a 20% additional tax, and penalties. California taxpayers are subject to an additional 20% tax mirroring the federal tax penalty. As noted in previous alerts, the final deadline for documentary compliance with Section 409A was December 31, 2008. The Internal Revenue Service previously issued Notice 2008-113 [<http://www.irs.gov/pub/irs-drop/n-08-113.pdf>], which (as discussed in a previous alert [<http://www.mofo.com/news/updates/files/15204.html>]), provided an opportunity to correct operational errors violating Section 409A. Notice 2010-6 supplements and modifies Notice 2008-113 and provides companies an opportunity to correct certain documentary violations and reduce or avoid adverse tax consequences under Section 409A. Notice 2010-6 also modifies Notice 2008-115 [<http://www.irs.gov/pub/irs-drop/n-08-115.pdf>] regarding reporting and wage withholding requirements under Section 409A.

Eligibility for Correction

The documentary failures that may be corrected under Notice 2010-6 cover a broad spectrum of Section 409A pitfalls, including:

- Plan terms (such as “separation from service,” “change in control event,” and “disability”) that do

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- not meet the definitional requirements of Section 409A;
- Payment periods of longer than 90 days following a permissible payment event;
- Payment periods following a permissible payment event that are dependent upon the employee completing certain employment-related actions (such as executing a non-competition agreement or a release of claims);
- Impermissible payment events (such as an initial purchase offering that does not constitute a change in control event under Section 409A);
- Alternative payment schedules that depend on which type of permissible payment event occurs;
- Company or employee discretion regarding payment schedules following a permissible payment event (including subsequent deferral elections);
- Impermissible company discretion to accelerate payment events;
- Impermissible reimbursement of in-kind benefit provisions; and
- Failure to provide for the required six-month delay in payments to specified employees.

Assuming that an applicable documentary failure exists, a company must also satisfy certain general requirements to take advantage of the correction opportunities under Notice 2010-6. In addition to completion of the appropriate documentary corrections, any required amounts (i.e., under alternative (b) discussed below) must be recognized, and the company and employee must comply with various reporting requirements. The company is also required to take commercially reasonable steps to identify and correct (in accordance with the requirements of Notice 2010-6) any other plans with substantially similar failures. Relief is not available with respect to stock rights (discounted non-statutory stock options, “synthetic” stock rights such as phantom stock and restricted stock units, and stock rights covering non-service recipient stock), intentional failures, or certain listed transactions. Relief also is generally not available once the Internal Revenue Service has begun an audit, a consideration particularly worth noting in light of the Internal Revenue Service’s initiation of Section 409A audits (as discussed at the end of this alert).

Relief

As noted above, Notice 2010-6 pertains to the correction of documentary violations of Section 409A: that is, to deferred compensation arrangements that are drafted in violation of Section 409A, whether or not such violations have resulted in any impermissible payments. In this context, it is important to note that deferred compensation arrangements drafted in violation of Section 409A are subject to acceleration of income recognition and the taxes and penalties under Section 409A even if no payments have been made with respect to such arrangements. Therefore, Notice 2010-6 offers a valuable opportunity to avoid or reduce the impact of that result.

The extent to which penalties may be avoided pursuant to Notice 2010-6 depends on the circumstances surrounding the particular deferred compensation arrangement. Generally, if the requirements of Notice 2010-6 are followed, the following relief applies:

(a) If a deferred compensation plan is corrected and such correction does not impact the operation of the plan for one year following the correction, if then all penalties under Section 409A may be avoided. In other words, if the correction does not prevent a payment from being made (where, prior to the correction, such payment would have been made in violation of Section 409A) and, similarly, the correction does not *cause* a payment to occur within one year (where it otherwise impermissibly would not have occurred), then the correction under Notice 2010-6 allows all of the adverse tax consequences that would otherwise have applied under Section 409A to be avoided; or

(b) If a deferred compensation plan is corrected and such correction *does* affect the operation of the plan within one year, correction under Notice 2010-6 generally permits a reduced portion – typically 50% – of the amount that otherwise would be penalized to be recognized and taxed under Section 409A.

Notice 2010-6 provides two important exceptions to alternative (b) above, allowing a complete avoidance of Section 409A penalties under the following circumstances:

- Transitional relief for corrections made in 2010: If documentary failures are corrected by December 31, 2010 (and all other requirements under Notice 2010-6 are satisfied), the

corrections will be treated as having been made on January 1, 2009. As a result, even where the operation of a plan is impacted within a year of a correction made during 2010, the correction will be treated as though it did not have such an impact, and therefore penalties under Section 409A may be completely avoided as described in alternative (a) above. However, it is important to note in this context that where amounts have *already* been impermissibly paid (or impermissibly failed to be paid) prior to a correction, even if such amounts would have been treated differently following the correction, these events must nonetheless be treated as operational failures and corrected under Notice 2008-113.

- Amendment shortly after adoption of certain plans: If a deferred compensation plan is a company's first plan of that type (disregarding any plans that are not subject to Section 409A or with respect to which all deferred amounts have already been paid or forfeited), Section 409A penalties otherwise arising from a documentary failure may be avoided (i.e., the treatment of alternative (a) may apply) if such failure is corrected by the later of (i) the end of the calendar year in which the first legally binding right to deferred compensation arises under the plan or (ii) the 15th day of the 3rd month following the date on which the first legally binding right to deferred compensation arises under the plan.

It is important to note that where a correction impacts the operation of a plan within the subsequent year (i.e., alternative (b) previously discussed), it is possible for an employee to owe taxes with respect to a payment that would have been made under the original plan, but that is not made under the corrected plan. For example, consider a deferred compensation plan that provides for a payment in the event of the employee's separation from service, but impermissibly includes in its definition of "separation from service" any reduction in the employee's hours. The plan is corrected to provide a stricter definition of "separation from service" as required by Section 409A, and the employee's hours are subsequently reduced (but not to an extent that constitutes a separation from service under the corrected plan) within one year following such correction. Regardless of the fact that the employee will not receive any payment under the corrected plan, 50% of the amount that would have been payable in the absence of the correction will nonetheless be subject to income recognition and the excise taxes imposed by Section 409A—clearly a detrimental circumstance for the employee. Therefore, the transitional relief available for corrections made in 2010 – which, if implemented correctly, can normally prevent these circumstances – is particularly valuable in some cases.

Clarification

Notice 2010-6 offers an additional important confirmation that the use of "as soon as reasonably practicable," or substantially similar language, to designate the timing of a payment following a permissible event does not fail to satisfy the requirements of Section 409A. However, the Notice qualifies this approval with a statement that if a company "has a pattern or practice of making late payments that do not qualify for a timeliness exception under the regulations, that plan [and any plan with similar language] will be treated as having failed to set forth a permissible payment date."^[iii]

A Note on Section 409A Audits

As mentioned above, the IRS has started including in its corporate audits for the 2006 tax year specific inquiries about Section 409A compliance. In line with this development, the IRS has begun preparation of documents to assist audit teams in this area (see 216 DTR G-2 (Daily Tax Report, Nov. 12, 2009) (noting two documents currently being drafted by the IRS, a lead sheet to provide audit steps and a framework for information document requests (IDRs)). These documents will increase audit coordination throughout the IRS. While this coordination effort is ongoing, we understand that IRS examiners have taken an aggressive audit approach by asking companies to tell them which plans are and are not subject to Section 409A, and to give the reasons upon which a company has based their conclusions regarding the exempt or compliant status of these plans. We recommend that taxpayers coordinate closely with counsel in order to understand how to best respond to the audit inquiries, which would include understanding the basis for decisions regarding the compliant or exempt nature of their plans. Of course, as with responding to all audit inquiries that touch on attorney-client communications, taxpayers should also be careful to avoid disclosing communications they have had between inside or outside counsel as such disclosure may be interpreted as a waiver of privilege protection.

Conclusion

Notice 2010-6 provides a valuable opportunity for companies that have not brought deferred compensation arrangements into documentary compliance with Section 409A to do so with reduced – or even no – adverse tax consequences. Companies would be especially well advised to consider such corrections prior to December 31, 2010 in order to take advantage of the transitional relief available this year.

Footnotes

[i] For these purposes, a correction is deemed to be effective on the latest of (i) the correction's adoption, (ii) the correction's effective date, and (iii) the correction's being set forth in writing.

[ii] Notice 2010-6 § IV(A)(2).