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Client Advisory | *February 2010*

IRS Releases Correction Program for Document Errors in Nonqualified Deferred Compensation Plans

The Internal Revenue Service (the "IRS") issued Notice 2010-6 establishing a correction program for nonqualified deferred compensation plans that fail to satisfy the documentary requirements of Section 409A of the Internal Revenue Code ("Section 409A").

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Although the IRS previously issued a program for correcting Section 409A operational failures, employers had no guidance on how to fix document errors. Notice 2010-6 gives employers an opportunity to voluntarily correct both operational failures and certain documentary failures under Section 409A, reducing, and in some cases eliminating, any adverse tax consequences imposed on employees as a result of a noncompliant arrangement.

Background

Section 409A requires all nonqualified deferred compensation arrangements to satisfy certain requirements governing how and when compensation may be deferred and distributed. In addition to the traditional deferred compensation plans, Section 409A applies to a variety of compensatory arrangements, including, among others, employment agreements, severance plans, change-in-control agreements, equity compensation plans and retention bonuses. Failure to satisfy Section 409A, in form or in operation, results in taxation to the individual covered by the arrangement of all amounts deferred (whether or not paid or available to be paid), plus a 20% federal penalty tax, plus an interest charge. Thus, an unintentional drafting error could prove very costly to an employee.

What Errors are Eligible for Correction?

The Notice both clarifies instances where certain provisions may not rise to a documentary failure and provides specific corrections for provisions that do. The documentary failures that may be corrected under Notice 2010-6 include:

- Impermissible definitions of Section 409A permissible payment events, such as "separation from service," "change in control," and "disability", for example, a definition of separation from service that includes a transfer from a parent to a subsidiary;
- Payment periods extending longer than 90 days following a permissible payment event, for example, providing for payment within 180 days following separation from service, with the exact timing within the 180 day period at the discretion of the employer;
- 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 public offering that does not otherwise qualify as a change in control, or enrollment of a child in college;
- Impermissible alternative payment schedules upon the occurrence of a permissible payment event, for example, a lump sum if the employee involuntarily separates from service or annual installments if the employee voluntarily separates from service;
- Company or employee discretion to change the time and form of payment following a permissible payment event, for example, the discretion to pay in a lump sum or in installments upon separation from service, the discretion to delay pay-

ments if certain cash flow targets are not met or discretion to make subsequent payment deferrals;
- Impermissible company discretion to accelerate payment events;
- Impermissible reimbursement or in-kind benefit provisions; and
- Failure to provide for the required six-month delay in payments to "specified employees" of publicly traded companies.

In a helpful clarification, the IRS noted that certain language contained in many plans will not cause a document failure unless there is a pattern or practice of a specific, noncompliant interpretation of the language. For example, if the plan uses "as soon as reasonably practicable," or substantially similar language, to designate the timing of a payment following a Section 409A permissible payment event, such language will not fail to satisfy Section 409A unless the employer has a pattern or practice of making late payments that do not qualify for the timeliness exception under the regulations. Likewise, using the term "acquisition event" rather than "change in control" as a payment event, without further definition, will not cause a Section 409A document error if the term is not interpreted to provide payments under any circumstances that would not constitute a "change in control," as defined in Section 409A.

What is Not Eligible for Correction under the Notice?

- **Employers and Employees under Examination.** Neither the federal income tax return of the employer nor the employee can be under audit for any year in which the document failure existed. In the employer's case, this limitation applies only if the employer has received written notification specifically citing nonqualified deferred compensation as an issue under consideration.
- **Intentional Failures and Listed Transactions.** The plan document failures must be inadvertent and unintentional. In addition, the plan document failure must not be directly or indirectly related to participation in any listed transaction.
- **Stock Rights.** Stock rights that are subject to Section 409A, such as discounted stock options and stock appreciation rights, are not eligible for relief under this Notice; however, Notice 2008-113 provides certain relief for operational failures resulting from the grant of discounted stock rights.

What Relief is Provided?

- **Significant Transition Relief Available for Document Errors corrected by December 31, 2010.** Document failures corrected by December 31, 2010 will be treated as having been made on January 1, 2009 (the first day of required documentary compliance). As a result, even where the operation of a plan is impacted within one year of a correction made during 2010 (see below), the correction will be treated as though it did not have such an impact, and therefore penalties under Section 409A may be completely avoided. However, any amounts paid before December 31, 2010 that would not have been made but for the corrected provisions (or that would have been made only on account of the amended provisions) are treated as operational failures and can be corrected under Notice 2008-113.
- **Certain Penalties May Apply if Distributions Occur within 12 Months of Correction.** Generally, if a deferred compensation plan is corrected and such correction does not impact the operation of the plan for one year following the correction, all penalties under Section 409A may be avoided. However, in those circumstances where the correction affects the operation of the plan in the 12 months following the correction, the Notice generally permits a reduced portion – ranging from 25% to 50% – of the amount that otherwise would be penalized to be included in income and taxed under Section 409A.
- **Corrections within Year Plan First Adopted.** Newly adopted plans with documentary failures, under certain circumstances, may be corrected by the end of the calendar year of adoption and avoid any Section 409A penalties.

What Other Requirements must be Satisfied?

- **Correction of Plan with "Substantially Similar" Document Failures.** Relief under the Notice is available to a plan for which a document failure has been corrected only if the employer takes commercially

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reasonable steps to identify and correct all other plans with substantially similar document failures.

- **Information and Reporting Requirements.** Employers are required to attach a statement to their federal income tax return, and provide affected employees with a similar statement for attachment to their federal income tax returns, for the year of the correction. The statement must identify the plan involved and the affected employees, contain information about the nature of the failure and specify the authority for correction.

Conclusion

Notice 2010-6 provides a valuable opportunity for employers to evaluate (or reevaluate) their nonqualified deferred compensation arrangements for documentary compliance with Section 409A and, if necessary, make any required corrections, in may cases with reduced – or even no – adverse tax consequences to their employees. Employers should consider the benefits of the correction opportunity offered by the Notice, especially the benefits to be achieved by making all necessary corrections by December 31, 2010.

Neither the federal income tax return of the employer nor the employee can be under audit for any year in which the document failure existed.

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