

## IRS Issues Section 409A Document Correction Program

The Internal Revenue Service ("IRS") recently released Notice 2010-6 (the "Notice"), which provides for the ability to correct certain documentary failures with respect to non-qualified deferred compensation plans.

Under Code Section 409A of the Internal Revenue Code and the regulations issued thereunder ("Section 409A"), non-qualified deferred compensation plans were required to be in documentary compliance with Section 409A by January 1, 2009. According to the IRS, if a plan document contains an impermissible provision on or after such date, then even if the offending provision is never utilized, all vested amounts under such plan are immediately taxable to each plan participant and each participant is also subject to the 20% additional tax plus interest and penalties imposed under Section 409A. The IRS had promised guidance which would provide for the ability to correct certain documentary failures. The Notice addresses both plan terms which may be interpreted in ways other than as required under Section 409A, as well as provisions that are directly violative of Section 409A.

### Ambiguity

The Notice provides relief with respect to terms under non-qualified deferred compensation plans that may be considered ambiguous under Section 409A.

Many non-qualified deferred compensation plans provide that payment will be made "as soon as practical" (or similar language providing administrative convenience) following a permissible payment event. The Notice states that retaining these types of phrases in a non-

qualified deferred compensation plan will not be considered a documentary failure, provided that payments are actually commenced by the later of the end of the participant's taxable year in which the permissible payment event occurs or the fifteenth day of the third calendar month following such payment event. No amendment is generally required to these types of terms for the document to be in compliance with Section 409A.

Additionally, the Notice provides relief for plan terms that could be interpreted to be compliant with Section 409A, but which do not specifically use terms defined in Section 409A. For example, many non-qualified deferred compensation plans use terms such as "termination of employment" to mean a "separation of service." Under Section 409A, a "separation of service" generally means a reduction in services to 20% or less of the participant's pre-break services. As required under Section 409A, any plan providing for a distribution on a separation of service must make distribution upon any event which meets the Section 409A definition. The ambiguity in using a term such as "termination of employment" arises because such term could mean either that an event, which is not a separation of service, would be interpreted to be a distribution event or, alternatively, that an event, which is a separation of service, would not be interpreted to be a distribution event. Any such ambiguity may be clarified by an

amendment. However, the IRS will not require such amendment as long as the plan is operated in a manner consistent with Section 409A.

## Documentary Failures

The Notice also provides relief for certain documentary failures that are not mere ambiguities. However, correction of these failures must comply with certain general eligibility requirements, in addition to meeting the specific correction procedure with respect to such failure. Such requirements include that the failure be unintentional, the plan sponsor must take steps to correct all substantially similar document failures, neither the plan sponsor nor the participant may be under examination by the IRS, and the participant must report and timely pay all applicable taxes required under the Notice, including any penalty imposed on such amounts.

In addition, eligibility under the Notice in most cases is condition upon compliance with certain notice and reporting requirements. Generally, both the plan sponsor and the participant will be required to attach a statement to their respective federal tax returns that provides certain information about the correction.

## Payments Contingent on Releases

The IRS takes the position that many standard release provisions in employment and severance agreements violate Section 409A. Under Section 409A, payments upon a separation of service must commence within 90 days after the separation and the participant must not have an election as to when to commence payments. Under many employment and severance agreements, severance only becomes payable when the employee executes a release of claims in favor of the employer. The IRS takes the position that giving the employee a period of time to return the release actually provides the employee with an election as to when payments commence, which violates Section 409A.

The Notice provides the ability to correct a plan provision that makes payment contingent upon the execution and submission of a non-competition agreement, a non-solicitation agreement or a release of claims. The offending plan provision may be corrected to provide for payment on the last day of the period in which the employee may return the non-competition/non-solicitation agreement or release (as

long as the period is no greater than 90 days following the separation of service) or if no period is stated, the amendment must provide that payment will commence on either the 60th or the 90th days following the separation of service. If the employee does not return the release in this time period, the severance would presumably need to be forfeited.

As long as the document is corrected as described above prior to the employee's separation of service, the amounts deferred (including severance) under the plan or agreement will not be subject to immediate taxation or penalty under Section 409A.

## Other Documentary Failures

Below is a brief summary of the other types of events eligible for correction and a general description of the procedure to correct:

- **Impermissible separation of service definition.** If the non-qualified deferred compensation plan either includes events that would not be or omits events that would be considered a separation of service under Section 409A, then the plan may be corrected. The amendment may not otherwise expand or narrow the definition except as required to comply with Section 409A and must be effective immediately. There is no tax due for such correction unless the impermissible event set forth in the non-compliant document occurs (or an omitted event which would constitute a separation of service occurs) within one year of the amendment. In either such event, then each affected participant would be subject to taxation and penalty under Section 409A on 50% of the amount deferred under the plan.
- **Impermissible change in control definition.** A non-qualified deferred compensation plan, which does not have a compliant change in control definition, may be amended in a fashion similar to a plan with an impermissible separation of service definition. However, if the impermissible change in control event occurs within one year of the amendment, then each participant would be subject to taxation and penalty under Section 409A on 25% of the amount deferred under the plan.
- **Impermissible definition of disability.** An impermissible definition of disability may be amended and no tax or penalty is due if the amendment is effective prior to the occurrence of an event that would be a disability under the plan, but would not be a disability under Section 409A. If the plan is not amended until after such event, then the

plan may still be amended and the erroneous distribution would be treated as an operational defect eligible for correction under IRS Notice 2008-113.

- **Payment period greater than 90 days after a payment event.** A non-compliant plan document may be amended to shorten the timeframe during which a benefit may be commenced to either 60 or 90 days following the permissible payment event. If the plan is amended prior to the occurrence of such payment event—no tax or penalty under Section 409A will be due. However, if the plan is amended after the payment event, then each effected participant would be subject to taxation and penalty under Section 409A on 50% of the amount deferred under the plan.
- **Plans with permissible and impermissible payment events.** A non-compliant plan document may be amended to eliminate the impermissible payment events, provided that none of the impermissible events afforded discretion to either the plan sponsor or the participant. In this case, if none of the impermissible payment events actually occur within one year after the amendment—no tax or penalty under Section 409A will be due. However, if one of the impermissible payment events does occur with such time frame, then each effected participant would be subject to taxation and penalty under Section 409A on 50% of the amount deferred under the plan.
- **Plans with only impermissible payment events.** If the non-compliant plan document only provides for impermissible payment events, then the plan may only be corrected by an amendment which provides for payment upon the later of the: the participant's separation of service or the 6th anniversary of the date of correction. In addition, each participant would be subject to taxation and penalty under Section 409A on 50% of the amount deferred under the plan for the year of correction.
- **Failure to provide for the required six month delay.** Non-qualified deferred compensation plans of public companies must generally provide that benefits under such plans which are payable to a "specified employee" upon a separation of service will be delayed for at least six months. If a plan does not impose this required delay, the plan may be amended to provide that payments to a "specified employee" upon a separation of service will not be made until the later to occur of: 18 months after the amendment date or six months after the separation of service. No penalty is generally due under Section 409A unless a separation of service

occurs within one year of the correction, in which case each effected participant would be subject to taxation and penalty under Section 409A on 50% of the amount deferred under the plan.

- **Impermissible alternative payment schedule.** A non-compliant plan document that provides for alternative payment schedules upon a single permissible payment event violates Section 409A. Generally, these types of failures can be corrected by retaining the alternative payment with the latest payment date. No penalty is generally due under Section 409A unless the payment date occurs within one year of the correction, in which case each effected participant would be subject to taxation and penalty under Section 409A on 50% of the amount deferred under the plan.
- **Other.** Similar procedures apply for correcting other documentary failures, such as: failures corrected within the first year of a plan's adoption, failures that provide for the exercise of impermissible discretion as to time and/or form of payment by either the plan sponsor or the participant, failures with respect to reimbursement of taxable benefits, or failures with respect to initial deferral elections.

## Transition Relief

Notwithstanding the above, any documentary failures that are corrected in accordance with the Notice prior to December 31, 2010 will be treated as if such correction occurred on January 1, 2009. This means that any requirement of income inclusion under Section 409A will not apply to corrections made by December 31, 2010. However, any amounts which were erroneously paid or not paid under a provision that is subsequently corrected under this Notice must be treated as an operational failures and corrected under Notice 2008-113. Such operational correction would also need to occur by December 31, 2010.

As a result of this generous relief provision, sponsors of non-qualified deferred compensation plans should again review their existing plans especially in light of the guidance provided under the Notice to determine if additional amendments are warranted in order to ensure compliance with Section 409A. This is especially true with respect to employment contracts and severance agreements where payment is contingent on execution of a release, as many unintentional failures are likely in this area.

---

## Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at [www.dechert.com/employeebenefits](http://www.dechert.com/employeebenefits).

**Robert W. Ballenger**  
Philadelphia  
+1 215 994 2208  
robert.ballenger@dechert.com

**Richard D. Belford**  
New York  
+1 212 698 3607  
richard.belford@dechert.com

**Susan M. Camillo**  
Boston  
+1 617 728 7125  
susan.camillo@dechert.com

**David F. Jones (Chair)**  
Philadelphia  
+1 215 994 2822  
david.jones@dechert.com

**Drew A. Picciafoco**  
Boston  
+1 617 728 7109  
drew.picciafoco@dechert.com

**Beth L. Rubin**  
Philadelphia  
+1 215 994 2535  
beth.rubin@dechert.com

**Eric B. Rubin**  
Philadelphia  
+1 215 994 2946  
eric.rubin@dechert.com

**Shannon Rushing**  
Philadelphia  
+1 215 994 2949  
shannon.rushing@dechert.com

**Stephen W. Skonieczny**  
New York  
+1 212 698 3524  
stephen.skonieczny@dechert.com

**Frank B. Tripodi**  
Philadelphia  
215 994 2685  
frank.tripodi@dechert.com

**Jessica R. Zaklad**  
Philadelphia  
+1 215 994 2175  
jessica.zaklad@dechert.com

**Kathleen Ziga**  
Philadelphia  
+1 215 994 2674  
kathleen.ziga@dechert.com