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IRS Announces Long-Awaited Section 409A Document Correction Program

The IRS has announced a long-awaited program that permits companies to amend non-qualified deferred compensation plan documents to comply with Internal Revenue Code Section 409A, in exchange for reduced penalties, or in certain cases, no penalties. This new program provides welcome relief for companies and executives. The new program is described in [Notice 2010-6](#).

This program may be helpful for companies that, while operating their arrangements in compliance with Section 409A, may have failed to properly or fully amend their plans to comply with Section 409A by the end of 2008.

Highlights of New Program. The new program:

- permits companies to correct ***specifically identified*** document failures;
- ***does not*** apply to document failures (1) not specifically identified in the program, (2) related to stock rights, or (3) except as noted below, under non-qualified deferred compensation plans linked to other non-qualified plans or to tax-qualified plans (“linked plans”);
- provides transitional relief for certain corrections made in 2010 and other corrections made by the end of 2011 and for corrections under newly-adopted plans;
- permits self-correction without payments or reporting in some cases, while requiring payments and reporting in other cases;
- requires full correction of the document failure and substantially similar document failures;
- applies only to inadvertent and unintentional errors and generally only if the company’s or participant’s federal tax returns are not under audit with respect to non-qualified deferred compensation for the year in which the document failure exists; and
- for the first time, provides specific examples of plan language or provisions that the IRS considers objectionable or ambiguous, such as using the term “termination of employment” instead of “separation from service” and, in certain cases, requiring employees to sign release agreements in exchange for being paid severance that is subject to Section 409A.

Section 409A Generally. Section 409A imposes strict rules for non-qualified deferred compensation arrangements and strict penalties and other adverse tax consequences on participants if the rules are not followed. These penalties include a 20% penalty tax, interest at the federal underpayment rate plus 1% and immediate taxation upon vesting. These adverse tax consequences apply both to the non-compliant arrangement as well as any similar arrangement that must be aggregated with the non-compliant arrangement for purposes of Section 409A, regardless of whether the similar arrangement complies with Section 409A.

Section 409A applies to both public and private companies and to a broad range of arrangements, including traditional deferred compensation plans, excess retirement and savings plans, bonus plans and employment agreements.

Section 409A became effective in 2005. Companies have been required to operate their non-qualified deferred compensation plans in accordance with (or under an exemption from) Section 409A since January 1, 2005. Companies were given until the end of 2008 to amend non-qualified deferred compensation plan documents to comply with (or be exempt from) Section 409A's plan document rules.

In December 2008, the IRS established a correction program where companies could correct certain **operational** violations of Section 409A. The correction program is set forth in [IRS Notice 2008-113](#) and summarized in our [previous client alert](#).

The IRS has now established a correction program for **documentary** violations of Section 409A.

Program Eligibility. Relief is available under the program only if:

- the document failure and all substantially similar document failures under other plans are fully corrected;
- the document failure is inadvertent and unintentional and is not a "listed transaction" (certain abusive transactions) under the tax code;
- the document failure is specifically identified in the program;
- the company's and participant's federal tax returns are not under audit with respect to non-qualified deferred compensation for the year in which the document failure exists (certain exceptions apply);
- where required under the program, the participant includes in income and pays taxes (and in some cases penalties) on amounts required to be included in income under the program;
- where required under the program, the company complies with the program's reporting requirements, including reporting the violation and correction and related W-2 reporting; and
- all requirements specified in the program for correcting the specific document failure are met.

Eligible Document Failures. The following document failures may be corrected under the program:

- ambiguities in plan language;
- permissible payment events with no definition or an ambiguous definition, such as "termination of employment" instead of "separation from service";
- non-compliant definitions, such as definitions of "separation from service," "change in control event" or "disability" that do not meet the requirements of Section 409A;

- impermissible payment periods following permissible payment events, such as payments earlier or later than permitted by Section 409A or payments subject to execution of certain release agreements or other restrictive covenants;
- certain impermissible payment events and payment schedules, including non-compliant reimbursement or in-kind benefits;
- failure to include the six-month wait for specified employees; and
- impermissible initial deferral elections.

Ineligible Document Failures. The following document failures may not be corrected under the program:

- document failures related to stock rights, such as discount stock options;
- document failures under linked plans (limited exceptions apply); and
- document failures not specifically identified in the program.

2010 Transitional Relief. Special relief is available for eligible document failures corrected by December 31, 2010. Eligible document failures corrected by December 31, 2010 are deemed to have been corrected on January 1, 2009. As long as any impermissible payments or non-payments made before the end of 2010 are treated as operational failures and corrected under the IRS's operational corrections program, any income inclusion that would otherwise be required under the document correction program will be waived. Companies must still report the violation and correction and comply with other reporting requirements under the program.

2011 Transitional Relief. Document failures under linked plans are generally not eligible for correction under the program. However, certain document failures under non-qualified deferred compensation plans that are linked to other **non-qualified** plans may be corrected by the end of 2011. The program also provides relief for certain impermissible payment schedules corrected by the end of 2011. Finally, the program permits companies and participants whose tax returns are under audit with respect to a particular document failure to correct by the end of 2011 other document failures that have not been identified by the IRS.

Special Relief for Newly-Adopted Plans. Document failures may be corrected under new non-qualified deferred compensation plans by the end of the calendar year in which a legally binding right arises under the plan (or any similar plan required to be aggregated with such plan) or, if later, by the 15th day of the third month of the following calendar year.

Required Corrections. In general, the program requires that each document failure and all substantially similar document failures be fully corrected.

- However, in certain cases, no correction is required under the program. For example, plans may continue to use the phrase “as soon as reasonably practicable” (or substantially similar language) to describe the payment schedule following a permissible payment event, as long as payment is made by the time required under Section 409A.
- In some cases, document failures may be “self-corrected” without adverse tax consequences or reporting, provided corrective amendments are made and certain other requirements are met. For example, non-qualified deferred compensation plans that use the term “termination of employment” instead of “separation from service” may be amended to use the term “separation from service” (as defined in Section 409A), provided that plan payments have only been paid upon terminations of employment that constitute a separation from service (or another permissible payment event) under Section 409A and provided certain other requirements are met.
- In most cases, in addition to making required corrective amendments, companies will be required to report the violation and correction (see “Reporting Requirements” below) and participants may be required to include amounts in income and pay reduced penalties. In general, for many document failures, participants will be required to include in income a reduced amount (50% or 25% of the deferred amount) and pay the 20% penalty tax, if payment would otherwise occur within one year after the date of correction.
 - For example, assume a plan permits payment in the event of a change of control that does not qualify as a change in control event under Section 409A. Under the program, the definition of change of control is amended to comply with Section 409A. Assume an event occurs that does not comply with Section 409A’s definition of change in control event, but that would have triggered a payment under the “pre-amendment” definition of change in control event, within one year after the amendment. As long as the company does not pay the employee upon such change in control, the participant must include 25% of the amount deferred in income. The company must also comply with the reporting requirements under the program.

Reporting Requirements. Companies must report most corrections under the program.

- To report a correction under the program, a company must file an information statement entitled “§ 409A Document Correction under § [INSERT APPROPRIATE SECTION(S)] of Notice 2010.”
- The information statement must include (1) the affected participants’ names and taxpayer identification numbers, (2) the affected plan names, (3) specified information related to the document failure and correction, and (4) the amount involved, the amount of includible income reported by the participant and the percentage of the amount involved.

- The information statement must be attached to the company's timely-filed (including extensions) federal tax return for the taxable year in which the correction was made and, if the participant is required to include any amount in income to receive relief under the program, for the subsequent calendar year.
- The company must also furnish a copy of the information statement to affected participants.
- The participant must file a copy of the information statement with the participant's timely-filed (including extensions) federal tax return for the calendar year in which the correction occurred and, if the participant is required to include any amount in income to receive relief under the program, for the subsequent calendar year.

New Examples of Impermissible Plan Language. As noted above, for the first time, the IRS has formally provided examples of plan language and provisions that it deems do not comply with Section 409A. These include, for example:

- Use of the term "as soon as reasonably practicable" to describe when payment will be made following a permissible payment event. (Fortunately, the program makes clear that this language may continue to be used as long as payments are made within the time required by Section 409A and certain other requirements are met);
- Including "initial public offering" in the definition of a change in control event that is otherwise intended to comply with Section 409A; and
- Requiring that employees execute a general release or restrictive covenant agreement in exchange for severance benefits that are subject to Section 409A, without including a fixed date or dates for payment, even if the plan requires payment within 90 days following separation from service.

Next Steps. As a result of this new guidance, companies are encouraged to take a fresh look at their non-qualified plans to determine whether their plans comply with Section 409A. To the extent document failures are discovered that may be corrected under this program, companies should work with their counsel to determine if they should take advantage of this program and correct document failures by the end of 2010.

Comments Requested. The IRS has requested comments on the new program. We plan to submit comments in an effort to (1) expand the scope of corrections under the program, (2) seek relief with respect to any document failures involving plan language or provisions that were recently identified by the IRS as non-compliant, (3) clarify how the program coordinates with other correction methods that may be available, and (4) clarify other provisions in Notice 2010-6.

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