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Re: Correcting Deferred Compensation Plan Document Failures Under Code §409A

Dear Clients and Other Friends:

New IRS Notice 2010-6 provides guidance to sponsors of deferred compensation plans regarding the correction of certain failures to comply with the plan document requirements of Code §409A. Notice 2010-6 identifies a wide range of plan document defects which may be corrected. However, the list is not exhaustive, and some types of document defects are outside the scope of the correction program. **This notice gives employers an opportunity during 2010 to correct plan document deficiencies without incurring significant penalties under §409A**.

Some situations where this new program will be useful are:

- Small employer simply didn't realize that §409A applied to its deferred compensation plan and therefore did not adopt required §409A amendments.
- Employer knew §409A amendments were needed, but didn't spot all the plans requiring such amendments. For example, the employer failed to recognize that an individual employment agreement provided for deferred compensation and therefore needed to include §409A wording.
- Employer correctly identified the plans subject to §409A and adopted timely amendments, but some of the amendment details failed to comply with §409A.

In all of these cases, employees participating in the defective deferred compensation plans are exposed to significant tax penalties as a result of the §409A plan document failure. Notice 2010-6 provides a way to reduce or eliminate these tax penalties.

Employers can minimize potential penalties by correcting plan document failures during a limited **transition period**. For most corrections, the transition period ends December 31, 2010.[1] Using the transition correction provisions would involve these steps:

[1] For two rather limited types of corrections, the transition period extends to December 31, 2011. These include: (i) non-qualified deferred compensation plans where the benefits are offset by benefits under another non-qualified deferred compensation plan with a different time or form of payment, and (ii) plans where payment is contingent on payments to the employer (e.g. amounts due from a customer), but the details are inconsistent with the §409A regulations.

First, identify all plans subject to §409A and review them to determine whether §409A amendments were adopted and comply with §409A requirements.

Second, amend plans as needed.

Third, if payments have already been made based on plan provisions which did not comply with §409A, correct such payments as provided in IRS Notice 2008-113, the IRS correction program for "operational failures".

Fourth, comply with the reporting and disclosure requirements outlined later in this letter by advising the IRS and affected participants about the corrections.

If plan document errors are not corrected during the transition period, corrections may still be made later but are subject to greater penalties.

Employers using the correction program during or after the transition period must notify affected employees (and other affected individuals including former employees and independent contractors) about the corrections. Notice to the IRS also is required, both by attaching an explanation to the employer's federal income tax return and by attaching similar notices to the returns of affected employees. Also, any amounts which are subject to tax in connection with the correction must be reported on Form W-2 for affected employees or Form 1099 for independent contractors.

There are limits on use of this program if the employer or an affected individual is under federal tax audit for a year in which the document failure existed.

In addition to the correction program outlined above, Notice 2010-6 also identifies two plan document issues where correction is not needed at all or can be accomplished on a more streamlined basis. These are:

Plan provisions requiring payment to be made "as soon as practicable" after a payment event. This writer and other practitioners have been concerned that if a plan says benefits will be paid upon, say, "separation from service" but requires payment to be made "as soon as practicable" after the separation, the payment window is too vague and therefore violates §409A. The IRS says that the "as soon as practicable" wording is not a problem so long as the separation from service date is treated as the payment event and payment is completed by the later of: (i) the end of the calendar year in which the separation occurred, or (ii) 2 ½ months after the month in which the separation occurred. Payment after the deadline is treated as an operational failure and can be corrected under IRS Notice 2008-113, so long as the employer doesn't have a pattern of consistently paying after the permitted time frame. This IRS interpretation is quite helpful because the "as soon as practicable" language was pervasive in pre-§409A documents and still appears in many documents that are subject to §409A.

Failure to define events triggering payment. Notice 2010-6 clarifies that if a deferred compensation document triggers payment on an event that is permitted under §409A but does not precisely define the event, the document does not violate §409A so long as it is interpreted in a way that is §409A compliant. For example, a plan that triggers payment upon "separation from service" or "termination of employment" is okay as long as the employer interprets it in a way that is consistent with the §409A separation from service definition. A similar concept applies with regard to failure to define "change in control" or "disability". In such documents, it is helpful (but not necessarily required) that the document state explicitly that it will be interpreted in accordance with §409A. That wording can be added now if it is not already in the document (or more explicit definitions of the terms in question may be added), and such an amendment does not require the employee notices and IRS notices that are required under the main Notice 2010-6 correction program.

The new notice also gives an indication of how the IRS views various other §409A interpretation issues. For example, it explains how a plan where benefits are payable only if the employee signs a release can operate without violating the §409A payment timing requirements. We would be happy to discuss these with you if you are interested.

We expect that most companies and individuals on our distribution list are already in full compliance with the §409A plan document requirements, so that Notice 2010-6 will be of limited interest. However, given the complexity of the §409A requirements, we suspect that some of you will need to consider using this new program. Let us know if you would like more information about it.

Sincerely,

A. David Kelly

ADK/bz