

Correcting Operational and Document Failures to Comply with IRC Section 409A

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Contents

Correcting Operational and Document Failures to Comply with IRC Section 409A.....	3
Overview.....	3
What is the Basic Purpose of Section 409A?.....	4
In a Nutshell, How does Section 409A Work?.....	5
What Compensation is Covered by Section 409A?.....	9
What Compensation is Exempt from Section 409A?.....	10
Who is Impacted by a failure to comply with Section 409A?.....	13
What Current IRS Audit Initiatives Focus on Compliance with Section 409A?.....	14
What Correction Programs are Available for Noncompliance with 409A?.....	19
Correction Programs for Operational Failures.....	19
Overview.....	19
What are Operational Failures?.....	20
Which Operational Failures can be Corrected Using the Corrective Procedure?.....	21
Who is Eligible to Use the Corrective Procedure?.....	22
What are the Deadlines for Correcting Operational Failures?.....	24
Examples of How to Correct Common Operational Failures.....	30
Correction Programs for Document Failures.....	35
Overview.....	35
Who is Eligible to Use the Corrective Procedure?.....	35
What are the Deadlines for Correcting Document Failures?.....	37
Transitional Relief ending on December 31, 2012 for Errors related to Conditioning Payment of Deferred Compensation on Giving Release, Non-Compete, or the Like.....	45
What is the “Release Timing” Problem?.....	46
How does the New Corrective Procedure Work?.....	46
How Do I Amend a Non-Compliant Plan to Qualify for Relief?.....	47

Correcting Operational and Document Failures to Comply with IRC Section 409A

Overview

A surprising range of agreements include an element of deferred compensation that is subject to Internal Revenue Code Section 409A (“**Section 409A**”) and its implementing Treasury Regulations, Section 1.409A-1, et seq. (the “**409A Rules**”). The penalties for failure to comply are quite harsh. The IRS is stepping up its audit activity in this area, and has recently provided guidance on self-correction procedures. The IRS guidance covers operational failures and document failures, and often provides the best relief if corrections are made during the plan year in which the failure occurs. This segment will review the Section 409A self-correction program guidance offered by the IRS; as well as current audit guidelines. This segment will also provide a brief review of the types of deferred compensation that are subject to compliance with Section 409A; applicable exemptions; and a review of common errors.

NOTE – The following summary of Section 409A and the 409A Rules is provided for the sole purpose of helping you spot potential problems with deferred compensation arrangements that are required to comply with the requirements of Section 409A. Since the focus of this program is how to use the available IRS correction programs to correct such problems once you identify them, these program materials provide what is, by design, a very simplified overview of a very complex set of rules. The summary is not intended as a guide on how to properly draft or administer a deferred compensation arrangement that complies with, or is exempt from compliance with, Section 409A. You should not use it for that purpose.

What is the Basic Purpose of Section 409A?

The purpose of Section 409A is to deny the recipient of deferred compensation any and all discretionary rights to control the time at which deferred compensation is ultimately paid, or the form in which it is paid. In order to understand the intentional rigidity of Section 409A and the 409A Rules, and the stringent manner in which the IRS enforces the 409A Rules, it is important to understand the history of deferred compensation prior to the enactment of Section 409A.

The common law that had developed prior to the enactment of Section 409A was not particularly favorable to the IRS. Taxpayers were, in many cases, permitted to defer recognition of taxable income, while retaining a fairly significant amount of control over how and when that income was actually paid. For example, prior to the enactment of Section 409A, it was common for deferred compensation plans to give the recipient of the deferred compensation the right to elect whether to receive the compensation in a lump sum, or in a series of periodic payments. It was also a fairly common for deferred compensation plans to include a “haircut” provision which allowed the recipient to accelerate the date of payment in consideration for taking a reduced payment (the theory being that the “haircut” constituted a substantial risk of forfeiture that justified the deferred income recognition, notwithstanding the discretionary right to accelerate the date of payment). The IRS took the position that, if the taxpayer retained any discretionary rights to elect a form of payment, or to change the time of payment, then there was no actual deferral of income and, hence, no deferral of income recognition. However, due to unfavorable common law, the IRS had been unable to successfully enforce its position.

With the enactment of Section 409A, the IRS finally gained the tools it needed to implement its desired policy position. Although the 409A Rules exceed 400 pages in length, and

are quite complex, the basic philosophy behind these rules is fairly simple. The 409A Rules are designed to make it virtually impossible for a recipient of deferred compensation – after the date of award – to change the time at which that deferred compensation is paid, or the form in which it is paid, without triggering the inclusion of that deferred compensation in current income (and incurring significant additional tax penalties).

The 409A Rules also seem to assume that employers and employees are actively looking for ways to manipulate a broad range of compensation practices with an eye towards allowing employees to earn the right to income in one year, and defer the recognition of tax on that income into future years. Once you understand the mindset of the IRS drafters, it makes it easier for you to spot potential problems that you may be able to correct using one of the IRS correction programs.

In a Nutshell, How does Section 409A Work?

If compensation is “deferred compensation” for purposes of Section 409A, then:

- The compensation may not be paid to the service provider until a permissible payment event occurs. See Treas. Reg. 1.409A-3(a). The only permissible payment events are:
 - **A fixed date or series of fixed dates** (for example – a single lump sum payment on January 1, 2013, or a series of 10 annual payments of \$10,000 each, commencing on January 1, 2013 and continuing on January 1 of each of the subsequent 9 years).
 - **A separation from service** (Caution – you may think that separation from service = termination. That is not necessarily the case. The definition of what constitutes a bona fide “separation from service” is complex and under certain circumstances,

it may be that no separation from service has occurred, even when an employee has been terminated (for example, when the former employee is retained as a consultant).

- **Death** (Amazingly, the IRS chose not to promulgate regulations defining death – but if you are fan of tax-related humor, you can find some fake Section 409A regulations defining “death” that are circulating on the internet).
- **Disability** (Caution – the 409A Rules have a very specific definition of what constitutes “disability” and it is much more restrictive than the typical disability insurance policy).
- **A change in control transaction** (There is a complex definition that largely follows the rules promulgated under IRC Section 280G with respect to the taxation of excess parachute payments).
- **Unforeseeable emergency** (Caution – the definition of “unforeseeable emergency” is fairly restrictive and is generally limited to bona fide medical emergencies or similar events that could not be foreseen – deciding you need money to pay for a child’s college education does not count.)
- Generally, a plan may designate only one time and form of payment for each permissible payment event. See Treas. Reg. 1.409A-3(c). However, there are some exceptions to this rule. For example, alternate payment schedules are permitted if (i) death, disability or a change in control occurs before or after a single specified date (i.e. before or after attainment of a specified age or specified number of years of service), (ii) a separation from service occurs before or after a single specified date, or (iii) a separation from

service occurs within a limited period following a change in control that cannot exceed 2 years.

- If the service provider is given the right to designate the time and form of payment (i.e. – the applicable payment trigger, and whether the payment is lump sum or a series of periodic payments), then the service provider must generally make an irrevocable election by the last day of the tax year before the year in which the service provider performs the services to which the compensation relates. See Treas. Reg. 1.409A-2(a). In certain cases, the service provider will also be permitted to make an irrevocable election not later than the 30th day after becoming eligible to participate in deferred compensation plan. Generally speaking, the time and form of payment may not be changed at a later date. See Treas. Reg. 1.409A-2(b).
- Regardless of whether or not the service provider is given the right to designate the time and form of payment, the agreement providing the deferred compensation must provide:
 - a specific, fixed payment date (for example, either the date the permissible payment event occurs, or a payment date following the occurrence of the permissible payment event, that is objectively determinable and non-discretionary (for example – payment will be made on the first day of the second month following the service provider’s death); and
 - a specific, fixed form of payment (for example, a lump sum payment, or a series of periodic payments in amounts and at dates that are specified at the time the compensation is initially deferred). See Treas. Reg. 1.409A-2(a).
- Generally speaking, the time and form of payment may not be changed after it is initially selected. See Treas. Reg. 1.409A-2(b).

- The deferred compensation must be paid at the exact time and in the exact form specified in the deferred compensation agreement. In almost all cases, no acceleration of payment is permitted, and no additional deferral is permitted. See Treas. Reg. 1.409A-3(j), and see Treas. Reg. 1.409A-2(b). The 409A Rules provide almost no discretion to the service recipient to make allowances for changed circumstances or other factors (such as settlement of a legal claim in connection with severance) that might make the service recipient amenable to allowing an accelerated payment or further deferral of compensation. The 409A Rules do, however, impose a mandatory 6-month delay in the payment of deferred compensation to service providers that are deemed to be “specified employees” of a service recipient. See Treas. Reg. 1.409A-1(c)(v). Basically, the mandatory delay provision applies only to certain senior executive or highly compensated employees of public companies (think of this as the “Enron Rule”). The delay is intended to allow publicly traded companies (or their regulators) to prevent the payment of deferred compensation to executives who want to take golden parachutes and leave a public company shortly before it fails.
- If the terms of a deferred compensation arrangement do not comply with the 409A Rules (a “**document failure**”), or the deferred compensation agreement is not administered in a manner that complies with the 409A Rules (an “**operational failure**”), then all compensation deferred under that agreement for the taxable year and all preceding taxable years must be included in the gross income of the affected service provider, to the extent that the deferred compensation is not subject to a substantial risk of forfeiture, and not previously included in gross income. See Section 409A (a)(1)(A)(i); see also Proposed Treas. Reg. 1-409A-4. In addition, the tax on all compensation that is

required to be included in gross income under Section 409A will be increased by 20%, plus interest. Interest is determined at the underpayment rate, plus 1% on the underpayments that would have occurred had the deferred compensation been included in gross income for the taxable year in which it was first deferred (or if later, the first taxable year in which such deferred compensation was no longer subject to a substantial risk of forfeiture). See Section 409A(a)(1)(B). The interest component is often referred to as the “**Premium Interest Tax.**”

- Even worse, Section 409A imposes “plan aggregation” rules that require all plans of a similar type maintained by the same employer to be aggregated for purposes of testing compliance with Section 409A. Consequently, a Section 409A violation with respect to one plan or agreement will result in current taxation of all vested compensation deferred under arrangements maintained by the same employer that are deemed to be of the same type for purposes of the 409A Rules. See Treas. Reg. 1.409A-1(c)(2).

What Compensation is Covered by Section 409A?

In simplest terms, the 409A Rules define “deferred compensation” to include virtually every compensation arrangement that creates the legally binding right in one year to compensation that is paid in a later year. See Treas. Reg. 1.409A-1(b)(1). Your default assumption ought to be that anything other than regular wage payments could be deferred compensation that is subject to the 409A Rules. Then, your challenge will be to find an applicable exemption from compliance with Section 409A.

Examples of items that may qualify as deferred compensation for purposes of the 409A Regulations include:

- Bonus payments;
- Incentive compensation;
- Taxable fringe benefits and perquisites;
- Reimbursement of business expenses;
- Severance pay;
- Split-dollar life insurance;
- Traditional non-qualified deferred compensation arrangements, such as SERPs, Salary Continuation Agreements, Director Fee Continuation Agreements, and the like;
- Golden parachutes or other payments made in connection with a change-in-control transaction;
- Equity compensation, including certain types of stock options, stock appreciation rights, and the like; and
- Employment agreements that include elements of deferred compensation (i.e. potentially any employment agreement that provides for compensation other than regular wages).

What Compensation is Exempt from Section 409A?

The 409A Rules exempt certain types of compensation from compliance with Section 409A. The exemptions are described in Treas. Reg. 1.409A-1(a)(2)-(5) and in Treas. Reg. 1.409A-1(b)(3) – (12), and include the following:

Transactional Exemptions:

- **Compensation paid pursuant to the service recipient's customary payment schedule** – provided it is paid no later than 30 days after the end of the service provider's taxable year (for example, a scheduled payment of regular wages for work performed during the final regular pay period of the previous year). See Treas. Reg. 1.409A-1(b)(3).
- **Short term deferrals** – which generally refers to compensation paid within 2 and ½ months after the end of the year in which the compensation is earned and vested (for example, an annual bonus earned in one year that is paid shortly after the end of that year). See Treas. Reg. 1.409A-1(b)(4).
- **Certain Separation Pay in connection with Involuntary Separation from Service (a/k/a – the 2 year/2 x exception)** – If (i) a service provider experiences an involuntary separation from service, and (ii) all separation pay triggered by such involuntary separation from service is paid not later than the end of the second year following the year in which the involuntary separation from service occurred, and (iii) the total separation pay does not exceed the lesser of (A) two x annual compensation for the taxable year of the service provider preceding the year in which the involuntary separation from service occurred, or (B) the maximum amount that may be taken into account under a qualified plan under IRC Section 401(a)(17) for the year in which the separation from service occurred. See Treas. Reg. 1.409A-1(b)(9)(iii).

Categorical Exemptions (but the definitions define categories quite narrowly, and with many limitations – so be careful):

- Restricted Stock (stock issued to a service recipient which remains subject to certain forfeiture provisions).
- Incentive Stock Options (i.e. options that meet the statutory requirements of IRC 422).
- Nonqualified Stock Options, **if the option exercise price is no less than fair market value at the time of grant, and** no ability exists to defer income recognition past the exercise date.
- Certain types of stock appreciation rights (generally, this means a stock appreciation right that is the functional equivalent of a non-qualified stock option that would qualify as exempt under the 409A Rules).
- Tax qualified retirement plans such as 401(k) plans and tax qualified pension plans; 403(b) plans (tax sheltered annuity contracts purchased for an employee by tax exempt employers or public schools); SEPs; SIMPLE Retirement Accounts; 457(b) plans maintained by governmental agencies and tax exempt organizations (Caution – 457(f) plans are a different story – they excess deferred compensation plans for executives of non-profits, and are covered by Section 409A and by the restrictive rules of IRC 457(f), which makes things even more difficult); and bona fide health and welfare plans.
- Compensation that remains subject to a substantial risk of forfeiture – as defined in IRC Section 83 and Treas. Reg. 1.83-3(b).
- Certain bona fide separation pay plans (for example, collectively bargained plans or so-called “window” programs). Be careful with this one. Severance pay is quite often covered by Section 409A.

- Certain indemnification and liability insurance plans (for example, directors' and officers' liability insurance).
- Certain settlement payments (for example, settlement payments to resolve bona fide wrongful termination, employment discrimination, fair labor standards act, or workers compensation claims). Again, be careful with this one.

Who is Impacted by a failure to comply with Section 409A?

It is important to remember that Section 409A applies to deferred compensation paid to employees and to independent contractors, including consultants and corporate directors.

Section 409A applies to all deferred compensation paid to individuals for services rendered, unless a specific provision of Section 409A or the 409A Rules provides an applicable exemption.

In these materials, the employer/business/non-profit that pays the deferred compensation will be referred to as the “**service recipient**” and the employee/officer/director/independent contractor who receives payment for services rendered to a service recipient will be referred to as the “**service provider.**”

The tax penalties imposed by Section 409A are assessed against the service provider who receives the deferred compensation. However, the service recipient that pays the deferred compensation can face significant problems too, because:

- The service recipient often wishes to maintain a good relationship with the service provider, and will feel obligated to reimburse the service provider for the taxes imposed as a result of the service recipient's failure to draft and administer a deferred compensation arrangement in compliance with Section 409A;

- The service recipient has an obligation to disclose to the IRS that income inclusion is required under Section 409A; and
- The service recipient may have failed to properly report W-2 or 1099 income to the service provider, and may have failed to withhold and remit payroll taxes on that income.

DISCLAIMER:

- **The foregoing summary of Section 409A and the 409A Rules is, by design, intended to be a highly simplified summary of a set of highly complex rules.**
- **The principal purpose of the summary is to help you spot potential failures to comply with the 409A Rules – so that you can more easily identify document and operational failures that should be corrected as promptly as possible using one of the correction programs discussed below.**
- **For sake of simplicity – the summary omits discussion of certain features of the 409A Rules, such as (1) the limited circumstances under which payment of deferred compensation may be accelerated or delayed; and (2) the limited circumstances under which the form of payment may be changed.**
- **The summary also omits discussion of many complexities that can arise when trying to design or administer a plan that is intended to be exempt from, or compliant with, the 409A Rules.**

What Current IRS Audit Initiatives Focus on Compliance with Section 409A?

On December 8, 2011, the IRS transmitted new NRP Examination Guidelines for an Employment Tax Study. See IRM 4.22.10, National Research Program (NRP), Employment Tax Study - NRP Examination Guidelines (the “**Exam Guidelines**”). Section 4.22.10.5.1 of the

Exam Guidelines states that executive and non-executive fringe benefits, specifically including non-qualified deferred compensation, are a required exam topic. See para. 4, 5, 6, 7 and 8 of Section 4.22.10.5.1. Thus, if your client is notified that the IRS will be conducting an employment tax audit, you need to be prepared to deal with an audit of your client's compliance with Section 409A and the 409A Rules.

The NRP Program is, by its terms, applicable to a random selection of large and small businesses, public and private, for-profit and non-profit. However, the NRP Program reportedly will focus a majority of its efforts on small businesses.

Reportedly, when the IRS conducts employment tax audits under this program, it issues Information Document Requests (“**IDRs**”), which ask more than 15 separate questions on Section 409A compliance, including the following:

- Identify each plan and arrangement (and the corresponding participants/service providers) that provided any participant/service provider with a legally binding right in one year to a payment of compensation in a subsequent year, and that was not a nonqualified deferred compensation plan subject to Section 409A. For all such identified plans and arrangements, provide the basis for your position that such arrangement is not a nonqualified deferred compensation plan subject to Section 409A; and if that basis is predicated on the short-term deferral exclusion, the terms of the plan or arrangement, including any relevant substantial risk of forfeiture.
- Did the Company maintain any plan or arrangement under which a service provider elected to defer the receipt of compensation that would otherwise have been paid during

the applicable year or a later year? If so, provide the terms for deferral elections and any relevant deadlines for making such elections.

- Did the Company defer a payment beyond the originally scheduled payment date? If so, provide the terms for subsequent deferral elections (such as changes to prior deferral elections), including the original payment date and the rescheduled payment date.
- Did the Company permit any service provider to elect to receive a payment under a non-qualified deferred compensation arrangement before the originally scheduled payment date? If so, provide any acceleration in payment made before the originally scheduled date, including due to elections made under available transition relief and the deadlines for such elections; and identification of the original payment date and the actual payment date.
- Provide the names of “specified employees” in public companies and the period during which such individuals were specified employees.
- Provide information regarding payments of nonqualified deferred compensation made during the applicable year to specified employees upon separation from service, and whether such payments were made within six months after the date of separation from service.
- At any time during the applicable year, did any service provider hold an outstanding stock right (whether vested or unvested) with all of the following characteristics? (1) exercise right below fair market value as of date of grant, or containing a deferral feature; (2) granted in connection with performance of services for the Company; and (3) granted on or after January 1, 2005, was not earned or vested before January 1, 2005, or was materially modified on or after January 1, 2005.

- Did any assets become restricted to the payment of deferred compensation, or did any amount of deferred compensation become funded or payable during the applicable year, as a result of any event that may relate to a decline in the Company's financial condition? If yes, describe each such deferred compensation amount and the participant to whom such amount was paid or owed.
- Did the Company modify any arrangement under which amounts deferred under the plan are subject to Section 409A to comply with the rules under Section 409A? If so, describe plan or arrangement, and each of the modifications.
- To date, have you identified any violations of the requirements of Section 409A? If so, please explain the nature of the violation(s) and state whether the Company have reported amounts to the affected service providers on Form W-2, Box 12 using Code Z or Form 1099, Box 15b.
- Various questions regarding timing of federal employment tax withholding in connection with earned and vested deferred compensation; and reporting of same on IRS Form W-2 or IRS Form 1099.
- Requests for detailed descriptions of hardship or unforeseeable emergency payments, including circumstances and procedures followed.

In addition, practitioners have reported that Section 409A compliance audits have come up in the context of IRS screenings for compliance with worker classification rules. Specifically, audits for compliance with Section 409A have resulted from employer responses to IRS Form SS-8, "Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding."

The IRS uses Form 1099s that are issued to service providers to identify companies it believes should receive Form SS-8. Form SS-8 is used to gather information relevant to the determination of whether an individual or group of service providers is classified properly as independent contractor or employee. The IRS uses the responses given on Form SS-8 to determine whether to audit a company to determine whether payroll taxes are being withheld and paid. Reportedly, the IRS has begun to pair IRS Form SS-8 requests with IDRs of the type described above. Consequently, tax practitioners need to be aware that if a client is required to respond to a Form SS-8 and an IDR, the client runs a risk of disclosing one or more compensation arrangements that have never been identified as deferred compensation plans, and which may be non-compliant with Section 409A and the 409A Rules.

Typical problem areas uncovered in IRS audits of non-qualified deferred compensation arrangements include the following:

- Failure to properly use the “short-term” deferral rule;
- Failure to identify “specified employees” of public companies (including companies that are members of the public company’s controlled group);
- Failure to properly designate the time and form of payment (typically by giving the service provider too much discretion to determine the time and form of payment); and
- Discounted stock-options (i.e. stock-options with an exercise price below fair market value on the date of grant).

What Correction Programs are Available for Noncompliance with 409A?

- **IRS Notice 2008-113** provides procedures for correcting inadvertent failures to operate a plan or agreement in compliance with Section 409A and the 409A Rules.
- **IRS Notice 2010-6** provides procedures for correcting provisions in plans and agreements that inadvertently fail to comply with Section 409A and the 409A Rules.
- **IRS Notice 2010-80** modifies the guidance given by Notice 2008-113 and Notice 2010-6 by clarifying certain provisions of each notice, expanding the relief provided by each notice, and providing certain additional methods of correction.

Correction Programs for Operational Failures

Overview

IRS Notice 2008-113 provides procedures for correcting certain inadvertent operational failures to comply with Section 409A (but not plan document failures). The corrective procedures outlined in the Notice allow taxpayers to obtain relief from:

- The full application of the Section 409A income inclusion rules; and
- The additional taxes that would otherwise apply under Section 409A.

Correction often requires the service provider to pay back to the service recipient amounts that were distributed in a manner that did not comply with the requirements of Section 409A. In some cases interest must be paid on the amounts received, and if the non-compliant payments relate to under or over-deferrals, earnings or losses may have to be adjusted too.

(Cautionary Note – No repayment will be deemed to have been made if the service recipient pays or otherwise provides the service provider with any sort of substitute benefit (payable then

or in the future), or provides a loan to the service provider – so make sure that your client does not get too clever. See Section III, E of Notice 2008-133; and Section III, A of Notice 2010-6.)

If the operational error can be corrected using Notice 2008-113, penalties will be eliminated in some cases and reduced in other cases; and applicable penalties will apply only to the specific amount(s) of deferred compensation that pertain to the operational failure, and not to all deferrals under the same plan (or series of related plans, under the plan aggregation rules). In many cases, the correction procedures require inclusion and reporting of current year income on the service provider's W-2 or 1099, or the issuance of corrected W-2s or 1099s for prior year's income that was not properly included and reported for the prior year; and may require corrective income and payroll tax withholdings and reports. In all cases, the correction procedures require compliance with the information reporting requirements described in Section IX of the Notice (information required to be included with service recipient's and service provider's tax returns for correction year; and service recipient's obligation to provide required information reporting to service recipient by W-2 filing deadline for service provider).

What are Operational Failures?

You may have a deferred compensation arrangement that is documented in a manner that complies fully with Section 409A. However, if your client fails to administer the deferred compensation arrangement in compliance with the requirements of Section 409A, then all of your good drafting may go to waste. Consequently, it is important to make sure that your clients actually administer their deferred compensation arrangements in a manner that complies with the 409A Rules.

Operational failures can occur in a variety of ways, including the following:

- Making payments when no permissible payment event has occurred;
- Making payments not expressly permitted by the plan (even if the payment is made in connection with an event that would be a permissible payment event, if it were written into the plan);
- Changing the form or schedule of payment(s) (except in the limited circumstances permitted by Section 409A);
- Making payments more than 30 days before the payment date specified in the plan;
- Making payments to specified employees before the end of the 6-month waiting period that applies to specified employees;
- Delaying payments beyond the specified payment date; and
- If the service provider is permitted to make elective deferrals, making excess or insufficient deferrals (i.e. deferral of more or less compensation than the service provider asked you to defer).

Which Operational Failures can be Corrected Using the Corrective Procedure?

Unfortunately, not all operational failures can be corrected using Notice 2008-113. The Notice provides corrective procedures only for the following specific operational failures:

- **Erroneous payments (mistaken payout/failure to defer)** – meaning payments of deferred compensation that are paid or made available in a taxable year before the taxable year when payment was due (this includes both mistaken payouts and mistaken failures to honor a service provider’s deferral election);
- **Premature payments (in violation of 30 day or 6-month rules)** – meaning, either (i) a payment made in the correct tax year but that is made more than 30 days before the specified payment date, or (ii) in the case of a specified employee,

a payment made prior to the end of the six-month delay period that applies to specified employees;

- **Erroneous Deferrals (excess deferral/failure to pay when due)** – meaning compensation payable to the service provider in a taxable year is not paid and is erroneously treated as deferred compensation (this includes both mistaken excess deferrals, and mistaken failures to pay deferred compensation when a permissible payment trigger occurs); and
- **Stock Option and Stock Appreciation Right Failures** – meaning, a failure that occurs when an option or SAR is accidentally granted with an exercise price that is less than the fair market value of the underlying stock on the date of grant. No other sort of stock option or SAR failure can be corrected under the Notice.

Who is Eligible to Use the Corrective Procedure?

Eligibility requirements are described in Section III of the Notice. Taxpayers claiming relief under the corrective procedures described in the Notice have the burden of demonstrating eligibility for relief and compliance with all requirements for relief; and that eligibility for relief is subject to examination by the IRS. See Section III, A. of Notice 2008-113.

General Standard – No Relief for Repeated Similar Failures. The relief provided by the Notice is available only if the service recipient can demonstrate that it has taken commercially reasonable steps to avoid the recurrence of the operational failure. This means that, if the same or a substantially similar operational failure has occurred previously, the relief provided under the Notice is not available unless the service recipient (or service provider) can demonstrate that the service recipient

established practices and procedures reasonably designed to ensure that such operational failure would not recur; followed those practices and procedures; and the failure occurred despite the service recipient's diligent efforts.

No Relief – If Service Provider under Audit for 409A Compliance. The relief provided by the corrective procedures is not available if the federal income tax return of the relevant service provider, for the service provider's taxable year in which the operational failure occurred, is under examination with respect to the plan.

Additional Eligibility Requirements. The following additional limits on eligibility also apply:

- The Notice provides relief only for certain operational failures that are specifically described in the Notice (and not any other operational failures or plan document failures);
- No relief is available with respect to any exercise of a stock right in violation of Section 409A;
- Relief is available only for inadvertent and unintentional failures;
- Relief otherwise available under the Notice is conditioned upon the timely filing and providing of information to the IRS with respect to the correction;
- Relief is not available for any "listed" transaction (i.e. a listed tax avoidance transaction);
- Required repayments must be made on the gross amount paid to the service provider (before the application of any withholding requirements), and must be

made before the applicable deadline for such repayment as described in the Notice (see clarification made by Section XIII, A. of Notice 2010-6); and

- Relief is not available if the service recipient (i.e. the employer) experiences a substantial financial downturn, if that downturn indicates a significant risk that the service recipient will be unable to pay the deferred compensation when due. This means, no relief will be allowed if it looks like a company made a payment in violation of Section 409A when it looked like the company was about to fail. This is what might be called the “Enron” eligibility rule. The IRS does not want to provide any relief in situations where it looks like preferential payments were made in anticipation of the company failing.
- As noted below, the nature of any permitted relief will also depend on whether the service provider is an “insider” and on how quickly the operational failure is identified and corrected.

What are the Deadlines for Correcting Operational Failures?

Overview. There are a few different deadlines for correcting operational failures. The first deadline is the taxable year in which the operational failure occurred. If the operational failure is corrected during the taxable year in which it occurred, then all taxes and penalties can generally be avoided, even if the correction pertains to a plan maintained for an “insider”. The second deadline is the taxable year after the operational failure occurred. If a plan is not maintained for an “insider” and that plan is corrected during the taxable year after the operational failure occurred, then all taxes and penalties can generally be avoided. The final deadline is the second taxable year after the year in which the failure occurred. Correction prior to this deadline (but after the end of the first taxable year following the year in which the failure occurred),

generally results in the reduction, but not elimination, of Section 409A taxes and penalties. **Note** – the relevant taxable year is the service provider’s, not the service recipient’s -- so we are talking about a calendar year. The term “**insider**” means the officers, directors and certain beneficial owners of 10% or more of a company’s stock, determined under the rules of Section 16 of the Securities Exchange Act of 1934, as amended, except without regard to whether the company is publicly traded.

Operational Failures Corrected in the Year they Occur. An operational failure may be corrected in the same taxable year in which it occurred without payment of the 20% tax or Premium Interest Tax imposed by Section 409A. See Section IV of the Notice. Even insiders can correct without tax or penalty if they meet this deadline (and the other eligibility rules are met). The receipt of an erroneous payment by a service provider is generally corrected by the service provider’s repayment of that amount before the end of the taxable year in which it was received, and in such case the amount repaid is not required to be reported as W-2 or 1099 income to the service provider. If repayment would cause a financial hardship, repayment may be made over a 24-month period (with interest, calculated using the short-term AFR – and don’t forget the compounding requirement, see p. 11 of Notice 2008-113), if the service provider is not an insider. If the service provider is an insider, no hardship repayment period is allowed, and the amount must be repaid with interest (calculated using the short-term AFR, and the required compounding method). Repayment may be done by a reduction in compensation otherwise payable to the service provider, but the reduction must be reported as taxable income to the service provider. If the operational failure was caused by a failure to defer, the service recipient is also generally permitted to adjusting the account balance (including earnings and losses) to reflect the failure to defer, provided that such adjustment is made before the end of the taxable

year in which the operational failure occurred – except that no such adjustment for earnings is permitted for an premature payment in violation of the 30-day rule, or six-month rule for specified employees.

In addition, the corrective procedure applicable to premature payments made in violation of the 30-day rule, or the 6-month rule applicable to specified employees, require plan amendments to delay the date of receipt of payment by an additional time period (as described in the examples shown below). Thus, you should be aware that correction of such an operational failure will most likely require an appropriate plan amendment, in addition to the repayment.

If the failure was caused by an excess deferral, it may be corrected by paying the excess deferral to the service provider before the end of the taxable year in which such excess deferral occurred. If the excess deferral was made for an insider, the insider's remaining account balance or other deferred compensation under the plan must be adjusted for earnings (and may, but need not, be adjusted for losses) retroactive to the date the excess amount was incorrectly credited to the insider's account or otherwise incorrectly treated as deferred under the plan; and such adjustment must be made before the last day of the service provider's taxable year in which such excess deferral occurred. (Note – such adjustments are optional if the service provider is not an insider and it is a same year correction.) In addition, in the case of same year plan corrections only, the service provider may be paid reasonable interest as compensation for the erroneous deferral, or otherwise compensated for the time value of money, if such payment is made before the end of the same taxable year in which the correction is made.

A failure in the exercise price of a stock option or SAR (i.e. an exercise price that was inadvertently set below fair market value as of the date of grant) may be corrected by resetting

the exercise price to not less than fair market value as of the date of grant, but only if the option or SAR has not been exercised.

Operational Failures Involving Non-Insiders Corrected in the Year After the Failure Occurs. Service providers who are not “insiders” may correct operational failures during the taxable year after the operational failure occurred without paying the 20% tax or Premium Interest Tax imposed by Section 409A. See Section V of the Notice. This relief is not available to insiders (who are limited to the less advantageous relief described below). The permitted correction methods are generally the same as described above with respect to same-year corrections, except that erroneous payments must be repaid with interest (calculated using the short-term AFR, and required compounding method referenced above); and in the case of excess deferrals, the service provider’s remaining account balance or other deferred compensation under the plan must be adjusted for earnings (and may, but need not, be adjusted for losses) retroactive to the date the excess amount was incorrectly credited or otherwise incorrectly treated as deferred under the plan; and such adjustment must be made before the last day of the service provider’s taxable year in which such excess deferral occurred. The service provider cannot be compensated for the excess deferral by payment of reasonable interest or other compensation for the time value of money.

Deferred compensation erroneously paid to the service provider that is subsequently repaid by the service provider, and deferred compensation that is paid to a service provider to correct an excess deferral, must be included in the service provider’s income and reported on the service provider’s W-2 or 1099. Payments of excess deferrals are included and reported in the year the excess deferral is paid to the service provider. Erroneous payments that are subsequently repaid by the service provider must be included and reported as income to the

service provider in the year erroneously paid, but the service provider is permitted to take a subsequent deduction in determining adjusted gross income, in an amount equal to repayments (not including any interest payments) made to the service recipient. (Note – the “benefit” of this subsequent deduction is not permitted under the additional, less advantageous, correction programs described below.)

Operational Failures Involving “Limited Amounts” Corrected within Two Years After the Failure Occurs. Section VI of the Notice provides an additional corrective procedure for operational failures involving amounts that do not exceed the annual deferral limit that applies to qualified plans under IRC Section 402(g)(1)(B) for the year in which the operational failure occurred (referred to herein as a “**limited amount**”). (**Note** – The plan aggregation rules under Treas. Reg. 1.409-1(c) apply in calculating whether the failure qualifies as a “limited amount” so be careful to aggregate all payments when making this calculation.) This correction procedure may be used as an alternative to the corrective procedures described in Sections V and VII of the Notice – and as discussed below, there may be advantages to doing so.

Correction using Section VI may be advantageous when “limited amounts” are involved, because the Section VI correction procedure does not require repayment of under-deferrals (and for purposes of Section VI, under deferrals are deemed to include premature payments in violation of the 30-day rule, or the 6-month rule applicable to specified employees). Instead, the service recipient reports the amount of the erroneous payment of deferred compensation on the service provider’s W-2 or 1099 (including reporting such amount on Form W-2, Box 12 using Code Z, if applicable) within two year after the taxable year in which the failure to defer occurred; and the service provider must include such amount in income and pay the 20% tax imposed by Section 409A (but not the Premium Interest Tax). Thus, 409A tax applies only to

the specific “limited amount” amount involved in the failure. Remaining compensation deferred under the plan or arrangement is not subject to any Section 409A tax or penalty.

If the operational failure results from a failure to pay deferred compensation when required and the amount qualifies as a “limited amount” then the service recipient must make the payment to the service provider within two years following the taxable year in which the payment failure occurred; and the service recipient must report the late payment of deferred compensation on the service provider’s W-2 or 1099 (including reporting such amount on Form W-2, Box 12 using Code Z, if applicable) for the year in which the late payment is made. In such case, the Notice provides that the service recipient will not be subjected to penalties or liability for the failure to properly withhold under IRC Section 3402(d). Earnings and/or losses on late payments must be added to or subtracted from the reported payment, or permanently forfeited, if the Section VI correction procedure is used.

Other Operational Failures that Can be Corrected within Two Years After the Failure Occurred. Section VII of the Notice provides an additional alternative corrective procedure for operational failures which are not or cannot be corrected by other means. Unlike Section VI, this corrective procedure is available, regardless of the amount of the operational failure.

Correction using this procedure is generally less advantageous than correction by any other means. Erroneous payments of deferred compensation must be repaid (with interest if repayment is made by an insider). In the case of excess deferrals, the service provider’s remaining account balance or other deferred compensation under the plan must be adjusted for earnings (and may, but need not, be adjusted for losses) retroactive to the date the excess amount was incorrectly credited or otherwise incorrectly treated as deferred under the plan; and such

adjustment must be made before the last day of the service provider's taxable year in which such excess deferral occurred. The service provider may not be compensated for the excess deferral by payment of reasonable interest or other compensation for the time value of money. No relief is available under Section VII for operational failures related to stock option and SAR pricing failures.

The Section VII correction procedure requires payment of the 20% tax imposed by Section 409A, but does not require payment of the Premium Interest Tax. The 409A tax applies only to the specific amount involved in the failure. Remaining compensation deferred under the plan or arrangement is not subject to any Section 409A tax or penalty.

Under the Section VII correction procedures, deferred compensation erroneously paid to the service provider that is subsequently repaid by the service provider, and deferred compensation that is paid to a service provider to correct an excess deferral, must be included in the service provider's income and reported on the service provider's W-2 or 1099. Payments of excess deferrals are reported in the year the excess deferral is paid to the service provider. Erroneous payments that are subsequently repaid by the service provider must be reported as income to the service provider in the year erroneously paid. However, the service provider is not permitted, under the Section VII corrective procedure, to take a subsequent deduction in determining adjusted gross income.

Examples of How to Correct Common Operational Failures

As with all other aspects of Section 409A, the corrective procedures are technically complex and exacting. Please use the following summaries only as a starting point in your efforts to fully comply with the requirements of Notice 2008-113. As noted above, the burden of

proving compliance is on the taxpayer, and the IRS intends to require complete requirements with all of the technical provisions of the corrective procedures.

- **Erroneous payments (mistaken payout/failure to defer)** – meaning payments of deferred compensation that are paid or made available in a taxable year before the taxable year when payment was due (this includes both mistaken payouts and mistaken failures to honor a service provider’s deferral election).
 - Steps for correction:
 - Service provider repays the amount that was incorrectly paid (or erroneously not deferred);
 - If the service provider is an insider, the repayment must be made with interest (calculated at short-term AFR – and don’t forget the compounding requirement, see p. 11 of Notice 2008-113);
 - If the service provider is not an insider – payment may be spread over 24 months (but interest is required, calculated as described above, if a payment plan is used by the non-insider);
 - Make sure that under the terms of the plan document, immediately after repayment, the service provider has a legally binding right to payment of the deferred amount at the same time and in the same amount as would have occurred, but for the erroneous payment (Amend the plan document, if need be, to satisfy this requirement);
 - Satisfy W-2 or 1099 income reporting requirements, and applicable withholding requirements;

- Adjust the plan account balance as required to effect the correction; and
- Satisfy service recipient information statement requirements (i.e. statements required to be filed with the service recipient's income tax return); the disclosure statement required to be provided to the service provider by the service recipient; and satisfy service provider information statement requirements (i.e. statements required to be filed with the service provider's income tax return).

See Section IX of Notice 2008-113.

- **Premature payments (in violation of 30 day or 6-month rules)** – meaning, either (i) a payment made in the correct tax year but that is made more than 30 days before the specified payment date, or (ii) in the case of a specified employee, a payment made prior to the end of the six-month delay period that applies to specified employees.
 - Service provider repays the amount that was paid prematurely;
 - The plan document must be amended so that, immediately after such repayment, the service provider has a legally binding right to receive payment of such refunded amount on a date, following the date of such repayment, that is the same number of days following the repayment date as -- the number of days elapsed over the period that commenced on the day after the date on which the erroneous payment was made (i.e. the early payment date) and ended on the date on which such payment should have been made

under the terms of the plan (i.e. the permissible payment date stated in the plan). In essence, this means that (i) you must determine how many days early payment was made (for example, payment is made 61 days early), (ii) add that number of days to the date on which repayment was made to the service recipient (for example, August 1, 2013), and (iii) the service provider must be given a legally binding right to payment of the refunded sum on such later date (i.e. October 1, 2013, which is the date that is 61 days after the premature payment was repaid). See example on p. 32 of Notice; and see Section III, H of the Notice for instructions on how to calculate this time period;

- Satisfy W-2 or 1099 income reporting requirements, and applicable withholding requirements;
- Adjust the plan account balance as required to effect the correction; and
- Satisfy service recipient information statement requirements (i.e. statements required to be filed with the service recipient's income tax return); the disclosure statement required to be provided to the service provider by the service recipient; and satisfy service provider information statement requirements (i.e. statements required to be filed with the service provider's income tax return). See Section IX of Notice 2008-113.

- **Erroneous Deferrals (excess deferral/failure to pay when due)** – meaning compensation payable to the service provider in a taxable year is not paid and is erroneously treated as deferred compensation (this includes both mistaken excess deferrals, and mistaken failures to pay deferred compensation when a permissible payment trigger occurs).
 - The erroneous deferral must be paid to the service provider;
 - The service provider’s remaining deferred compensation under the plan must be adjusted to reflect this payment (including forfeiture of earnings, if required under the applicable correction procedure);
 - If permitted under the applicable correction procedure, the service recipient may pay the service provider interest to compensate for the excess deferral;
 - Satisfy W-2 or 1099 income reporting requirements, and applicable withholding requirements; and
 - Satisfy service recipient information statement requirements (i.e. statements required to be filed with the service recipient’s income tax return); the disclosure statement required to be provided to the service provider by the service recipient; and satisfy service provider information statement requirements (i.e. statements required to be filed with the service provider’s income tax return).

See Section IX of Notice 2008-113.

Correction Programs for Document Failures

Overview

IRS Notice 2010-6 provides procedures for correcting certain inadvertent document failures to comply with Section 409A (but not operational failures). The corrective procedures described in the Notice allow taxpayers to obtain relief from:

- The full application of the Section 409A income inclusion rules; and
- The additional taxes that would otherwise apply under Section 409A.

Correction requires amendment of plan documents to comply with Section 409A (in some cases using required corrective language); and many of the corrective procedures require that corrective amendments be completed not less than one year before the occurrence of any event that would have resulted in a payment under the non-compliant plan terms that were corrected. If the document error can be corrected using Notice 2010-6, penalties will be eliminated in some cases and reduced in other cases; and applicable penalties will apply only to the specific amount(s) of deferred compensation that pertain to the document failure, and not to all deferrals under the same plan (or series of related plans, under the plan aggregation rules).

Who is Eligible to Use the Corrective Procedure?

Eligibility requirements are described in Section III of the Notice. Taxpayers claiming relief under the corrective procedures described in the Notice have the burden of demonstrating eligibility for relief and compliance with all requirements for relief; and that eligibility for relief is subject to examination by the IRS. See Section III, A. of Notice 2010-6.

General Standard – No Relief for Repeated Similar Failures. The relief provided by the Notice is available only if the service recipient can demonstrate that it has taken

commercially reasonable steps to avoid the recurrence of the document failure. This means that, if the same or a substantially similar document failure has occurred previously, the relief provided under the Notice is not available unless the service recipient (or service provider) can demonstrate that the service recipient established commercially reasonable steps to identify all similar document failures, and to correct all such failures in a manner consistent with the Notice.

No Relief if Service Provider or Service Recipient under Audit for 409A Compliance.

Generally speaking, the relief provided by the corrective procedures is not available if the federal income tax return of the relevant service provider or a federal tax return of a service recipient is under examination with respect to non-qualified deferred compensation for any taxable year in which the document failure existed. However, a service provider and service recipient will not fail to qualify for relief merely because the service provider or service recipient becomes under examination with respect to nonqualified deferred compensation after the date of correction – if all of the requirements for relief are otherwise satisfied and the neither was under examination on the date of correction.

Additional Eligibility Requirements. The following additional limits on eligibility also apply:

- The Notice provides relief only for certain document failures that are specifically described in the Notice (and not any other plan document failures or operational failures);
- Relief is available only for inadvertent and unintentional failures;
- Relief is not available for any “listed” transaction (i.e. a listed tax avoidance transaction);

- If the applicable corrective procedure under the Notice requires that the service provider include an amount deferred in income under Section 409A(a), relief is conditioned on:
 - the service provider including the required amount in income on the appropriate tax return and paying all applicable federal taxes including the 20% tax imposed by Section 409A (but not the Premium Interest Tax); and
 - the service recipient complying with applicable information statement reporting requirements described in the relevant corrective procedure (including W-2 or 1099 reporting and disclosure of correction on the service recipient's federal tax return). See Section XII of Notice.
- Generally speaking, Notice 2010-6 provides no relief for document failures related to linked plans or stock rights, or with respect to document provisions that grant the service provider discretion to accelerate a payment of deferred compensation (for example, discretion to accelerate payment in consideration for taking a "haircut"). See examples contained in Section VII, A, 1 and Section VII, D, 1 of the Notice. However, see clarifications in Section III, A of Notice 2010-80, which provide some potential relief for linked plans and stock rights under the document failure correction programs described in Notice 2010-6.

What are the Deadlines for Correcting Document Failures?

The Notice provides that the date of correction of a document failure is the latest of the date on which (i) the correction is adopted, (ii) the correction is effective, or (iii) the correction is set forth in writing in one or more documents. See Section III, F of the Notice. Under many of

the corrective procedures described in the Notice, the most favorable relief (i.e. correction without payment of any Section 409A tax or interest) is available only if certain events do not occur within one year following the date of the correction (this is what is referred to below as the “**One Year Rule**”). **Cautionary Note** – the Notice provides that the term “one year following” a date means the period beginning on such date and ending on the first anniversary of such date (referred to below as the “**One Year Period**”). (For example, one year following January 1, 2012 means January 1, 2013.) See Section III, F of the Notice.

Correction of Non-Compliant Payment and Election Provisions without additional Tax or Penalty – If One Year Rule is Satisfied. The following document failures may be corrected under Notice 2010-6 without additional tax or penalty under Section 409A – if the One-Year Rule is satisfied. If the payment provision or election provision becomes applicable prior to the expiration of the One Year Period, then the One Year Rule is not satisfied and 50% of the vested deferred amount must be included in income under Section 409A (or 25% in the case of certain changes in control), and the service provider must pay federal income tax and the 20% tax imposed by Section 409A, but not the Premium Interest Tax.

- Section V, A permits the correction of an impermissible definition of a Separation from Service, but does not allow the expansion or narrowing of any separation of service definition to include or exclude an event that would have constituted a separation from service as originally defined, except to the limited extent necessary to create a compliant definition.
- Section V, B permits the correction of an impermissible definition of a Change in Control event, but does not allow the expansion or narrowing of any change in control definition to include or exclude an event that would have constituted a

change in control as originally defined, except to the limited extent necessary to create a compliant definition.

- Section VII, A permits the correction of an impermissible payment event if the deferred compensation arrangement includes at least one permissible payment event. The correction is made by deleting the impermissible payment event.
- Section VII, C permits the correction of plan provisions that permits alternate payment schedules on voluntary versus involuntary separations from service (i.e. periodic payments versus lump sum). Correction is made by amending the voluntary payment form to be the same as the involuntary payment form (because you don't want to allow the service provider to "select" an alternate form of payment by quitting).
- Section VII, C also permits correction of other plan provisions that permit alternate payment provisions on the occurrence of a single permissible payment event (which is generally not permitted under the 409A Rules). The amendment must be done in a way that ensures that the only surviving payment provision is the payment provision with the latest actual or possible payment date, or if the payment dates are the same, the payment provision with the latest actual or potential payment commencement date, or if these dates are the same, the payment provision which is generally anticipated to result in the amount deferred being paid at the later date.
- Section VII, F permits the correction of an impermissible reimbursement or in-kind benefit provision. Correction is done by amending the provision to comply with the requirements of Treas. Reg. 1.409A-3(i)(1)(iv).

- Section VIII permits the correction of the failure to include a six-month payment delay for specified employees. The Notice provides that this correction is made by adding a provision that delays payment to the later of (i) 18 months following the date of correction, or (ii) 6 months following the separation from service.

Note – The 409A Rules provide that a deferred compensation arrangement that is for a service provider that is not a specified employee does not fail because it omits the “specified employee” language. Treas. Reg. 1.409A-1(c)(3)(v).

However, you risk an inadvertent violation if there is any theoretical possibility that the service provider will ever be a specified employee. (For example, what if your client is acquired by, and becomes part of the controlled group of, a publicly traded company?).

Non-Compliant Payment Provisions that may be Corrected without additional Tax or Penalty at any time before an Impermissible Payment Event Occurs. The following document failures may be corrected under Notice 2010-6 without additional tax or penalty under Section 409A – even if the One-Year Rule is not satisfied. Correction need only be completed before the impermissible payment event occurs. If payment is made on the occurrence of the impermissible event, the payment-related correction noted below is required.

- Section V, C permits the correction of an impermissible disability definition at any time before a payment is made for an event which does not meet the definition of “disability” set forth in the 409A Rules. Correction may be made by deleting the payment event, or making it compliant with the definition of “disability” set forth in the 409A Rules. If payment is made on the occurrence of

a non-qualifying disability event, the payment must be corrected as an operational failure using the procedures described in Notice 2008-113.

- Section VI, A permits the correction of a payment provision that allows payment at any time within a period that is greater than 90 days from the occurrence of a permissible payment event (for example, within 180 days of a change in control). This correction is only available if the payment period that is being amended does not exceed 365 days. The correction may eliminate the payment period or shorten it to fit within the permissible 90 day payment period. If the payment is triggered before the provision is corrected, and correction occurs within a “reasonable time” after such payment, a 50% penalty applies to vested amounts deferred under the plan.
- Document failures related to conditioning payments of deferred compensation on delivery of a “release” or the like. Correction is permitted under Section VI, B, but this provision was deemed to be so confusing (based on numerous comments received), that the IRS issued a clarification in Notice 2010-80, discussed below. There is a transition period for correction that expires at the end of 2012. The transitional relief includes two deadlines. If a non-compliant provision was in effect as of December 31, 2010, and payment was made on or before March 31, 2011, then there is deemed to be no document failure and no operational failure. If an employee separates from service prior to correction, and such separation from service occurred on or after April 1, 2011 but before the end of 2012, then the failure is treated as an operational failure only, which may be corrected using the procedures described in Notice 2008-113. An employee who separates from

service after correction is made is not subject to any tax or penalties under Section 409A. However, absent the transitional relief described above, any employee who separates prior to correction will be required to include all amounts deferred under the plan in current income (even if no discretionary benefit was obtained by timing the delivery of the release to change the tax year in which payment was actually made).

- Section VII, E permits the correction of a plan provision that permits an employer to terminate a plan and pay out deferred amounts at any time (but this correction is not available if the discretion is given to the employee – i.e. a discretionary right to accelerate that can be effected by the employee in consideration for taking a “haircut”). Correction is made by deleting the provision that gives the employer this discretion.

Non-Compliant Payment Provisions that may be Corrected if a 50% Tax Penalty is

Paid. If a deferred compensation arrangement contains no permissible payment provisions (i.e. the only payment events are impermissible payment events), then correction may be made only by amending the arrangement before payment is triggered, and paying the 20% tax imposed by Section 409A on an amount equal to 50% of the vested amount deferred under the arrangement (but not the Premium Interest Tax). See Section VII, B. Correction is made by deleting the impermissible payment event(s) and replacing them with a provision that provides for payment on the later of (i) separation from service, or (ii) the sixth anniversary of the correction date.

Correction Procedures for Document Failures Related to Impermissible Deferral

Elections. The following procedures apply to the correction of impermissible deferral elections:

- Section IX permits the correction of an impermissible provision for an initial deferral election (for example, a provision that allows deferral of an annual bonus any time prior to the end of the year in which it is earned – as opposed to no later than December 31 of the year prior to the year in which it is earned). The correction is made by amending the plan to remove the impermissible initial deferral provision before the end of the second taxable year immediately following the taxable year in which the initial deferral election should have been made under Treas. Reg. 1.409A-2(a) (in our example, by the end of the second taxable year that follows the end of the year in which the bonus deferral election should have been made). In addition, the elections made under the non-compliant election provision must be revoked and treated as operational failures under Notice 2008-113 (i.e. excess deferrals that must be repaid to the service provider). **Note** – Section IX, C, 2 of Notice 2010-6 provides that there is no document failure with respect to an employee who has made no election under the non-compliant initial election provision.
- Section VII, D permits the correction of provisions that permit the service provider or the service recipient impermissible discretion with respect to a payment schedule following a permissible payment event (including impermissible provisions with regard to subsequent deferral elections). If an arrangement provides for a default time and form and payment that would apply if discretion was not exercised, correction is made by deleting the discretionary provisions, and leaving only the default provision. If the plan has no default time and form of payment, the correction method is not entirely clear. The Notice requires correction in a manner similar to that required in Section VII, C (which provides the corrective procedure if a plan improperly permits

alternate times and forms of payments on the occurrence of the same permissible payment event). Section VII, C generally requires an amendment that effects the latest possible payment date, but if the arrangement has no default payment rule, it may be difficult to figure out what is required (perhaps, payment only on death – which is, by default, the ultimate final payment date, in the absence of anything else).

Correction Procedures for Ambiguous Plan Terms. Section IV of Notice 2010-6 provides some helpful rules of interpretation with regard to how certain undefined plan terms are to be interpreted under Section 409A, and how certain ambiguous payment terms are to be interpreted under Section 409A. Section IV, A states that if a plan provision sets forth a permissible payment event, but requires payment “as soon as reasonably practicable” following the permissible payment event (or words of similar import), then the ambiguous payment term will be deemed to require payment on the occurrence of the permissible payment event. Thus, if payment is not made by the later of (i) the end of the service provider’s taxable year in which the permissible payment event occurred, or (ii) the 15th day of the third calendar month following the permissible payment event, then the failure to pay will constitute an operational failure which may potentially be corrected under Notice 2008-113.

Section IV, B provides that if a plan provision designates a payment event without defining the payment event, and the designated payment event could be construed as a permissible payment event under Section 409A, then the provision will be treated as “ambiguous” and therefore potentially compliant. However, the benefits of ambiguity are not available if (i) the provision expressly violates Section 409A by its terms, (ii) there is a pattern or practice of administering the provision in a way that does not comply with Section 409A, or (iii)

a court has interpreted the provision in a way that does not result in compliance with Section 409A.

The benefits of Section IV, and the manner in which it permits ambiguous terms to be applied, can be maximized by amendment of a plan to add a 409A savings clause, stating that the plan will be interpreted and administered in compliance with Section 409A. This may be preferable to amending the ambiguous terms or payment provisions, if there is any concern that an amendment would, itself, result in a violation of Section 409A (for example, by being deemed to have added or subtracted payment events – which can be a real concern if the plan is ambiguous to begin with). See Section IV, B, 1 of the Notice – regarding 409A savings clauses.

Transitional Relief ending on December 31, 2012 for Errors related to Conditioning Payment of Deferred Compensation on Giving Release, Non-Compete, or the Like

Although IRS Notice 2010-6 was styled as a correction program, it also served to clarify a number of issues that were not covered by the 409A Regulations. One “clarification” made by Notice 2010-6 was with regard to severance payments conditioned on the execution of a release or a similar condition. The IRS received a large number of comments regarding Notice 2010-6 and how to apply it in practice. Consequently, the IRS issued Notice 2010-80, which among other things, provides transitional relief for deferred compensation arrangements that were in existence on or before December 31, 2010 that do not comply with the Section 409A timing rules that apply to payments that are conditioned on giving a release or the like. The transition relief expires on December 31, 2012, so it is very important to take advantage of this relief before it expires.

What is the “Release Timing” Problem?

Many employment agreements, change in control agreements, settlement agreements and other arrangements that provide severance payments include provisions that condition payment of such severance benefit on the signing of a release of claims, non-competition agreement, non-solicitation agreement, and/or return of company property. In IRS Notice 2010-6, the IRS made clear that it is concerned that such arrangements permit a service provider to manipulate the year in which taxable income is received; and that any arrangement which gives such discretion to a service provider violates Section 409A. The corrective procedure provided in IRS Notice 2010-6 apparently raised more questions than it answered, and IRS Notice 2010-80 provides an additional correction procedure for such plan failures.

How does the New Corrective Procedure Work?

The additional corrective procedure is described in Section III, B. and Section III, E. of Notice 2010-80, which provide as follows:

- The non-compliant “release” language must be corrected before a payment event occurs (i.e. correction must occur before severance payment is triggered).
- The correction is done by amending the plan to remove the service provider’s ability to delay or accelerate the timing of payment as a result of the service provider’s action (i.e. by revising the plan’s language in a manner that prevents the service provider from manipulating the time of payment by means of selecting the time at which to satisfy the condition for payment).
- The amendment which corrects the “release” language must be completed no later than December 31, 2012.

- The service recipient (i.e. employer) must file a statement of correction with its corporate tax return. However, the employee/service provider is not required to file a statement of correction with his or her income tax return; and no Section 409A taxes will apply in connection with such correction. See last sentence of para. 2, entitled “Service Provider Requirements” on page 13 of Notice 2010-80.

How Do I Amend a Non-Compliant Plan to Qualify for Relief?

Notice 2010-80 provides two methods for amending non-compliant “release” language. A severance payment that constitutes non-qualified deferred compensation, and which is conditioned on delivery of a release or some other action by the service provider, will be deemed to comply with Section 409A if it provides that:

- Regardless of the date the release of claims (or non-compete, non-solicitation, company property, etc.) is returned and becomes effective, payment will be made or will commence:
 - On a fixed date that is either 60 or 90 days following the employment-related event that gave rise to the payment (i.e. termination of employment); or
 - During a specified period no longer than 90 days following the employment-related payment event, with payment made or commencing in the later taxable year if the specified period could span two taxable years.

Notice 2010-80 adds a number of additional examples which illustrate the corrective procedure. See Notice 2010-80 at pages 8-11. The examples are useful, and should be reviewed.