
If at First You Don't Succeed—IRS Releases Section 409A Correction Relief for Certain Documentary "Errors"

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Background

Companies, individuals, and advisers continue to struggle with the complexities of the “new” deferred compensation rules under Section 409A of the Internal Revenue Code governing certain plans or arrangements, including severance, retention, equity and expense reimbursement plans that may pay compensation in a later year. The IRS recently released Notice 2010-6 (the “2010 Notice,” available [here](#)) as the latest in its long string of complicated pronouncements, this time in the form of a wide-ranging corrections procedure for documentary “errors.” This guidance provides some relief for interpreting provisions without amendment and other relief for revising outstanding plans and agreements, with more generous provisions for corrections made in 2010. It also clarifies a few aspects of last year’s operational corrections notice (Notice 2008-113) with respect to payments in stock and to certain operational failures corrected in the year immediately following the year in which the failure occurred. (Notice 2008-113 (the “2008 Notice”) is available [here](#) and is previously discussed in our alert, entitled “[Window Closing this Year for Most Favorable 409A Correction Relief for Operational Errors Made Before 2009](#)”).

Plans and arrangements that are subject to Section 409A must comply with its requirements both in form and in operation. Either documentary failures or operational failures can result in the employee or other service provider having all amounts deferred under the plan or arrangement treated as current income, as well as triggering a 20% additional tax and a requirement to pay interest on unpaid taxes at a premium rate.

Summary

Generally, relief and correction procedures are provided under the 2010 Notice for six categories of documentary failures. Some of these require changes in the language, while others provide that the existing language can remain as long as it’s actually interpreted and applied in a manner that complies with Section 409A. The areas covered include corrections or presumptive interpretations for:

- Ambiguous plan terms (*i.e.* requiring payment “as soon as reasonably practicable” following the payment event);
- Impermissible definitions of certain Section 409A-compliant payment events (*i.e.* “separation from service,” “change in control,” “disability”);
- Impermissible payment periods following certain Section 409A-compliant payment events (*i.e.*, payment periods longer than 90 days following the payment event or payment periods dependent upon the completion of employment-related activities by the individual, such as providing a release of claims);
- Impermissible payment triggers and payment schedules;
- Failures for public companies to include the potential six-month delay of payment in plans and agreements covering “specified employees”; and
- Provisions allowing impermissible initial and subsequent deferral elections.

Transition Relief

The 2010 Notice provides that, if a documentary correction is made on or before December 31, 2010, the plan will be treated as having been corrected on January 1, 2009 (*i.e.*, to have always been in documentary compliance when required to be) and avoid any income inclusion that would otherwise be required by a correction procedure, provided that any operational failures resulting from the corrected document failure are corrected in 2010 in accordance with the 2008 Notice. This means that the costs of correction (generally in the form of partial penalties) that apply to improper documentation would often be waived for corrections in 2010.

Although Notice 2010-6 generally doesn't provide corrections procedures for “linked plans” (where nonqualified deferred compensation plans operate in tandem in some respects with qualified plans like defined benefit plans or 401(k) plans), the 2010 Notice also provides correction procedures to make the time and form of payment identical in linked plans before December 31, 2011.

General Requirements

Like the 2008 Notice, the 2010 Notice includes certain eligibility requirements that apply to all correction procedures, in addition to category-specific eligibility requirements. These include the requirement that: (1) the company take commercially reasonable steps to identify all other deferred compensation plans that have documentary failures substantially similar to that initially identified and corrected; (2) neither the federal income tax return of the individual or that of the company be under examination with respect to nonqualified deferred compensation for any taxable year in which the documentary failure existed; and (3) the documentary failure be inadvertent, unintentional and not directly or indirectly related to participation in any of a list of transactions that the IRS considers

to be potentially tax abusive (available [here](#)). In addition, taxpayers must satisfy the applicable information and reporting requirements, including the reporting of information regarding the nature of the error and the amount of compensation involved in each document failure, to qualify for the relief offered by the 2010 Notice where that relief requires a change to the documents (rather than just the new interpretive rules).

If all the requirements of the 2010 Notice are met, then, except as specifically provided by the applicable correction procedure, neither reporting nor income inclusion under Section 409A is necessary solely as a result of the documentary failure in any taxable year before the taxable year in which the correction is made. Indeed, depending upon what is corrected, when it is corrected, and whether events occur within 12 months following the correction that involve the corrected topic, the individual may be able to avoid all Section 409A penalties or, at least to limit the accelerated income inclusion to some percentage of the deferred amount and then subject only that portion to the 20% additional tax (and not the premium interest tax).

Clarification of Notice 2008-113

With respect to the 2008 Notice, Notice 2010-6 clarifies how the amount that must be either paid by the company in correction of a late payment or repaid by the individual in correction of an early payment should be calculated if the payment was or should be made in property, such as shares of stock. It also fills in a hole in the prior guidance by specifically allowing taxpayers to use the subsequent year correction method in Section V. D of Notice 2008-113 when they pay deferred amounts late as opposed to just having the method available for deferred amounts that should not have been deferred compensation under a plan or arrangement but were erroneously credited to an individual's account or otherwise treated as deferred compensation.

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