

IRS Issues Notice Allowing Correction of Documentary Errors for Purposes of Section 409A

On January 5, 2010, the Internal Revenue Service (“IRS”) issued Notice 2010-6 (“the Notice”) to allow certain documentary failures in nonqualified deferred compensation plans to be corrected so as to avoid the excise tax and other penalties under Section 409A of the Internal Revenue Code of 1986 (the “Code”). The Notice provides some useful guidance and the first means to correct a nonconforming document to avoid the punitive taxes imposed by Section 409A. Unfortunately, it also contains provisions that may create additional problems for employers.

Correctable Failures

Among the documentary failures that can be corrected are:

- Impermissible definitions of separation from service, change in control, and disability that do not comply with Section 409A. Correcting such definitions can create a risk for employees in that if the event occurs within one year of the plan amendment, affected employees will have to recognize a percentage of the deferred amount in income (and pay the excise tax) even if they do not receive a payment. For example, assume a plan that now defines a “change in control” to include an internal corporate transfer amends the definition to eliminate that clause. If an employee should be transferred from the parent to a subsidiary within a year, 25% of the deferred amount would be subject to Section 409A (even though the employee received nothing).
- Failing to provide a six-month delay for payments to “specified employees” of public companies.
- Impermissible deferral elections.
- Impermissible payment events.
- Payment periods of more than 90 days following a payment event.
- Having the payment date dependent on an employee’s actions, such as following execution of a release or noncompetition agreement. The Notice instead approves conditioning payment on a specified date if a release has been executed by that date (*e.g.*, 60 days after separation from service). This guidance is particularly troubling in that it does not seem consistent with the statute, and the language the IRS deemed unacceptable is quite typical in employment and severance agreements.

Provisions that Do Not Need Correction

The Notice ends concern that Section 409A is violated by provisions that: (i) do not specify a payment date after a permissible payment event (*i.e.*, payment will be “as soon as practicable” or similar language after the date), or (ii) ambiguously define a “payment event.” The Notice warns, however, that such flexibility in language could result in an operational failure (*e.g.*, if “as soon as practicable” provision results in payment being delayed beyond the maximum periods allowed under Code Section 409A).

General Requirements

In all cases, correction must be made by a written amendment effective before the date on which the event that underlies the documentary failure occurs, and must not expand the circumstances under which payment would have been made prior to the correction. If correction is made before December 31, 2010, it will be treated as having been made on January 1, 2009, and no income inclusion will be necessary. The relief also is conditioned on the employer and employee reporting the correction. The employer also must

take commercially reasonable steps to identify any other arrangements that have substantially similar failures and correct those as well.

As noted above, in certain cases, if the event affected by the chance occurs within one year of the date the correction is made, the taxpayer will be required to include 50% (25% in some cases) of the deferred amount in income *and* pay the 20% excise tax on this amount. This provision is troubling in that it could result in service providers incurring tax penalties even though they received no part of the deferred amount.

Advice

Despite the huge number of hours many employers have already spent on compliance efforts, it appears that the IRS would find many plans noncompliant. Accordingly, a (hopefully) final effort to review all arrangements subject to Section 409A appears advisable at this time.

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