

IRS Issues Relief for Documentary Failures Under Section 409A of the Internal Revenue Code

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Stuart N. Alperin

New York
212.735.3920
stuart.alperin@skadden.com

Michael A. Lawson

Los Angeles
213.687.5380
michael.lawson@skadden.com

Neil M. Leff

New York
212.735.3269
neil.leff@skadden.com

Regina Olshan

New York
212.735.3963
regina.olshan@skadden.com

Joseph M. Yaffe

Palo Alto
650.470.4650
joseph.yaffe@skadden.com

* * *

This memorandum is provided by Skadden, Arps, Slate, Meagher & Flom LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum is considered advertising under applicable state laws.

On January 5, 2010, the IRS issued Notice 2010-6, which enables taxpayers to correct certain failures to comply with the documentation requirements applicable under Section 409A of the Internal Revenue Code. Set out below in two parts are:

- A brief summary of the relief that is made available under the Notice for documentary 409A violations, and
- A description of some of the more noteworthy aspects of the Notice, including highlights of some of its least and most favorable features and a discussion of certain common practices that the IRS suggests violate 409A.

Unfortunately the relief under the Notice appears to be limited in scope and, in many instances, provides only partial protection from the 409A penalty tax.

The Notice is lengthy and technical. Taxpayers and their advisers will need to pay careful attention to its terms to effect any correction. As described more fully below, more favorable relief is available for corrections effected during 2010 (and, in some cases, 2011), and taxpayers are thus urged to consult their advisers promptly to ensure sufficient time to correct before the more favorable relief expires and to help minimize penalties, which in some cases are dependent upon the timeliness of the correction.

The Notice complements the relief previously provided for operational failures under Notice 2008-113, some provisions of which are clarified by the new Notice. Notice 2008-113 was the subject of an earlier Skadden mailing: [“IRS Expands Relief for Operational Violations Under Section 409A.”](#)

Summary of Available Relief

Categories of Available Relief

Relief under the Notice is available only for specified categories of documentary failure:

- Impermissible definitions of separation from service, change in control and disability;
- Payment periods of longer than 90 days following an otherwise permissible payment event and payment periods following a permissible payment event that are impermissibly dependent upon employee actions, such as execution of a noncompete or a release of claims;

- Impermissible payment events or schedules (including payments triggered upon impermissible events, alternative payment forms triggered by the same payment event, impermissible discretion regarding payment schedules following permissible payment events, impermissible payment acceleration rights, and impermissible reimbursement or in-kind benefit provisions);
- Failure to require a six-month payment delay for specified employees of public companies; and
- Provisions permitting impermissible initial and subsequent deferral elections.

The IRS requested comments regarding other document failures that commonly occur and proposed methods to correct them, and thus it is possible that the scope of available relief may expand over time.

No relief is provided for failures applicable to stock rights (though certain relief for stock rights with an exercise price that is less than the grant date fair market value of the underlying stock is provided under Notice 2008-113). Moreover, as discussed briefly below, only limited transitional relief is provided for so-called linked plans where the amount deferred or the timing of payment is affected by the provisions of a separate qualified or nonqualified plan.

General Correction Principles

Correction must be effected by way of a written plan amendment. The Notice generally imposes constraints on the nature of the amendment that may be made. For example, in most cases the amendment must not expand the circumstances under which payment could be made under the plan before the correction.

Any amendment generally must be effective before the occurrence of the event that is the subject of the documentary failure. Nevertheless, in many instances, if that event subsequently occurs within one year of the correction, the service provider still will be required to include a portion (generally 50 percent but in some circumstances 25 percent) of the affected deferral in income and pay regular income tax and the 20 percent penalty tax (but not the 409A premium interest tax) on that amount.

For example, where a plan provides for payment upon a change in the employment relationship that does not constitute a “separation from service” under 409A, the plan may be amended before such an impermissible event occurs, provided generally that the amendment does not have the effect of either expanding the triggering circumstances to include any event that was not already a payment event under the plan or narrowing the circumstances to eliminate any permissible payment events. However, if within one year of the correction an event occurs that is not a 409A separation from service but that would have required payment under the pre-correction plan provision, the service provider must include 50 percent of the amount deferred under the plan to which the pre-correction provision would have applied in income under 409A (and a 20 percent tax will apply to this amount) in the year in which the event occurs (even though the amount is not then paid under the corrected plan).

General Eligibility Requirements

Relief under the Notice is available only for “inadvertent and unintentional” failures and is not available if the failure is directly or indirectly related to participation in any “listed transaction” (certain specifically enumerated practices that are deemed abusive), or if either the service provider or the service recipient is under IRS audit with respect to deferred compensation matters (meaning, in the case of individuals, that their federal income tax return is under audit or, for other taxpayers, that they have been notified in writing by the examining agent that nonqualified deferred compensation is under review).

Finally, the relief under the Notice is conditioned upon the service recipient and service provider reporting the correction, and the service provider timely paying any tax that applies under the applicable correction method.

Transition Relief

If a plan defect is corrected on or before December 31, 2010, the plan will be treated as having been amended effective as of January 1, 2009 (the first day on which documentary compliance was required), and any income inclusion otherwise required under the Notice will not apply, provided that any payment made before December 31, 2010, that would not have been made under the amended provision (or any payment not made before December 31, 2010, that would have been made under the amended provision) is treated as an operational failure and corrected under Notice 2008-113 before December 31, 2010.

Plans that fail to comply with 409A by reason of the payment schedule under the plan being determined by the timing of payments received by the service recipient (a “back-to-back” arrangement) generally may be amended on or before December 31, 2011, to eliminate the impermissible provision. Any payments made under the plan that would not have been made if the amended provision had been in effect (or any failures to make payments that would have been due had the amended provision been in effect) must be corrected under Notice 2008-113 on or before December 31, 2011. Similar relief applies where a plan fails to comply by reason of the payment schedule being impermissibly linked to another plan. However, in the case of such linked plans, the time and form of payment under the two plans must be made identical, and any permissible payment event under either plan must be retained.

Special transition relief also is available for newly established plans. Any of the defects described above may be corrected by not later than the end of the calendar year in which, or by the 15th day of the third calendar month following, the date the first legally binding right to deferred compensation arose under that plan and all other plans with which it must be aggregated under 409A. If corrected by that deadline, any income inclusion otherwise required under the Notice will not apply if any amounts paid that would not have been paid under the corrected plan provision are treated as operational failures and corrected under Notice 2008-113 by the end of the calendar year in which the document failure is corrected.

Particularly Noteworthy Features

Set out below is a summary of some particularly noteworthy — and in some cases troubling — aspects of the Notice.

Correction Alternatives

Nothing in the Notice limits alternative correction techniques that are available under existing guidance. Most importantly, under currently proposed IRS regulations, unvested deferrals are not included in income for 409A purposes until the year in which they vest. Thus, generally, if a non-compliant arrangement is amended to comply with 409A before the year of vesting (which, depending on the circumstances, might be a separation from service or a change in control, for example), no amount will be includible in income or subject to penalty under 409A even without use of the Notice.

Plan Aggregation

The Notice confirms that the plan aggregation rules otherwise applicable under 409A do not apply to documentary requirements. Accordingly, deferrals under an arrangement that is noncompliant merely because of a failure to satisfy the 409A documentary requirements are not aggregated with deferrals under compliant arrangements and, even if not corrected, the failure will not subject amounts deferred under compliant plans to 409A income inclusion or penalties. However, the correction relief provided under the Notice is not available with respect to any noncompliant plan or arrangement unless the service recipient takes commercially reasonable steps to identify all other plans and arrangements that have a substantially similar document failure and correct all such failures (regardless of whether the additional plans are otherwise aggregated with the first plan or cover any of the same service providers).

Effect of a Release of Claims

The Notice states that an employment agreement (or other plan) providing for payment to be made during a specified period following a separation from service after a release of claims is executed and becomes irrevocable violates 409A (though such violation may be remedied without penalty under the terms of the Notice if effected before the separation from service). While practitioners have been concerned that the IRS might advance this view, it is not clearly the correct interpretation of 409A and it is especially troubling given how commonplace release requirements are. The Notice makes clear that it is permissible to make payment on a specified date subject to a release becoming irrevocable prior to such date (for instance, 60 days following separation from service provided the release has then been executed and become irrevocable), but such an approach is, of course, less attractive to service providers and, often, service recipients. As noted above, it also should be possible to correct any violation without penalty on potentially more flexible terms if the agreement or other plan is amended before the year in which the service provider vests in his or her right to payment (*i.e.*, in a typical case, before the year in which the separation from service occurs).

Use of Ambiguous Terms

The Notice recognizes that some nonqualified deferred compensation plans use terms that are intended to comply with 409A but whose meaning is potentially ambiguous.

Many plans provided for payment “as soon as reasonably practicable” (or words to similar effect) following an otherwise permissible payment event. Because the period is not specified, there is a possibility that payment would not be made within the required time period following the payment event. The IRS provides that such a plan will not violate 409A unless the service recipient has a pattern or practice of making payments that do not satisfy the 409A timing rules.

In addition, a plan may define a payment event in an ambiguous way (such that the term could reasonably be interpreted to comply with 409A but could also reasonably be interpreted to be noncompliant). The Notice provides as an example a plan which provides for payment on “termination of employment” rather than “separation from service” (or, similarly, upon “acquisition” of a service recipient rather than a change in control event as defined under 409A). Unless the particular plan provision has been interpreted on or after January 1, 2009, in a way that is violative of 409A (or was intentionally made vague), this type of plan will not violate 409A.

The Notice provides that, if a plan contains (or is amended to contain) language requiring that the terms of the plan be interpreted as necessary to comply with the requirements of 409A, any ambiguous terms will be treated as compliant. Notwithstanding this favorable treatment of such savings language or the favorable treatment of ambiguous terms more generally, we recommend that taxpayers continue to refine their plan documents to incorporate language that explicitly complies with the requirements of 409A. Note that, in the meantime, it appears that a plan that attempts to comply with 409A but includes a technical defect, ironically, may be worse off than a plan that simply uses a non-409A term, such as “termination of employment,” in that the former violates 409A while the latter generally does not.

Burdensome Correction Requirements

The Notice imposes correction requirements under some circumstances that are quite burdensome — most notably the income inclusion requirement discussed above. Presumably these barriers to relief are to further the IRS’s stated goal of not providing an advantage to taxpayers participating in plans that initially fail to comply with 409A over taxpayers participating in plans that comply with 409A.

This approach overlooks the fact that many of the 409A rules are very complex and that many of them remain unclear to this day, more than five years after the effective date of 409A. Further, since the 409A penalty falls on the service provider, who generally is not involved in the technical plan documentation, and the relief under the Notice is available only for inadvertent and unintentional failures, the income inclusion and penalty requirements of the corrections notice appear to be unduly harsh.

Two of the more burdensome requirements apply in the following circumstances:

- Impermissible Alternative Payment Forms

Where multiple forms of payment are available upon the occurrence of any one particular type of payment event and multiple payment forms are not permitted (a so-called impermissible “toggle”), the correction must preserve only the payment form with the latest possible final payment date. This requirement may frustrate participant expectations, particularly where lengthy installment payment alternatives were offered under the plan.

- Delay in Payment Commencement

Where a plan provides only impermissible payment events, payment under the plan as corrected may not be made before the later of a participant’s separation from service or the sixth anniversary of the correction. Particularly if the plan provided only one (impermissible) payment event, the length of the required payment delay may frustrate participant expectations.

Similarly, where a plan is corrected by adding a required six-month delay requirement for specified employees, payment may not be made until 18 months following correction (or, if later, six months following separation from service). Moreover, the employee must include 50 percent of the deferral in income (and pay the 409A penalty but not premium interest tax on such amount) even before the distribution if the separation from service occurs within one year of the correction.

* * *

Relief under the Notice is subject to many exceptions and special rules not discussed above. As noted, taxpayers and their advisers will need to pay careful attention to the terms of the Notice, and they should act promptly to identify and correct any documentary defects so as to take advantage of the transitional relief provided under the Notice.