



# EMPLOYEE BENEFITS CLIENT ALERT

January 8, 2010

## NEW IRS GUIDANCE ON CORRECTING 409A DOCUMENT FAILURES

On January 5, 2010 the Internal Revenue Service and the Department of the Treasury issued Notice 2010-6, which provides guidance on how to correct document failures under Section 409A of the Internal Revenue Code (the "Code"). Taxpayers may rely on this guidance for tax years beginning on or after January 1, 2010.

### BACKGROUND

Code Section 409A regulates compensation deferred from one year to a future year under a nonqualified deferred compensation plan or agreement (a "NQDC Plan"). For additional Background, please see our Client Alerts generally describing Code Section 409A by clicking [here](#) and [here](#).

If a NQDC Plan fails to comply with Code Section 409A, the compensation deferred under the plan generally is immediately included in income (even if not paid to the taxpayer) and the taxpayer is subject to a 20% excise tax. In 2008, the IRS released Notice 2008-113 which provides procedures on how employers can correct operational errors with respect to NQDC Plans. Now, with Notice 2010-6, the IRS is providing a process to correct document errors with respect to the NQDC Plans themselves. Notice 2010-6 also clarifies certain provisions of Notice 2008-113 (relating to operational corrections) and Notice 2008-115 (relating to tax reporting and wage withholding for NQDC Plans).

### CORRECTING DOCUMENT FAILURES

Notice 2010-6 allows employers to correct certain enumerated NQDC Plan document failures. If corrected properly under Notice 2010-6, the NQDC plan will not be deemed to fail Code Section 409A as a result of the document failure so long as the correction does not affect the operation of the plan within one year of the correction date. This will allow taxpayers to avoid Code Section 409A's adverse tax consequences (including the 20% excise tax). Even where the correction affects the operation of the plan within a year of the correction, Notice 2010-6 limits the amount of compensation subject to Code Section 409A's adverse tax consequences. The correction procedures also provide transition relief if certain document and operational failures are corrected by December 31, 2010.

An example of a document failure addressed by Notice 2010-6 is when a NQDC Plan document for a publicly traded company fails to require a six-month delay on certain distributions to "specified employees". (Under Code Section 409A, certain distributions to specified employees by reason of separation from service may not be made before six months following such separation.) Where a NQDC Plan does not contain the six-month delay, the NQDC Plan has a document failure under Code Section 409A. Prior to Notice 2010-6, all compensation deferred under the NQDC Plan for specified employees could be subject to immediate taxation and the 20% excise tax as a result of this document failure. Since this Code Section 409A failure relates to the document and not operations, this defect could not have been corrected under the prior IRS correction program.

Now, this type of failure can be corrected under Notice 2010-6 by amending the NQDC Plan to include the six-month delay. For this particular correction, the amendment must also provide that no payment will be paid for 18 months following the date of correction. As long as this change does not affect the



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operation of the NQDC Plan within one year of the correction, the NQDC Plan will be deemed not to violate Code Section 409A. However, if within one year of the correction a specified employee has a separation from service that results in the correction being applied to avoid a payment that would have been due prior to the correction, 50% of the amount deferred under the NQDC Plan must be included in income and subjected to the 20% excise tax.

Another example of a document failure addressed by Notice 2010-6 is when a NQDC Plan contains a defined term that does not comply with Code Section 409A. For example, a NQDC Plan may contain a definition of "Separation from Service" that is either too expansive or too restrictive under Code Section 409A. Prior to Notice 2010-6, if a NQDC Plan document authorized distributions under a faulty definition of "Separation from Service," all affected employees could be subject to immediate taxation and the 20% excise tax. This type of failure can now be corrected under Notice 2010-6. To correct this defect, the incorrect definition in the NQDC Plan must be amended to comply with Code Section 409A. As long as this change does not affect the operation of the NQDC Plan within one year of the correction, the NQDC Plan will be deemed not to violate Code Section 409A. However, if within one year following the correction an event occurs that would have been a "Separation from Service" under the prior definition but is not under the corrected definition, 50% of the amount deferred under the NQDC Plan must be included in income and subjected to the 20% excise tax.

Other document failures addressed by Notice 2010-6 include when a plan contains potentially ambiguous language, impermissible payment periods, impermissible payment events and payment schedules, and impermissible deferral elections.

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