

# New IRS Notice Provides Employers with Ability to Correct Defects in Nonqualified Plan Documents

January 28, 2010

## Executive Summary

Nonqualified deferred compensation plans (Nonqualified Plans) that are subject to Section 409A of the Internal Revenue Code (Section 409A) must comply with Section 409A both *in form* and *in operation*. In Notice 2008-113 (the 2008 Notice), available at <http://www.irs.gov/pub/irs-drop/n-08-113.pdf>, the Internal Revenue Service (the IRS) established a program for correcting Section 409A *operational failures*, which renewed calls from practitioners for an IRS program to correct Section 409A *document failures*. (Visit [http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object\\_id/5b9f4b64-d157-4fba-888c-713fde300737.cfm](http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object_id/5b9f4b64-d157-4fba-888c-713fde300737.cfm) for a prior *On the Subject* on Notice 2008-113.)

In Notice 2010-6 (the 2010 Notice), available at <http://www.irs.gov/pub/irs-drop/n-10-06.pdf>, the IRS has instituted a new program that allows “Service Recipients” (referred to herein as Employers) to correct certain document failures. The 2010 Notice provides the following important relief:

- **Correction Opportunities with *No* Section 409A Penalties.** The 2010 Notice provides relief permitting corrections of certain document failures without current income inclusion or additional taxes under Section 409A in the following situations:
  - i) Relief may be obtained if the document failure is corrected by December 31, 2010, and any operational failures resulting from the document failure are also corrected in accordance with the 2008 Notice by December 31, 2010. This transition relief is intended as an incentive for plan sponsors to promptly correct any plan document defects eligible for correction under the 2010 Notice.
  - ii) Relief may be obtained if the document failure is corrected after December 31, 2010, and the corrected plan provision does not affect the operation of the Nonqualified Plan within one year following the date of correction. For purposes of the 2010 Notice, the date of correction of a document failure is the latest of (1) the date on which the correction is adopted, (2) the date on which the correction is effective, or (3) the date on which the correction is set forth in writing in one or more documents.
  - iii) Relief may be obtained if the Nonqualified Plan is the Employer’s first plan of that type and the failure is corrected within a limited period following adoption of the Nonqualified Plan.
- **Correction Opportunities with *Limited* Section 409A Penalties.** The 2010 Notice provides relief limiting the amount currently includible in income and limiting the additional taxes under Section 409A for certain document failures, if correction of the failure affects the operation of the Nonqualified Plan within one year following the date of correction. Requiring taxation in this circumstance after 2010 is intended to treat an Employer that corrects a plan document defect because of the pending occurrence of an impermissible payment event differently than an Employer that proactively makes plan document corrections. If the Nonqualified Plan contains multiple plan document failures, the 2010 Notice only requires that the “Service Provider” (referred to herein as Employee) include the largest of the amounts in income (rather than requiring that the amounts be aggregated) and, if the document failures span multiple years, the 2010 Notice provides additional relief.
- **Plan Language Relief.** The 2010 Notice clarifies that certain language commonly included in plan documents (*e.g.*, payment will occur “as soon as practicable” or payment will be made upon “termination of employment”) will not, by itself, cause a document failure.
- **Clarifications of the 2008 Notice.** The 2010 Notice also clarifies certain aspects of the 2008 Notice.

The IRS appears to be taking a “carrot and stick” approach to Section 409A. The stick is the widely reported efforts of the IRS to increase Section 409A audit activity, which may also expand as part of the employment tax audit initiative of 6,000 companies. One carrot is the 2010 Notice, which the IRS acknowledged “is intended to encourage taxpayers to review their Nonqualified Plans to identify provisions that fail to comply with Section 409A and to correct those plan provisions promptly.”

The correction mechanisms provided by the 2010 Notice (along with the 2008 Notice and the proposed income inclusion regulations under Section 409A) provide Employers with an opportunity to review the form and operation of their plans and thereby minimize or eliminate penalties, particularly if action is taken prior to December 31, 2010. After the expiration of the transition period, the cost and administrative burden of correction will increase significantly.

Although the 2010 Notice provides that corrective actions, where available, generally can be taken on or before December 31, 2010, there are potential risks in delaying corrective actions until year-end. In particular, it should be noted that the relief provided by the 2010 Notice will no longer be available if (1) the Employer is under IRS examination and is notified that a specific document failure has been identified as an issue in the examination, or (2) the Employee is under examination for any reason.

The remainder of this paper reviews the types of plan document corrections available under the 2010 Notice, summarizes the eligibility requirements to make corrections under the 2010 Notice, describes the information and reporting requirements, and provides practical steps for Employers to take in response to the 2010 Notice.

## Background on Section 409A

Section 409A was adopted in 2004 as part of the American Jobs Creation Act of 2004, and imposed strict requirements on Nonqualified Plans and the timing and form of payments available thereunder. Effective as of January 1, 2005, Nonqualified Plans were required to be operated in reasonable good faith compliance with the requirements of Section 409A, with full documentary compliance being required by January 1, 2009. Absent any correction programs, failure to comply with Section 409A generally results in immediate inclusion in the taxable income of the Employees of any amounts deferred under the Nonqualified Plan(s), the imposition of a 20 percent additional tax and the assessment of premium interest penalty tax. Additionally, the Employer is subject to withholding and reporting requirements, and potential penalties if those requirements are not satisfied.

## Special Transition Relief

The 2010 Notice provides special transition relief if certain plan failures are corrected in accordance with the requirements of the 2010 Notice on or before December 31, 2010, or in some cases December 31, 2011. If a Nonqualified Plan qualifies for transition relief and is corrected on or before December 31, 2010, it will be treated as having been corrected retroactively as of January 1, 2009.

Due to the retroactive nature of the amendments, however, such corrections could result in operational failures under the corrected plan (*e.g.*, payments were made under the previous version of the plan which should not have been made under the corrected plan). Any operational failures that result from the retroactive application of the correction must also be corrected under the 2008 Notice prior to December 31, 2010.

In addition to the transition relief described above, the 2010 Notice provides transition relief for correction of the following:

- **Impermissible Provisions Linking Nonqualified Plans** (*i.e.*, plans in which an amount under one nonqualified plan is determined by, or the time or form of payment is affected by, an amount deferred under, or the payment provisions of, another nonqualified plan, thus causing both plans to fail to satisfy the requirements of Section 409A). These plans must be amended prior to *December 31, 2011*, to provide for identical time and form of payment using the narrower/longer payment schedule.
- **Payment Schedules Determined by the Timing of Payments Received by the Employer.** Payment schedules that would otherwise satisfy the requirement of a fixed schedule of payments under Section 409A but that fail to satisfy the conditions described in the Section 409A regulations for identifying an objective, nondiscretionary payment schedule will not be treated as failing that requirement if amended to satisfy those conditions by *December 31, 2011*.
- **New Plans.** The 2010 Notice provides a special opportunity for Employers who recently adopted plans to correct any plan document failures; however, any correction must be made no later than the end of the calendar year in which, or the 15th day of the third calendar month following, the date the first legally binding right to deferred compensation arose under the Nonqualified Plan (including all plans that are required to be aggregated with that plan).

## Types of Plan Document Failures That can be Corrected Under the 2010 Notice

This section discusses the limited types of plan document defects that can be corrected under the 2010 Notice. Any other type of plan document violation will result in the full adverse Section 409A consequences, at least for now. (In the 2010 Notice, the U.S. Department of the Treasury and the IRS requested comments regarding other document failures that commonly occur and methods to correct them.)

As described below, the amount of tax, if any, that must be paid due to a plan document failure depends on when the corrective amendment is made (*e.g.*, the corrective amendment is made within one year of when a payment event would have otherwise occurred) and the type of failure. Also, none of the Section 409A taxes and penalties apply if the corrective amendments and the "correction" are completed before the end of this year as described in the Special Transition Relief section above.

### IMPERMISSIBLE DEFINITIONS OF OTHERWISE PERMISSIBLE PAYMENT EVENTS

The 2010 Notice provides Nonqualified Plan sponsors the opportunity to correct certain impermissible definitions of permissible payments events. Nonqualified Plans that provide for payments upon either a separation from service, a change in control or the disability of the Employee may be amended to include Section 409A-compliant definitions for such events. To be eligible for relief under the 2010 Notice, the corrections must meet certain requirements:

- Nonqualified Plans with an impermissible definition of separation from service must be corrected before the date an event occurs that would constitute a payment event under the improper definition set forth in the Nonqualified Plan, or that would constitute a separation from service as defined in Section 409A.
- Similarly, Nonqualified Plans with an impermissible definition of change in control must be amended prior to the date an event occurs that does not constitute a change in control event under Section 409A but is a payment event under the Nonqualified Plan.

In either case, the correction requires that the Nonqualified Plan be amended, effective immediately, to include a Section 409A-compliant definition of separation from service or a change in control event, provided the new definition does not expand or narrow the definition already included in the Nonqualified Plan, except as needed to be made Section 409A-compliant. Additionally, if within one year following the date of correction, an event occurs that requires application of the corrected definition to either make a payment or prevent a payment from being made, the Employee will be treated as follows:

- i) The Employee will be required to include in income in the year in which such event occurs a specified percentage—50 percent in the case of a separation from service, and 25 percent in the case of a change in control event—of the amount deferred under the Nonqualified Plan to which the improper definition would have applied.
- ii) The Employee will be subject to a 20 percent additional tax on the amount in item (i) immediately above.
- iii) The Employee will not be subject to the additional premium interest tax.

Nonqualified Plans with improper definitions of disability may be amended by either removing the improper payment event or redefining the payment event so that it meets the requirements of Section 409A. If the correction is made before an event occurs that would trigger a payment under the impermissible definition, the Nonqualified Plan will not be treated as failing to satisfy the requirements of Section 409A. Corrections occurring after an event has occurred that resulted in payment under the impermissible definition will require correction under the 2008 Notice.

### IMPERMISSIBLE PAYMENT PERIODS FOLLOWING A PERMISSIBLE PAYMENT

The 2010 Notice provides relief for Nonqualified Plans that properly designate permissible payment events, but include impermissible payment periods following such payment events.

- *Payments Scheduled to Occur More Than 90 Days After a Specified Payment Event.* If a Nonqualified Plan provides that payment following a permissible payment event may be made or commenced later than 90 days and earlier than 366 days following such payment event, it may be corrected by amending the Nonqualified Plan either to remove the period following the permissible payment event during which payment may be made or commenced, or to define a payment period immediately following the permissible payment event that complies with Section 409A (so that it is a period not exceeding

90 days and the Employee does not have a right to designate the taxable year of payment).

If the Nonqualified Plan is not amended before the occurrence of the permissible payment event, but is amended within a reasonable time thereafter, the Nonqualified Plan may be treated as not failing to comply with Section 409A for the affected Employee solely due to the impermissible payment period, provided that upon the occurrence of the permissible payment event, 50 percent of the amount deferred is included in income under Section 409A in the year in which the event occurs, and all applicable taxes are paid on such amount, including the 20 percent additional tax but not the additional premium interest tax.

- *Payments Conditioned on an Employee Release.* If a Nonqualified Plan provides that payment is conditioned upon employment-related action of the Employee (such as the execution of a release or restrictive covenants), then the Nonqualified Plan may be corrected by amending the Nonqualified Plan before the occurrence of a permissible payment event to remove the ability of the Employee to delay or accelerate the timing of the payment as a result of the Employee's actions, provided the following: (1) if the Nonqualified Plan provides for payment within a designated period following the permissible payment event, the amendment must provide for payment only on the last day of such designated period, or (2) if the Nonqualified Plan does not provide for payment within a designated period following the permissible payment event, the amendment must provide for payment only upon a fixed date either 60 or 90 days after the occurrence of the permissible payment event.

For example, if an Employee's employment agreement provides that the Employee is entitled to severance payments, which will be payable within 90 days of the Employee's separation from service with the Employer, but only if the Employee executes a release that becomes irrevocable within such 90-day period, the agreement should be amended before the Employee's separation from service to provide that the payments will be made on the 90th day following the Employee's separation from employment, assuming the release condition is satisfied.

Note that the timing and structure for a release as described above is not applicable to benefits under a severance agreement that does not provide for nonqualified deferred compensation for purposes of Section 409A.

#### CERTAIN IMPERMISSIBLE PAYMENT EVENTS AND PAYMENT SCHEDULES

The 2010 Notice also provides relief for Nonqualified Plans containing the following plan document failures that are corrected as described below:

- *Plans With Both Permissible and Impermissible Payment Events.* Such plans may be amended to remove the impermissible payment event before the Employee elects that event as a payment event under the Nonqualified Plan. For these purposes, an election will not be treated as having been made until the election is irrevocable. Even if the Employee's election with respect to the impermissible payment event has become irrevocable, the Nonqualified Plan may be amended before the occurrence of such event to remove any such impermissible payment events.
- *Plans With Only Impermissible Payment Events.* Such plans may be corrected before the date one or more of the impermissible events occurs, by amending the Nonqualified Plan to remove the impermissible payment events and providing instead for payment upon the later of the Employee's separation from service and the sixth anniversary of the correction.
- *Certain Impermissible Alternative Payment Schedules.* A Nonqualified Plan that allows for different forms of payment relating to an Employee's voluntary and involuntary separation from service may be corrected before the Employee's separation from service, by amending the Nonqualified Plan to provide the same form of payment on a voluntary separation from service as was provided under the pre-correction plan for an involuntary separation from service. If the Nonqualified Plan provides for alternative forms of payment based on some factor other than whether the Employee's separation from service is voluntary or involuntary, one payment schedule should be removed so as to provide payment at the latest possible commencement date and/or over the longest period of time.
- *Impermissible Discretion With Respect to a Payment Schedule Following a Permissible Payment Event (Including Subsequent Deferral Elections by Employees).* Such a plan (e.g., a Nonqualified Plan that provides for installment payments upon the Employee's separation from service, unless the Employer otherwise determines in its discretion to pay such amounts in a lump sum) may be corrected in one of two ways:

- i) If the Nonqualified Plan includes a default payment provision and there is no discretion to change the time or form of payment after the permissible payment event occurs, the plan will not be treated as failing to meet the requirements of Section 409A, provided that the Employee and the Employer either do not exercise their discretion, or they revoke any exercise of discretion more than one year prior to the occurrence of a payment event. However, if a Nonqualified Plan with such a provision covers more than one Employee, and the Employer or any one of the covered Employees exercises their discretion and fails to revoke it within one year before the payment event occurs, then the Nonqualified Plan must be corrected as to all Employees.
- ii) If the Nonqualified Plan includes a default payment provision that applies if the Employee or Employer does not exercise its discretion to change the time or form of payment, the Nonqualified Plan may be amended to remove the Employee's or Employer's discretion. If the Nonqualified Plan does not include any such default provision, the Nonqualified Plan may be amended to remove the Employee's or Employer's discretion and to specify the applicable time and form of payment as the latest final payment date available under the Nonqualified Plan prior to the amendment.

If a Nonqualified Plan is corrected to eliminate impermissible discretion, then the parties must also take commercially reasonable steps to identify and correct all substantially similar provisions in other plans with respect to which discretion has either not been exercised or has been revoked.

- *Impermissible Reimbursement of In-Kind Benefit Provisions.* If a Nonqualified Plan fails to meet the Section 409A requirements relating to reimbursements or in-kind benefits, the Nonqualified Plan may be corrected by amendment to provide for reimbursements or in-kind benefits that satisfy the requirements of Section 409A (taking into account any required *pro rata* allocations of reimbursements over the years in which the Employee is eligible to receive reimbursements, or at least three years if the prior non-complying period ended with an event). The Nonqualified Plan must be amended prior to the date an event occurs that would entitle an Employee to a reimbursement or an in-kind benefit.

For each of the Nonqualified Plan corrections described just above, the amendments must generally be effective immediately. Additionally, if within one year following the date of correction, an event occurs requiring application of the corrected provision, then 50 percent of the amount deferred under the Nonqualified Plan to which the pre-correction plan provision applied must be included in the Employee's income in the year in which the event occurs and will be subject to the 20 percent additional tax (but not the additional premium interest tax). However, for plans that included *only* impermissible payments events, the Employee must include 50 percent of the amount deferred under the Nonqualified Plan to which the pre-correction plan provision applied in his or her taxable income in the year in which the correction occurs, and such amount will be subject to the 20 percent additional tax (but not the additional premium interest tax), regardless of whether a subsequent event occurs.

Additionally, the 2010 Notice provides relief for a Nonqualified Plan failing to comply with Section 409A because it contains provisions granting the Employer discretion to accelerate and make payments regardless of whether a payment event has occurred (*e.g.*, a provision giving the Employer discretion to terminate the Nonqualified Plan and immediately pay all deferred amounts). Under the 2010 Notice, a Nonqualified Plan containing such a provision may be corrected by removing the Employer's discretion to accelerate payments. If the Nonqualified Plan is amended before the earlier of the date the Employer exercises its discretion, or the date a payment has been made under the Nonqualified Plan as a result of such discretion, no adverse Section 409A consequences will apply. Relief is not available for any payments made at the Employer's discretion before the Nonqualified Plan is amended to eliminate improper Employer discretion.

#### FAILURE TO INCLUDE SIX-MONTH DELAY FOR SPECIFIED EMPLOYEES

The 2010 Notice provides relief for plans sponsored by public companies that fail to require a six-month delay in the case of nonqualified deferred compensation payable to a specified employee after a separation from service. In such a case, the Nonqualified Plan may be corrected in accordance with the 2010 Notice prior to the date that such a delay would be required, if the plan is amended, effective immediately, to include the six-month delay and to further require that any amounts payable under the Nonqualified Plan that would otherwise be subject to such six-month delay may not be paid before the later of (1) 18 months following the date of the correction, or (2) six months following the date of the payment event. If an Employee incurs a separation from service within one year following the date of correction resulting in the application of the corrected provision, then 50 percent of the amount deferred under the Nonqualified Plan must be included in the Employee's income in the year in which the event occurs and the Employee will be subject to the 20 percent additional tax on such amount (but not the additional premium interest tax). Please note that this provision does not require that the six-month delay be included in plan documents for an entity that is not a public company.

## IMPERMISSIBLE INITIAL DEFERRAL ELECTIONS

The 2010 Notice also provides relief for plans permitting initial deferral elections that fail to comply with Section 409A. Under the 2010 Notice, a Nonqualified Plan allowing impermissible initial deferral elections may be corrected by amending it to remove the Employee's ability to make the impermissible deferral election. If the correction occurs no later than the end of the Employee's second taxable year immediately following the taxable year in which the deadline for making initial deferral elections occurs, then no adverse Section 409A results will occur. However, if any amounts were not paid to the Employee as a result of the impermissible initial deferral election, the Nonqualified Plan must be corrected in accordance with the 2008 Notice.

## Application of Section 409A to Certain Ambiguous Plan Terms

### "AS SOON AS PRACTICABLE"

Nonqualified Plans that include permissible payment events, yet provide that the payment will occur "as soon as practicable" (or within some other uncertain timeframe), should be carefully analyzed to avoid the occurrence of a plan document or operational failure. The IRS considers the phrase "as soon as reasonably practicable" (or other similar language) to be an ambiguous plan term. Thus, if an Employer's Nonqualified Plan contains such an ambiguous term, an operational failure or a plan document failure may result, unless the payment is actually made by the later of (1) the end of the Employee's taxable year in which the permissible payment occurs, or (2) the fifteenth day of the third month following the permissible payment event. Payments made later than the permitted deadline will result in an operational failure (unless the delay qualifies for a timeliness exception under the Section 409A regulations), but may qualify for correction under the 2008 Notice.

If a Nonqualified Plan contains an ambiguous term as described above, and the Employer has a pattern or practice of making late payments (other than those that qualify for a timeliness exception under the Section 409A regulations), that plan and any other plan of the Employer containing similar language will be treated as failing to include a permissible payment date, and the Employer should review the corrections approaches described above.

- ▶ **Action Item:** Employers should review their Nonqualified Plans and either eliminate phrases such as "as soon as reasonably practicable" or require payment be made in no event later than a stated time permitted under Section 409A.

### PERMISSIBLE PAYMENT EVENT—LACKING DEFINITION OR CONTAINING AN AMBIGUOUS DEFINITION

Even if a Nonqualified Plan designates a permissible payment event, the Nonqualified Plan could still be interpreted to include an impermissible payment event if the Nonqualified Plan does not define that event or contains an ambiguous definition for that event. For example, a Nonqualified Plan could provide for payment upon a "termination of employment," which could be interpreted to include only those events that constitute a separation from service within the meaning of Section 409A, or such term could be interpreted to include events that do not constitute a separation from service under Section 409A.

If a payment is made (or fails to be made) upon the occurrence of a payment event that is not defined in a manner that complies with Section 409A, the 2010 Notice allows that event to be treated as an operational failure eligible for relief under the 2008 Notice, which in many cases will result in no adverse Section 409A consequences. In order to obtain such relief, the Nonqualified Plan must be amended before the end of the Employee's taxable year during which the operational failure is corrected to either (1) include language requiring that plan terms be interpreted as necessary to comply with Section 409A, or (2) include specific definitions of the permissible payment events that comply with Section 409A.

Note that if (1) the Employer has developed a pattern or practice after January 1, 2009, of interpreting the Nonqualified Plan term in a manner that does not satisfy the requirements of Section 409A, (2) a court has defined the term in a manner that does not satisfy the requirements of Section 409A, (3) the definition of the payment event includes an event that is not a permissible payment event (or excludes events that must be required), or (4) the facts and circumstances indicate that the Employer intentionally included an ambiguous term, the Nonqualified Plan is not eligible for this relief (but may be eligible for the other correction methods described above for plans that do not specify a permissible payment date).

- ▶ **Observation:** The 2010 Notice provides that if the Nonqualified Plan already contains a provision that requires plan terms to be interpreted in compliance with the requirements of Section 409A, such terms will not be considered to be

ambiguous and no correction will be required. While Treasury and IRS previously downplayed the benefits of so-called Section 409A “savings clauses,” the 2010 Notice supports the continued use of such clauses.

## What Plans are Eligible for Relief?

Relief under the 2010 Notice is only available if certain eligibility criteria are met. Specifically, only plan document failures that are “inadvertent and unintentional” (a term that appears in both the 2010 Notice and the 2008 Notice, but is not defined) are eligible for relief under the 2010 Notice. Additionally, taxpayers must take commercially reasonable steps to identify all other Nonqualified Plans that have a document failure that is substantially similar to the failure that is being corrected, and must correct those failures in accordance with the 2010 Notice. A taxpayer claiming relief under the Notice has the burden of demonstrating eligibility for the relief and that all applicable requirements have been met.

The 2010 Notice specifically excludes certain items from relief, including the following:

- Employees and Employers whose federal tax returns are already under examination with the IRS relating to nonqualified deferred compensation are excluded from relief. However, with respect to a corporate Employer for periods beginning on or before December 31, 2011, being “under examination” means written notification from the examining agent(s) specifically citing nonqualified deferred compensation as an issue under consideration. (Among other things, this language helps preserve the eligibility of large Employers that may be continuously under examination.) With respect to an Employee, correction under the 2010 Notice will not be available if the Employee is under IRS examination (*i.e.*, Form 1040) for any reason.
- Plan document errors related to stock rights (which may be corrected under the 2008 Notice) or certain linked Nonqualified Plans (unless covered by the transition relief provisions of the Notice) are excluded from relief.
- Plan document failures related to participation in any listed transactions or for any intentional failures are excluded from relief.

## Information and Reporting Requirements

In addition to satisfying the eligibility and correction requirements, both the Employer and Employee generally must satisfy certain information and reporting requirements in order to obtain relief under the 2010 Notice. (There are no information and reporting requirements for corrections relating to “Certain Ambiguous Plan Terms.”)

An Employer obtaining relief under the 2010 Notice must attach to its timely filed federal income tax return (including any time for extensions) for the taxable year during which the failure was corrected a statement entitled “**Section 409A Document Correction under Section [Employer should insert appropriate section(s)] of the 2010 Notice.**” The statement must include the following information:

- The name and taxpayer identification number of each Employee affected by the failure
- Identification of the Nonqualified Plan in which the failure occurred
- A statement that (1) the document failure is eligible for correction under the 2010 Notice (and identifying the section of the Notice under which the correction occurs), (2) the Employer has satisfied all requirements for correction as of the last day of the Employer’s taxable year in which the correction was made (and possibly subsequent years), and (3) provides the correction date and the date of any event causing the inclusion of income for the Employee
- The amount involved in each document failure, the amount reported by the Employer as includible in income, and the percentage of the amount involved in each document that is required to be included in income

The Employer is also required to provide the Employee with a statement entitled, “**Section 409A Document Correction under Section [Employer should insert appropriate section(s)] of the 2010 Notice.**” The statement should cover the calendar year in which such corrections were made and the subsequent calendar year if the Employee is required to include any amounts in

income for such subsequent year, and must be delivered to the Employee by the date on which information returns (Form W-2 or 1099) are typically due. (However, we understand that defects corrected in 2009 may be treated as corrected in 2010 for purposes of when the information needs to be reported.) The statement must include the following information:

- A statement that the Employee is entitled to corrective relief and the section under which the document failure was corrected, and that the Employee must attach a copy of the statement to the Employee's tax return
- The same information the Employer must include on its statement, but only including the information that pertains to the Employee

Additionally, for certain corrections, the Employer must issue similar statements for the year following the year in which the failure was corrected. This requirement applies where the Employee must include an amount in income in the income tax return for the taxable year following the year in which the failure was corrected in order to complete the correction. The Employee must attach to his or her tax return a copy of the statement that the Employee received from the Employer.

## Effect on Previous Section 409A Guidance

In addition to providing permissible correction methods for plan document failures, the 2010 Notice modifies certain provisions of the 2008 Notice, the IRS's correction program for nonqualified plan operational failures:

- The 2010 Notice clarifies how amounts must be repaid by the Employee, in cases in which amounts were erroneously paid to the Employee under the Nonqualified Plan. Specifically, the 2010 Notice describes certain situations in which the Employee may only repay the net overpayment amount after withholding, rather than the gross amount. The 2010 Notice also clarifies how to calculate the amount that must be repaid by the Employee as a correction of an early payment of an amount deferred under a Nonqualified Plan if the early payment was made in property, such as shares of stock the value of which has appreciated or depreciated since the improper payment.
- The 2010 Notice clarifies the calculation of the amount that must be paid to the Employee to correct a late payment of an amount deferred under a Nonqualified Plan if the payment would have been made in property, such as shares of stock.

## What Should Employers Do Now?

Many Employers expended a great deal of effort from 2005 to 2008 to comply with Section 409A and understandably may have reached a certain level of Section 409A exhaustion. Nevertheless, it is possible that one or more of the types of plan defects described in the 2010 Notice may exist in one or more Nonqualified Plans, particularly for arrangements that might mistakenly have been considered to be exempt from Section 409A (such as short-term deferrals). If so, it could become quite expensive to address these issues after December 31, 2010. Employers should take advantage of this valuable opportunity to identify and address any potential plan document deficiencies. At minimum, Employers should ask the following questions:

- Have we recently reviewed and updated our list of arrangements potentially subject to Section 409A, including not just traditional nonqualified deferred compensation programs, but also equity arrangements, individual employment contracts or other agreements, *etc.*?
- Have our internal or external auditors identified any potential operational or documentary issues with our Nonqualified Plans? Before simply assuming there are "no issues," a helpful exercise would be to review a sample IRS audit request regarding Section 409A (please contact one of the authors, listed below, if you would like to review a sample), the 2008 Notice and the 2010 Notice to get a sense of the common defects.

Notable plan defects addressed in the 2010 Notice include the following:

- Failure to set a deadline for the period of time that an Employee has to sign a release for payment of benefits, or a fixed payment date regardless of when the release is signed

- Providing for the time of payment to be delayed to the extent that certain financial targets or loan covenants are not met (as opposed to only jeopardy to the plan sponsor as a going concern)
- Provisions that link payment to the occurrence of an initial public offering (IPO) (other than a payment that is exempt from 409A as a short-term deferral)

Undertaking this exercise will help an Employer identify whether its Nonqualified Plans comply with Section 409A both in form and in operation.

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