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Employee Benefits & Executive Compensation

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## EBEC (Employee Benefits / Executive Compensation) Law Update

March 7, 2010

### Notice 2010-6 - Voluntary Correction Program for § 409A Documentary Failures

[IRS Notice 2010-6](#), 2010-3 I.R.B. 275 (January 5, 2010), allows taxpayers to voluntarily correct many documentary failures under Internal Revenue Code § 409A. Previously, voluntary 409A corrections were available only for operational failures under [Notice 2008-113](#). (See my Feb. 28, 2009 memo at [www.ebeclaw.com](http://www.ebeclaw.com).)

Notice 2010-6 provides that certain ambiguous plan terms are permitted under § 409A even without correction if there is no pattern of noncompliance. Corrections are set forth for (i) impermissible definitions of payment events, (ii) impermissible payment periods, payment events or payment schedules, (iii) lack of six-month delay, (iv) impermissible initial deferrals, etc. It also provides certain transition rules and information and reporting requirements for documentary corrections.

1. General Eligibility Requirements. Correction for documentary failures generally requires the following:
  - The same correction must be made by the employer for substantially similar failures for all its deferred compensation arrangements. § III.B.
  - The employer and employee may not be under audit with respect to nonqualified deferred compensation. § III.C.
  - The failures are not intentional and are not listed transactions. § III.D.
  - For many of the correction methods below, income tax and additional 20% tax - but not premium interest - must be paid for a portion of the amount deferred if a violation would have occurred within one year. § III.E.<sup>1</sup>
  - Linked plans and stock rights plans are not eligible for documentary correction. § III.G.
  - Plan aggregation rules of the 409A regulations do not apply to documentary errors, (Treas. Reg. §1.409A-1(c)(3)) and therefore a failure with regard to one plan will not cause the other plans to be

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<sup>1</sup> The date of correction (e.g., for purposes of meeting the one year requirement below) is the later of adoption of correction, effective date of correction or when correction is set forth in writing. § III.F. Section 409A income for the period prior to the year of correction is not subject to penalty merely because it was included in the written plan prior to the year of correction. § III.I.

subject to 409A tax. Notice 2010-6 § III.J.

2. Certain Ambiguous Plan Terms Permitted Under § 409A Without Correction if No Pattern of Noncompliance

*Terms that Provide for a Payment “As Soon as Practicable” Following a Permissible Payment Event.* The notice provides that a plan that allows payments on distribution events “as soon as reasonably practicable” does not fail to meet the requirements for designated distribution events as long as the employer does not have a pattern or practice of making late payments that do not qualify under the timeliness exception of the regulations. Notice 2010-6 § IV.A.

- If payment is inadvertently made after the fifteenth day of the third month after the year of the event, but there is no pattern of making late payments, there will be only an operational failure, which may qualify for operational correction under Notice 2008-113. Notice 2010-6 §§ IV.A. and IV.C Ex. 1.
- The notice does not require a plan that has the “as soon as practicable” after a payment event provision to correct itself.
- The “as soon as practicable” language should also suffice for a short-term deferral payable as soon as practicable without stating the 2-1/2 month period, and for expense reimbursements payable as soon as practicable without stating that it must be paid by the end of the next taxable year. These provisions, however, do not appear to be subject to the written plan requirements of Treas. Reg. § 1.409A-1(c)(3), and therefore the ambiguity of the provisions should not matter as long as in operation the requirements are met.

*Permissible Payment Events with Ambiguous Definitions such as “Termination of Employment” or “Acquisition.”*

A plan that designates a payment event but does not define the payment event or has an ambiguous definition of the payment event will still be compliant, as long as: (i) the provision could reasonably be interpreted to be compliant with § 409A, (ii) the employer does not have a pattern or practice of applying an interpretation that does not satisfy § 409A and (iii) the provision is not interpreted by a court in a way that violates § 409A. § IV.B.1 & first sentence of § IV.B.2.<sup>2</sup>

For example, “termination of employment” as a payment event can be interpreted to mean only events that are a separation from service under § 409A, and not events that do not constitute a separation from service under 409A, as long as there is no pattern of applying a non-409A definition. Similarly, the term “acquisition” can be interpreted to be a change in control as defined in § 409A. § IV.B. See also, § IV.C Ex. 2 and 3. Note that:

- No plan amendment is required in the above cases to comply with § 409A.
- If the plan contains a provision requiring that the terms be interpreted to comply with § 409A, the ambiguous provision will be treated as not ambiguous and will satisfy § 409A even without the above provision. § IV.B.1.

If an amount is paid (or not paid) in a manner that is not compliant with § 409A, that payment (or failure to make payment) may be treated as an operational failure eligible for relief under Notice 2008-113 despite the interpretation of the written plan provision in a manner that does not comply with § 409A, provided that the plan is amended to fix such interpretation before the end of the employee’s taxable year during which the operational failure is corrected. § IV.B.2. The above amendment may be made by (i) adding language so that terms of plan be interpreted as necessary to comply with § 409A, or (ii) setting forth explicit definitions of the terms of the plan that comply with § 409A, provided that the amendment may not expand the definition to include a new

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<sup>2</sup> The ambiguity of the term in the agreement must not have been intentional. § IV.B.

payment event or to take away a payment event (other than the required change). Id.

### 3. Correction of Impermissible Definitions of Payment Events

*Impermissible Definition of Separation From Service.* If a plan allows distribution on an event involving a change in the relationship between the employee and the employer relating to: (i) the level of services provided by the employee (such as a change from full-time to part-time status), (ii) a change in the capacity in which the employee provides services (such as change from employee to independent contractor) or (iii) a change in the recipient of the services provided by the employee (such as change from one subsidiary to another subsidiary), but which is not separation from service under Treas. Reg. § 1.409A-3(a)(1), the plan can be corrected before an event occurs that would meet the plan definition but not the regulatory definition of separation from service. The correction requires an amendment of the plan to provide payment on separation from service only if it meets the requirement of Treas. Reg. § 1.409A-3(a), provided the amendment does not expand or narrow a payment event except as needed to satisfy the regulatory definition of separation from service. If within one year after the correction, an event occurs that would have been a separation from service under the plan's old definition but would not be a separation under the regulatory definition, the employee must include 50% of the amount deferred in income for purposes of income tax and 20% additional tax on the amount included in income (but not premium interest, as stated above). § V.A.

*Impermissible Definition of a Change in Control Event.* If a plan provides for payment on a sale or change in effective control that would not satisfy the change in control definition of Treas. Reg. § 1.409A-3(a)(5), then as in the case above the plan may be corrected before an event occurs that meets the old plan definition but not the regulatory definition, provided the amendment does not expand to payment event. § IV.B. If within one year after correction a transfer occurs that is a change of control event under the old plan definition but not the regulatory definition, the employee must include 25% of the amount deferred in income for purposes of income tax together with the 20% additional tax. Id.

*Impermissible Definition of Disability.* If a payment event relating to incapacity would be a disability payment event under the plan but not under Treas. Reg. § 1.409A-3(a)(2), the plan may be corrected by conforming to the regulatory definition prior to the occurrence of a payment event that would meet the old plan definition but not the regulatory definition. § V.C.

### 4. Correcting Impermissible Payment Periods (Including by Release) Following a Permissible Payment Event

*Payment Periods of Longer than 90 Days Following a Permissible Payment Event.* Where payment may be made later than 90 days (and earlier than 366 days) after the payment event (see Treas. Reg. § 1.409A-3(b)), the plan may be corrected by removing or shortening the period after the payment event in which the amount can be paid to 90 days or less as well as by eliminating any ability of the employee to designate the taxable year in which paid. § VI.A. This amendment must be made before such a payment event occurs or within 90 days thereafter. Id. If payment the permissible event under the pre-corrected plan but not under 409A occurs, 50% of the amount deferred is included in income under § 409A as well as the 20% additional tax. Id.

*Payment Periods Following a Permissible Payment Event Dependent on the Employee Executing a Release or Other Employment-Related Actions.* If a plan provides for payment on a permissible event but conditions the payment on employment-related action of the employee such as executing a release, non-solicitation agreement or non-compete agreement, correction can be made before the permissible payment event occurs by removing the ability of the employee to delay or accelerate the timing of the payment as a result of his or her actions, and fixing the payment date at 60 or 90 days after the payment event (or the last day of a designated period if such designated period were provided in the plan). § VI.B.

- By way of background, when payment of severance is conditioned on the employee's signing a release of claims, and the employee can sign the release at any time, this could cause the severance arrangement to fail to be a short-term deferral or not have a fixed payment date. The solution IRS officials had given

informally and now officially set forth in this notice is that regardless of whether the release is executed right away, the severance payment will only be made, e.g., 60 or 90 days after termination, provided an irrevocable release is in place by then.<sup>3</sup>

#### 5. Correction of Certain Impermissible Payment Events and Payment Schedules

*Plans with Permissible and Impermissible Payment Events.* If a plan provides for both permissible and impermissible payment events, but does not have employer or employee discretion to pay amounts on different payment events, the plan may be corrected to remove the impermissible payment event(s) before the date a separation from service occurs that could result in impermissible multiple forms of payment for the employee. § VII.A.

If a permissible payment event has already been elected by or become applicable to the employee, the plan could be corrected to immediately remove impermissible payment events before any occur. If a payment of an impermissible event under the pre-corrected plan occurs within one year after the correction, 50% of the amount deferred must be included in income under § 409A for income tax as well as the additional 20% tax. Id.

*Plans with Only Impermissible Payment Events.* If a plan provides only impermissible payment events under § 409A, the plan can be corrected before any impermissible payment event occurs by removing the impermissible payment events and replacing them with a provision for payment on the later of separation from service or the sixth anniversary of the date of correction. § VII B. Affected employees for whom a pre-correction impermissible payment event occurs within one year of correction must include 50% of the amount deferred in income under § 409A for income tax and 20% additional tax. Id.

*Correcting Impermissible Toggles.* Where there are multiple forms of payment for a single permissible payment event (“toggles”), correction can be made before the payment event. This generally means amending the plan, eliminating all the forms of payment except for the form with the latest final payment date. In the case of separate forms for voluntary or involuntary separation from service, the forms relating to voluntary separation from service should be removed, leaving just a single form relating to involuntary separation from service. § VII.C. If a payment relating to an optional form (toggle) that existed pre-correction occurs, 50% of the amount deferred will be subject to income tax and 20% additional tax. Id.

*Impermissible Discretion Relating to Payment Schedule Following Permissible Payment Event (Including Subsequent Deferrals).* If the plan allows discretion by the employer or employee to change the time or form of payment following a permissible payment event, which is not allowed under Treas. Reg. § 1.409A-2(b) & -3(j), the following will apply:

- If the plan has a default time and form of payment if no discretion is exercised, and discretion has not been exercised or discretion exercised is revoked more than one year before the payment event occurs then there is no § 409A violation. If however, discretion has been exercised and has not been revoked (or has not been revoked more than a year prior to payment event), then to be eligible to correct, all similar provisions if all the employer’s similar plans have discretion removed. VII.D. In either case the plan must be immediately amended to remove discretion.

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<sup>3</sup> Note that if the severance can be paid within the short term deferral period (e.g., has good 409A good reason definition) or within the two years two times pay exception for involuntary terminations, this would avoid application of 409A and therefore it would not be subject to the toggle rule relating to 409A payment events or the straddling of two years. The release would have a fixed deadline that must be executed and become irrevocable within e.g., 60 days, and the severance would have to be paid in all events no later than 2 ½ months (to ensure that it is a short-term deferral), or within two years if relying on that exception.

- If the plan does not have a default time and form of payment, the plan will need to be corrected to remove any employer or employee discretion as to form of payment, and the amendment must choose the time and form of payment with the latest final payment date. Id.
- In both cases, if the payment event occurs within one year after the correction, 50% of the amount deferred is subject to income and 20% additional tax. Id.

*Impermissible Employer Discretion to Accelerate Payment Event.* If a plan gives the employer discretion to accelerate payment even prior to payment event (which is not allowed under Treas. Reg. § 1.409A-3(j)), the plan must be corrected to remove employer discretion before the date that the service recipient exercises its discretion to accelerate payment and such a change is irrevocable, or if earlier, before the date of payment has been made pursuant to exercise of discretion. § VII.E.

*Impermissible Reimbursement or In-Kind Benefits.* Where reimbursement or in-kind benefits do not satisfy Treas. Reg. § 1.409A-3(i)(1)(iv), the plan can be corrected before occurrence of any event that would result in the employee becoming eligible to receive the reimbursement or in-kind benefits, and the plan should be amended immediately to provide for reimbursement or in-kind benefits in a way that complies with the 409A regulations. § VII.F. If the event that would have been made in violation of the regulation occurs within one year following correction, the employee must include 50% of the deferred amount in income, as well as the 20% additional tax. Id.

#### 6. Correcting Failure to Include Six-Month Delay for Specified Employees

A nonqualified deferred compensation plan of a public company that fails to include a six-month delay for specified employees may be corrected before an event that would trigger the six-month delay occurs, by amending the plan to include the six-month delay and by further providing that the termination payment may be paid to specified employees no earlier than 18 months following correction or, if later, 6 months after the payment event occurs. § VIII. If there occurs within the first year after correction a termination payment that would without the correction violate § 409A due to lack of six-month delay, 50% of such amount will be subject to income tax as well as 20% additional tax. Id.

#### 7. Correction of Impermissible Initial Deferral Elections

With respect to a provision allowing an initial election to defer compensation that does not comply with Treas. Reg. § 1.409A-2(a) (e.g., the requirement that initial elections as time and form of payment be made prior to the taxable year in which the services are performed), but has not yet been applied with respect to the employee, the initial deferral is treated as applied on the date of the applicable deadline. Correction to remove the ability to make the impermissible initial deferral election may be made no later than the end of the employee's second taxable year after the year in which the payment event occurs. § IX.

#### 8. Amendment Period Following Employer's Initial Adoption of a Plan

If a plan provision is eligible for correction under this notice and the document failure is corrected by the end of the calendar year in which the legally binding right occurs or, if later within 2-1/2 months after the legally binding right arises, and all similar provisions of the employer are corrected in the same time period, any amounts paid that would not have been paid if the correction was not made may be treated as operational failures correctable under Notice 2008-113, and there will not be any 409A income tax or 20% additional tax on events occurring within the first year of correction. § X.

9. Transition Relief

*Correction of Document Failure Described in the Notice.* If a documentary error is eligible for correction under Notice 2010-6 and is corrected by December 31, 2010, the plan may be treated as corrected by January 1, 2009, and thus the income inclusion for the event occurring within one year of correction will not apply, although the failure will be treated as an operational failure under Notice 2008-113. § XI.A.

*Correction of Impermissible Provisions Linking Nonqualified Deferred Compensation Plans by 12/31/11.* If an amount deferred or paid under a nonqualified deferred compensation plan is determined by the amount deferred or paid under another nonqualified deferred compensation plan such that the one or both plans fail to satisfy § 409A, the linkage will be disregarded if the plans are corrected by December 31, 2011. The correction requires that the time and form of payment under the two plans are made identical. If any amounts have been paid in a manner that is not consistent with the amended payment provisions, the payments must be treated as operational failures correctable under Notice 2008-113. § XI.B.

*Correction by 12/31/11 of Payment Schedules Determined by Timing of Payments Received by Employer.* If a nonqualified deferred compensation plan contains a payment provision tied to payments received by the employer that meets the requirements of Treas. Reg. § 1.409A-3(i)(1)(iii) except that it fails to meet paragraphs (C) of (D) (objective method of identifying the payments to the employer and objective schedule under which the payments will be made to the employee) , the payment provision will retain its status as a fixed schedule of payments if the plan is amended by 12/31/2011. § XI.C.

10. Information and Reporting Requirements for Documentary Corrections

An employer with respect to any of the corrections in the notice must attach to its corporate tax returns and to the W-2's and 1099's for the year of failure an exhibit entitled "409A Document Correction Under § \_\_\_ of Notice 2010-6." § XII.A. The attachment describing the documentary correction should set forth the name and tax identification number for each service provider affected by the failure, identification of the plan with the failure, a statement that the document failure is eligible for correction (and identifying the specific section of the notice) and stating the amount involved in the documentary error. § XII.B.

The employee must also be provided with a statement of the correction, is attached to the W-2 or 1099-S, and must contain the information in the previous paragraph, as well as a statement that the employee is entitled to relief under the notice. § XII.C. The employee must attach to his or her tax return a copy of the above statement regarding the failure. § XIII.D.

11. Reliance

Taxpayers may rely on Notice 2010-6 for taxable years beginning in 2009. § XIV.

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