IRS Issues Document Correction Program for Section 409A Deferred Compensation Arrangements

Under new guidance issued by the Internal Revenue Service interpreting §409A of the Internal Revenue Code, an employer will be permitted to correct certain failures to comply with the documentation requirements of §409A.

Document Failures Eligible for Correction

The guidance provides that deferred compensation arrangements with the following defects may be corrected:

- *Ambiguous Plan Terms*. Potential violations of §409A can occur where a deferred compensation arrangement provides that an employer will make payment "as soon as reasonably practicable" (or is otherwise silent as to timing) following a permissible payment trigger, or upon a payment trigger that could be interpreted to comply with §409A (such as a "termination of employment" or "acquisition"). While these concepts are commonly used in deferred compensation arrangements, they are not specifically sanctioned by §409A and could be interpreted to either comply with §409A or not. The new guidance clarifies that ambiguous terms will not result in a "document failure," so long as the company has no pattern or practice of interpreting these terms in a way that would violate §409A. (If there were a pattern or practice, this relief is not available.) In addition, an employer may amend the deferred compensation arrangement to clarify the ambiguous terms, or to state that the ambiguous provision must be interpreted in compliance with §409A. However, if the company makes (or fails to make) a payment under an ambiguous provision that violates §409A, it will be an "operational failure" that may be eligible for correction under guidance the IRS previously issued in Notice 2008-113.

- *Non-Compliant Definitions*. Section 409A violations can also occur where a deferred compensation arrangement contains non-compliant definitions of "separation from service", "change in control" or "disability". Under the new guidance, these errors can be corrected prior to the occurrence of the payment trigger by using a corrected definition that does not expand the one previously used by the deferred compensation arrangement. However, if a payment trigger occurs within the first year after correction and the trigger would have resulted in payment under the prior, uncorrected definition, the employee must include up to 50% of the amount deferred under his or her deferred compensation arrangement as income under §409A. There is, however, no similar one-year look-back rule for corrected disability definitions.

- *Non-Compliant Payment Periods Following a Compliant Payment Trigger*. The guidance will also permit a correction where a deferred compensation payment is triggered by a compliant trigger event, but pays out over a non-compliant payment period. This can occur, for example, where the payment is triggered by a "separation from service" but payment is made or commences more than 90 days (but less than 366 days) after the

- To correct the timing violation, an employer can remove the non-compliant payment period or designate a payment period that is 90 days or less. The employee is not permitted to designate the taxable year of payment. If the trigger event has already occurred, however, the deferred compensation arrangement may be corrected within a reasonable time thereafter if the arrangement designates a payment period that is 90 days or less and the employee cannot designate the taxable year of payment. Although no document failure will be deemed to have occurred, 50% of the deferred amount to which the prior provision would have applied must be included in the employee's income under §409A in the taxable year within which the trigger occurs.

- Payment schedules conditioned upon the execution of a release of claims or another document may be corrected, before the occurrence of the trigger event, by amending the deferred compensation arrangement to remove the ability of the employee to delay or accelerate the payment. If the plan provides for payment within a designated period following a payment trigger that complies with §409A, the amendment must provide for payment only on the last day of such period. If the plan does not provide for payment within such a designated period, the amendment must provide for payment only upon a fixed date that is 60 or 90 days following the occurrence of the trigger event. In any such case, the amendment may not otherwise change the time or form of payment.

- *Compliant and Non-Compliant Payment Triggers.* An employer may correct a deferred compensation arrangement that includes payment triggers that both comply with and violate §409A. The correction must generally occur before payment upon the non-compliant payment trigger and must remove the non-compliant trigger. If the correction is made after the employee's election and the previous non-compliant trigger occurs within one year following correction, 50% of the deferred amount to which the prior provision would have applied must be included in the employee's income under §409A in the taxable year within which the trigger occurs.

- *Only Non-Compliant Payment Triggers*. A deferred compensation arrangement that includes only non-compliant payment triggers may be corrected, before any such trigger occurs, by amending the plan to remove such events and providing for payment upon the later of the employee's separation from service and the sixth anniversary of the correction. Fifty percent of the deferred amount to which the prior provision would have applied must be included in the employee's income under §409A in the taxable year within which the correction occurs.

- *Non-Compliant Alternative Forms of Payment for a Compliant Payment Trigger*. If, for example, a deferred compensation arrangement provides for payment upon an employee's separation from service, but the form of payment varies depending on whether the separation is voluntary or involuntary, the arrangement would violate §409A. This violation can be corrected before the trigger event occurs, by amending the arrangement to provide that the form of payment upon a voluntary separation will be the

- *Non-Compliant Discretion Regarding Time or Form of Payment Following a Compliant Payment Event*. Generally, any employer or employee discretion to vary the time or form of payment following a permissible payment event will nonetheless violate §409A. If the plan provides for a default time or form of payment where no discretion is exercised, the arrangement will need to be amended before the payment trigger to remove such discretion. If the plan does not provide for a default option, the arrangement will need to be amended before the payment trigger to remove such discretion and provide that payment generally will be made or commenced on the *latest* date that would have been possible under the prior plan provision. Where an arrangement provides for a default option, but it does not permit any discretion after the payment trigger occurs, the arrangement will not be treated as having violated §409A so long as no discretion is actually exercised or, if it has been exercised, so long as such exercise is revoked more than one year before the payment trigger occurs. If the payment trigger occurs within one year following the correction, 50% of the deferred amount to which the prior provision would have applied must be included in the employee's income under §409A in the taxable year within which the trigger occurs.

- *Non-Compliant Employer Discretion to Accelerate Payments Regardless of Whether a Payment Trigger Has Occurred*. Section 409A will be violated where an employer has the discretionary authority to accelerate payments, even in the event a payment trigger has not occurred. This violation can be corrected before payment is made by amending the plan to remove the employer's discretion or to provide for an otherwise compliant method of acceleration.

- *Non-Compliant Reimbursement or In-Kind Benefits*. If a deferred compensation arrangement provides for reimbursements or in-kind benefits that would violate §409A, it may be corrected, before reimbursement or the provision of benefits, by conforming the arrangement to the §409A rules. However, the amount eligible for reimbursement or in-kind benefits must be allocated pro rata among the number of years (minimum of three years) during which the employee may be eligible to receive such reimbursements or in-kind benefits. If an event occurs within one year of the correction that would have made the employee eligible for reimbursements or in-kind benefits under the prior provision, 50% of the reimbursement or in-kind benefits to which the prior provision would have applied must be included in the employee's income under §409A in the taxable year within which such reimbursement or in-kind benefits were provided.

- *Failure to Include a Six-Month Delay*. Section 409A requires that payments upon a separation from service to "specified employees" (generally, highly compensated officers and 5% shareholders) of a public company must be delayed for at least six months

- *Non-Compliant Initial Deferral Elections*. Section 409A requires initial deferral elections to be made within strict time periods. Where a deferred compensation arrangement permits an election outside of these periods, the arrangement may be corrected to conform it to §409A's rules. The correction must be made no later than the end of the employee's second taxable year following the taxable year in which the initial deferral election should have been made. Any amounts that were not paid due to the non-compliant election are eligible for correction under Notice 2008-113.

- *Amendment Period Following Initial Adoption*. Document failures in a newly adopted deferred compensation arrangement may be corrected no later than the later of the end of the calendar year in which, or the 15th day of the third calendar month following, the date of the arrangement's initial adoption. If the arrangement is corrected by such deadline, any amount previously paid that would not have been paid under the corrected provision will be treated as an operational failure and must be corrected by the end of the calendar year in which the document failure is corrected. The same is true for any amount that was not paid but would have been paid had the corrected plan provision always been in effect. In addition, if the plan and the related operational failure are corrected by the applicable deadlines, no amounts deferred under the plan will be included in the employee's income solely as a result of the document failure.

General Requirements and Restrictions

In order for a document failure to be correctable, the employer must take commercially reasonable steps to identify and correct all other deferred compensation arrangements with a substantially similar document failure. In addition, the employer and any affected employee must satisfy specific information and reporting requirements, and the employee must pay all applicable taxes, including the 20% excise tax imposed by §409A, on any amounts required to be included into income under §409A. Special rules apply where there are multiple document failures. Relief is not available for intentional failures or if the employer or the employee is under examination by the IRS with respect to deferred compensation for any taxable year in which the document failure existed. Finally, no relief is provided for stock options or stock appreciation rights granted with a strike price below fair market value on the date of grant.

Transition Relief

The new guidance also provides transition relief to correct the document failures discussed above without current income inclusion or additional taxes under §409A (and treats the arrangement as having been corrected as of January 1, 2009), so long as the document failures are corrected by

December 31, 2010 (along with any resulting operational failures for payments actually made before December 31, 2010).

In addition, if two deferred compensation arrangements are linked—that is, if the amount deferred under one plan is determined by, or the time or form of payment is affected by, the other plan—and one or both of the arrangements violate §409A, the arrangement may be corrected by December 31, 2011 and will not be treated as having violated §409A solely because of the linkage. To be eligible for transition relief, the time or form of payment under the two arrangements must be made identical, and any related operational failures must also be corrected by December 31, 2011.

Our description of the Notice 2008-113, the IRS's guidance for correcting operational failures, is posted on our website, and may be accessed by clicking here.

In general, §409A limits how and when employees can elect to defer compensation, prohibits employers or employees from accelerating the payment of deferred compensation and restricts when an employee can receive payment. Deferral elections, plans and agreements that do not comply with §409A or deferred compensation payments made other than in accordance with six specified trigger events (an employee's separation from service, pursuant to a fixed time or schedule, a change of ownership or effective control, death, disability and an employee's unforeseeable emergency) will violate the statute and will result in, at a minimum, a 20% excise tax on the affected employee.

If you have any questions relating to the new guidance or §409A, please contact your primary attorney at Morrison Cohen LLP or any of the following:

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