

A horizontal banner image with a grid overlay. It features a scale of justice on the left, a computer keyboard in the center, and a gavel on the right. The text "JONES DAY COMMENTARY" is overlaid in white, with "JONES DAY" in a smaller font above "COMMENTARY".

JONES DAY
COMMENTARY

IRS RELEASES SECTION 409A DOCUMENTARY CORRECTION PROGRAM

Recently issued Notice 2010-6 (“Notice 2010-6” or the “Notice”) provides taxpayers with the opportunity to voluntarily correct certain failures to comply with the plan document requirements (each, a “document failure”) under Section 409A of the Internal Revenue Code and the final regulations promulgated thereunder (“Section 409A”). Compliance with the correction procedures under the Notice may reduce or eliminate the adverse tax consequences that could result from document failures. The Notice also clarifies that certain language commonly included in plans, agreements, and other compensation arrangements (collectively, “plans”) will not cause a document failure, and it provides substantive guidance on certain previously ambiguous Section 409A provisions. However, ambiguities still exist.

Importantly, the Notice provides generous transitional relief for correcting certain document failures in 2010.

This *Jones Day Commentary* summarizes the types of document failures eligible for correction under Notice 2010-6, as well as the eligibility requirements, timing considerations for correction, and information and reporting requirements required to be satisfied as a condition to relief.

BACKGROUND

Section 409A prescribes strict rules with respect to the deferral and payment of compensation under plans that provide for nonqualified deferred compensation. Failure to comply with those rules may require an employee or other service provider (for convenience, we will refer to all service providers as “employees”) to include in income all vested amounts deferred under the noncompliant plans (whether or not actually paid), and may subject the employee to an additional 20 percent income tax on such amounts and potential interest charges.

Section 409A required full documentary and operational compliance by January 1, 2009. The Internal Revenue Service (“IRS”) previously issued Notice 2008-113, which established a voluntary correction program for certain *operational* compliance failures but did not address correction of *documentary* compliance failures. Notice 2010-6 complements and modifies Notice 2008-113 and provides the first program to correct document failures, thereby allowing employees to reduce or avoid the adverse tax penalties that would otherwise apply under Section 409A.

RELIEF PROVIDED BY THE CORRECTION PROGRAM

Common Ambiguous Plan Terms That Do Not Cause a Document Failure

Notice 2010-6 clarifies that plans that set forth Section 409A-compliant permissible payment events but require payment “as soon as reasonably practicable” following such payment events (or include similar timing language) do not result in a document failure as long as the plan is operated in compliance with Section 409A and there has not been a pattern or practice of making late payments under these provisions.

Notice 2010-6 also clarifies that certain ambiguous payment provisions that could be interpreted either to comply with or violate Section 409A will not result in a document failure as long as there has not been a pattern or practice of interpreting the provision in a way that violates Section 409A. For example, a plan that references the term “termination of employment” as a payment event (*i.e.*, rather than “separation from service”) will not result in a document failure provided that there has not been a pattern or practice of interpreting the plan in a manner inconsistent with Section 409A (*i.e.*, a termination of employment must be interpreted to mean a separation from service).

In addition, if the plan contains a provision requiring that the term be interpreted to comply with Section 409A, the provision is deemed to comply with Section 409A. We therefore advise companies to consider incorporating into each of

their deferred compensation arrangements a provision to the effect that the plan is generally intended to comply with and, to the extent possible, should be interpreted in compliance with Section 409A. However, if the facts and circumstances indicate that a service recipient (the “employer”) intentionally used an ambiguous term for a noncompliant payment event in a plan or a similar result was reached by a court, the plan and all plans of the employer with the same or substantially similar language will not be eligible for relief under this clarification.

CORRECTION OF DOCUMENT FAILURES

Eligibility Requirements. Relief for correcting a document failure is subject to eligibility requirements outlined in the Notice, including:

- The employer must take commercially reasonable steps to identify and correct all other nonqualified deferred compensation plans that have a substantially similar document failure, even if the participants are different;
- The federal income tax return of the employer and the affected employee must not be under examination with respect to nonqualified deferred compensation for any taxable year in which the document failure existed (limited transitional relief is available for corrections made on or before December 31, 2011);
- The document failure must be inadvertent, unintentional, and not related to participation in a transaction that the IRS has listed as potentially tax abusive;
- The specific requirements applicable to the category of document failure are satisfied; and
- The employer and employee each satisfies certain information and reporting requirements.

Timing of Corrections. If eligible for relief under Notice 2010-6, the voluntary documentary correction program may be used at any time. In most cases, if a plan provision is

corrected in accordance with the Notice and the correction does not affect the operation of the plan during the one-year period following the correction, adverse tax consequences for violating Section 409A may be completely avoided. However, subject to a few exceptions, if the correction does affect the operation of the plan within one year following the correction, the employee is generally required to include as Section 409A income a specified percentage (typically 50 percent) of the deferred amount to which the pre-correction plan provision would have applied. Further, the amount includible in income will be subject to the additional 20 percent penalty tax, but not the additional interest charges under Section 409A. Reporting requirements also would apply.

The Notice provides two additional time-limited alternatives for avoiding the Section 409A tax penalties:

Transitional Relief for Corrections Made on or Before December 31, 2010. If a document failure is corrected under Notice 2010-6 on or before December 31, 2010, the plan may be treated as having been corrected on January 1, 2009 (the transitional relief deadline for full compliance with Section 409A), and no income inclusion under Section 409A will be required as a condition of the relief, as long as any operational failures are corrected in accordance with Notice 2008-113.

Temporary Relief Following an Employer's Initial Adoption of a Plan. Notice 2010-6 also provides temporary relief for certain document failure corrections made within a specified limited period following the initial adoption of a plan.

The general timing rule and the 2010 transition relief, as with other features of the Notice, are intended to encourage prompt corrections and to reduce incentives to wait to see if any advantage may be derived from retaining an impermissible provision.

Types of Corrections. Notice 2010-6 provides relief and correction procedures for the following types of document failures under Section 409A:

- **Impermissible Definitions of Permissible Payment Events.** Plan provisions that provide for payment of deferred compensation based on definitions of "separation from service," "change in control," and/or "disability" that do not comply with Section 409A (e.g., a "separation from service" definition that includes *any* change in status from an employee to an independent contractor or transfer of employment from parent to a subsidiary).
- **Impermissible Payment Periods Following a Permissible Payment Event.** A plan provision that provides for payment upon a permissible payment event under Section 409A, but then either (i) designates the period during which payment may be made as later than 90 days and earlier than 366 days following the payment event (e.g., a payment to be made any time during the 180-day period following a separation from service), or (ii) conditions the payment on an employment-related action of the employee (e.g., the execution of a noncompetition agreement or release of claims) in a manner that the IRS views as impermissible.
- **Impermissible Payment Events.** A plan provision that provides for payment of nonqualified deferred compensation upon the occurrence of one or more impermissible payment events under Section 409A (e.g., an initial public offering or enrollment of a child in college).
- **Impermissible Alternative Payment Schedules.** A plan provision that provides for more than one time or form of payment upon the occurrence of a single type of permissible payment event under Section 409A (often referred to as an impermissible "toggle") (e.g., a different time and form of payment for voluntary and involuntary separation from service).
- **Impermissible Employer or Employee Discretion with Respect to a Payment Schedule Following a Permissible Payment Event.** A plan provision that provides an employee or employer with discretion to change the time or form of payment of an amount due following a permissible payment event (e.g., an employer's discretion to delay payment for up to three years if certain cash flow targets are not met).

- **Impermissible Employer Discretion to Accelerate Payment Events.** A plan provision that provides an employer with discretion to accelerate a payment regardless of whether a payment event has occurred (e.g., the discretion to terminate the plan and immediately pay all deferred amounts).
- **Impermissible Reimbursement or In-Kind Benefit Provisions.** A plan provision that provides for reimbursement or in-kind benefits that does not comply with Section 409A (e.g., a provision providing for reimbursement of country club dues for three years, up to an aggregate of \$60,000, following an employee's separation from service).

Failure to Include Six-Month Delay of Payment for Specified Employees. A plan that fails to include a provision providing for a six-month delay for specified employees.

Impermissible Deferral Elections. A plan provision that provides for an initial deferral election that does not comply with Section 409A (other than an election as to the time and form of payment). Notably, Notice 2010-6 clarifies that a plan that provides for a noncompliant initial deferral election will not result in a plan document failure as long as the provision has not been applied with respect to the applicable employee.

Failures Excluded from Corrections. Certain types of documentary failures are expressly excluded from relief under the Notice.

- Documentary failures under linked plans, *i.e.*, nonqualified deferred compensation plans the benefits of which are determined by reference to another nonqualified deferred compensation plan or a qualified plan. Transition relief is provided, however, through December 31, 2011.
- Stock rights, although some relief is provided by Notice 2008-113 for discounted options.

In addition, presumably all types of documentary failures that are not expressly permitted to be corrected are excluded from the Notice. For example, a haircut provision or an error in short-term deferral provisions cannot be corrected under the Notice.

Information and Reporting Requirements. In addition to the eligibility requirements described above, relief under Notice 2010-6 is conditioned upon the employer and employee satisfying certain information and reporting requirements, including that the employer report the relevant information to the employee, and that both the employer and employee attach to each of their respective federal income tax returns a statement describing the correction, in certain cases for the year in which the correction is made, as well as the subsequent year. In addition, at the start of an examination of either the employer's or employee's federal income tax return, the employer or the employee, as applicable, must notify the examining agent of reliance on the relief under the Notice for the years covered by the examination.

Note that the necessity of satisfying these information and reporting requirements, particularly in light of the stringent, burdensome, and often uncertain eligibility requirements, may dissuade employers and employees from making use of the relief provided in Notice 2010-6, even where the correction otherwise would not result in adverse tax consequences.

Operational Failures. Notice 2010-6 modifies certain provisions of Notice 2008-113, which continues to be the chief guidance on correcting operational failures under Section 409A. Generally, Notice 2010-6 modifies Notice 2008-113 to clarify (i) the methods by which an employee may repay amounts required to be repaid to the employer in order to qualify for relief under Notice 2008-113, and (ii) how amounts that are required to be repaid to the employer by an employee should be calculated (particularly with respect to amounts paid in the form of property).

OBSERVATIONS

Notice 2010-6 provides welcome relief for companies to voluntarily correct certain Section 409A documentary compliance failures in their deferred compensation plans with reduced and, in some cases, no adverse tax consequences. As illustrated throughout the Notice, even subtle and unintentional failures to comply with Section 409A have the potential to subject employees to Section 409A's onerous tax penalties. It is therefore worthwhile for companies to familiarize themselves with the types of corrections eligible for relief under the Notice, conduct a review of their plans, and consider making the corrections prior to December 31, 2010, in order to take advantage of the more generous transitional relief available under the Notice. However, as is the case with the operational corrections program announced in Notice 2008-113, due to the numerous and sometimes unclear eligibility rules, the potential tax and other costs (which are often unpredictable), and the information and reporting requirements, the practical significance of Notice 2010-6 is uncertain.

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