



**It's a New Day With §409A:  
IRS Notice 2010-6  
Correction of Document Failures**

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# It's a New Day With §409A: IRS Notice 2010-6 Document Correction

## Agenda

- Lay of the Land – Understanding Existing IRS Correction Programs
  - Notice 2008-113 – Correction of Operational Failures
  - IRS Proposed Regulations §1.409A-4
  - Notice 2010-6 – Correction of Document Failures
  
- What To Do & Why Do It Now
  - Overview of Notice 2010-6, with Practical Examples
  - Importance of Correcting Document Failures in 2010



# IRS Guidance on Correction – Operation and Documentation

- IRS Notice 2008-113
  - Correction program for *operational* failures
  - Works in tandem with new Notice 2010-6
- IRS Proposed Regulations §1.409A-4
  - Address calculation of amount includible in income due to §409A violations
  - Not a correction program, per se, but provides guidance on some correction issues outside the notices for both types of errors
- IRS Notice 2010-6
  - Correction program for *document* failures
  - Transition relief for corrections made in 2010
- Correcting “outside” the guidance?

# IRS Guidance on Correction – Operational Defects

## IRS Notice 2008-113

- Limited correction program for operational (not document) errors
- Not available for a taxable year in which employer experiences substantial financial downturn or “financial or other issues” that create a significant risk of nonpayment when deferred amount is due
- Relief further limited for “insiders”
  - Directors, officers and 10% owners
- Must take reasonable steps to correct error and disclose use of program to IRS on the employer and service provider tax returns
- Consider: type of violation, how it was corrected, amount involved, who was affected (insider vs. non-insider)

# IRS Guidance on Correction – Operational Defects

IRS Notice 2008-113 covers:

- Failures corrected in same tax year as violation
  1. *Failure to defer* or incorrect payment of amount due in a later year (other than 6-month rule violation)
  2. *Early payment* of amount scheduled for same tax year
  3. *Excess deferred* amount, including delayed distributions
  4. *Correction of exercise price* of otherwise excluded stock rights (e.g., options/SARs granted with exercise rights below FMV)
  
- Failures corrected in first tax year following the year of the error (for non-insiders)
  - No 20% tax
  
- Failures corrected in second tax year following the year of the error, including
  - 20% tax but no “premium” interest



# IRS Guidance on Correction – Proposed Regs

## IRS Prop. Treas. Reg. §1.409A-4:

- Provides detailed guidance on how to calculate the amount to be included in income
- Each year's violation stands on its own (*e.g.*, error in year 1 does not taint year 2 if compliant in year 2); therefore, fix it and the plan can move on
  - No plan aggregation rule for plan document errors
  - Once an amount is included in income, only earnings on that amount are included in the future
  - Valuation of includible amounts generally done at the end of the year (amounts paid out during the year are added back)

# IRS Guidance on Correction – Proposed Regs

## IRS Prop. Treas. Reg. §1.409A-4:

### ➤ Important Correction Principle:

- §409A violations, even document violations, may be cured completely and without penalty before amounts are vested

### ➤ What does this mean?

- If no amounts are vested by year end, and
- The plan, as written is in violation and needs to be fixed, then
- The plan may be re-written to be compliant prior to year end, and
- The corrections programs are not necessary

### ➤ Proceed with caution:

- Beware of hidden vesting triggers – bad good reason rights, etc.



# IRS Guidance on Correction – Correcting Document Failures, Notice 2010-6

## IRS Notice 2010-6

- Provides previously unavailable relief for documents that fail to comply with §409A (*i.e.*, “document failures”)
  
- Certain ambiguous language (*e.g.*, pay “as soon as practicable” after event, or “termination of employment”) can be cleaned up easily
  - Does not cause a document failure – no correction required
  - Clean up ambiguous language to avoid future operational issues

# IRS Guidance on Correction – Correcting Document Failures, Notice 2010-6

## IRS Notice 2010-6

- Correct now!
  - Special transition relief is available for corrections made in 2010
- Many corrections are subject to a “One-Year Rule”
  - No current income inclusion or additional tax if correction does not affect operation within one year from correction date
  - Limited current income inclusion and additional tax if correction does affect operation within one year from correction date
- IRS reporting required, similar to Notice 2008-113 correction program for operational errors



## Notice 2010-6: Questions to Ask

### Questions to Ask Before Using Notice 2010-6 for Relief

- Is my failure an operational or a document failure?
  - Notice 2010-6 applies to document failures only
  - Notice 2008-113 applies to operational failures only
  - Some document corrections might lead to operational failures and you need both programs
- How do my documents fail to comply with §409A?
  - Identify documents of like type
    - Although no aggregation for document errors, IRS correction often requires fixing all similar plans
  - Identify each type of document failure
  - Remember – some “failures” may not even need correction – see exceptions for ambiguous language



## Notice 2010-6: Questions to Ask

### Questions to Ask Before Using Notice 2010-6 for Relief (cont.)

- Am I even eligible for relief?
  - Relief under Notice 2010-6 is only available if:
    - Neither the employer nor employee is under examination with respect to deferred compensation for period of failure
    - Failure to comply with §409A was inadvertent and unintentional
- Are any amounts under the plan vested by year end?
  - If no amounts are vested by year end, correction is possible without either program
  - No adverse tax consequences, no IRS filing or employee reporting



## Notice 2010-6: No Correction Required

### IRS Notice 2010-6 – No Correction Required

- Exceptions for certain ambiguous language
  - Payment “as soon as practicable” after permitted event
    - Must pay by later of (1) end of tax year in which the payment event occurs or (2) 15<sup>th</sup> day of the third month following the payment event
    - Be careful administering payment ASAP after death
  - No or ambiguous definition of permissible payment date
    - Example: plan pays on “termination of employment” (rather than separation from service)
    - Correctible as long as no pattern of operational violations
    - Adding a “savings clause” (e.g., plan to be interpreted under §409A) helps “interpret” ambiguous terms



## Notice 2010-6: No Correction Required

### IRS Notice 2010-6 – No Correction Required (cont.)

- Reasons to clean up ambiguous even though not a document “error”
  - Clearer is better
    - Clear language makes for better plan documents and avoids operational errors
  - Clean-up is easy
    - Because IRS does not require formal correction, clean up is a simple amendment; no tax, no filings
  - Bad pattern or practice of interpretation taints all
    - Pattern or practice of §409A violations based on erroneous interpretation taints the plan and all similar language in other plans
    - Makes all similar plans ineligible for correction without filing because they must all be interpreted the same way



## Notice 2010-6: Transition Relief

### IRS Notice 2010-6 – 2010 Transition Relief

- If correct by December 31, 2010, no income inclusion required, provided that:
  - Notice 2008-113 operational correction is used for
    - Payments actually made in 2010 that would not have been made under the amended provision, or
    - Payments not made in 2010 that should have been made under the amended provision
- If correct by December 31, 2010, correction date is January 1, 2009
  - Earlier correction date lessens impact of certain requirements:
    - “One-Year Rule” (see below) does not apply to corrections made by December 31, 2010
    - Additional 18-month delay on failure to include 6-month delay runs from the correction date



## Notice 2010-6: Transition Relief

The importance of 2010 Transition – Correction for 6-month delay

- **Failure:** Plan fails to include the requisite 6-month delay period for specified employees
- **Correction:** Amend plan before payment subject to 6-month delay to add 6-month delay
  - However, delayed payments cannot be made before the later of
    - 18 months following the “correction date”, or
    - 6 months following the payment date
  - What is your “correction date”?



## Notice 2010-6: Correcting in 2010

### Notice 2010-6 – Importance of Correcting in 2010

- Under 2010 transition, the January 1, 2009 correction date is crucial
  - Assume plan amended on December 31, 2010 to add the previously omitted 6-month delay
    - Specified employee terminates January 2, 2011
    - Payment must be delayed until the later of
      - July 1, 2011 (18 months from the correction date (January 1, 2009)) or
      - July 2, 2011 (6 months from the separation from service)
  - **Result: Payment date is July 2, 2011**



## Notice 2010-6: Correcting in 2010

### Notice 2010-6 – Importance of Correcting in 2010

- Under 2010 transition, the January 1, 2009 correction date is crucial
  - Now, assume the same facts, but employer corrects on January 1, 2011 instead of December 31, 2010
    - Specified employee terminates January 2, 2011
    - Payment must be delayed until the later of
      - July 1, 2012 (18 months from the correction date) or
      - July 2, 2011 (6 months from the separation from service)
    - **Result: payment date is July 1, 2012**



# Notice 2010-6: Document Failures Addressed

## Notice 2010-6 – Document Failures Addressed

- Impermissible definitions of §409A-compliant payment events
  - Separation from service
  - Change in control
  - Disability
- Failure to include 6-month delay for specified employees
- Impermissible payment periods following a §409A-compliant payment event
  - Payment to be made within a period of more than 90 days after the event
  - Payment period dependent on completion of employment related events
    - Example: payment made within 90 days upon signing a waiver/release



## Notice 2010-6: Document Failures Addressed

### Notice 2010-6 – Document Failures Addressed (cont.)

- Impermissible payment events and payment schedules, including
  - Plans with both permissible and impermissible payment events in the same document(s)
  - Plans with only impermissible payment events
  - Permissible payment event but multiple impermissible alternative payment schedules (e.g., different payments for voluntary/involuntary separation from service)
  - Impermissible discretion to change time or form of payment
  - Impermissible employer discretion to accelerate payments
  - Impermissible reimbursement or in-kind benefits provisions
- Impermissible initial deferral elections



## Notice 2010-6: Defined Payment Events

### Notice 2010-6 – Impermissible Definitions of §409A-Compliant Payment Events

- Payment on change in employment relationship that is not a §409A separation from service, change in control, or disability
- Examples of non-compliant payment events that can be corrected
  - Change from full-time to part-time employment, from employee to independent contractor, or from one subsidiary to another within controlled group
  - Board’s approval of a sale of all or substantially all assets
  - Initial public offering of company’s stock
  - Employee’s inability to work for a period of six months due to illness without true “separation from service”



## Notice 2010-6: Defined Payment Events

### Notice 2010-6 – Impermissible Definitions of §409A-Compliant Payment Events (cont.)

- Amend to revise impermissible definition
  - Adopt before the impermissible payment event occurs
  - Cannot expand or narrow definition of separation from service, or add new change in control payment events
- One-Year Rule: If
  - Bad payment event within one year of correction date and would have triggered payment under pre-corrected plan, or
  - Good event within one year that would not have triggered payment under old plan rule, then
  - Employee includes 50% (or, 25% for change in control event) of deferred amount in income and pays the 20% additional tax (but not additional interest tax); employer reports amount on Form W-2
- Note: One-Year Rule does not apply to correcting disability language



## Notice 2010-6: Payment Periods

### Notice 2010-6 – Impermissible Payment Periods Following a §409A-Compliant Payment Event

- **Failure:** Plan provides for a payment within a period of more than 90 (but less than 365) days following a permissible payment event (e.g., pay within 120 days of separation)
- **Correction:** Amend plan before payment event to provide for payment period of 90 days or less
  - No One-Year Rule
  - If payment event occurs before correction, but plan is amended within a “reasonable time thereafter,” employee includes 50% of the amount deferred in income and pays the 20% additional tax (but not additional interest tax); employer reports amount on Form W-2



## Notice 2010-6: Payment Periods

### Notice 2010-6 – Impermissible Payment Periods Following a §409A-Compliant Payment Event (cont.)

- **Failure:** Payment is conditioned on employee's execution of a release or non-compete or non-solicitation agreement within a certain period; effectively lets employee choose year of payment
- **Correction:** Amend plan, before payment event, so that payment will be made on a specified payment date (e.g., last day of 90-day period after event)
  - If no period was originally specified, can only choose a 60 or 90 day period
  - Cannot otherwise change the time and form of payment
  - No “One Year Rule”; BUT – if separate BEFORE correction, 100% of §409A tax apparently applies, even if employee does not choose year of payment



## Notice 2010-6: Examples

### Notice 2010-6 – Impermissible Payment Events and Schedules

- **Failure:** Plan provides both permissible and impermissible payment events (e.g., pay on earlier of IPO or separation from service); but no events subject to discretion
- **Correction:** Remove impermissible payment events
  - If amended before the bad event is irrevocably elected by the participant, One-Year Rule does not apply
  - If amended after the bad event is irrevocably elected by the participant, One-Year Rule applies:
    - If impermissible payment event occurs within one year of date of correction, employee includes in income 50% of the deferred amount and pays the 20% additional tax (but not additional interest tax); employer reports amount on Form W-2



## Notice 2010-6: Examples

### Notice 2010-6 – Impermissible Payment Events and Schedules (cont.)

- **Failure:** Plan only includes impermissible payment events (e.g., payment to be made upon child's college enrollment/graduation)
- **Correction:** Remove bad payment events, before payment event occurs, and provide payment on later of (1) the employee's §409A-compliant separation from service or (2) the sixth anniversary of the correction date
  - For the year of correction, employee includes 50% of the deferred amount in income and pays the 20% additional tax (but not additional interest tax); employer reports amount on Form W-2
  - One-Year Rule does not apply



## Notice 2010-6: Examples

### Notice 2010-6 – Impermissible Payment Events and Schedules (cont.)

- **Failure:** Plan “toggles” payment form based on voluntary vs. involuntary separation from service (e.g., lump sum on involuntary separation but installments on voluntary separation)
- **Correction:** Amend plan before a separation from service to provide that the form of payment for voluntary separation is same as involuntary separation
  - One-Year Rule applies to voluntary separations
    - If a voluntary separation from service occurs within one year of correction date and results in the avoidance of a pre-amendment form of payment, employee includes 50% of the amount deferred in income and pays the 20% additional tax (but not additional interest tax); employer reports amount on Form W-2



## Notice 2010-6: Examples

### Notice 2010-6 – Impermissible Payment Events and Schedules (cont.)

- **Failure:** Multiple payment forms for non-separation from service event (e.g., lump sum for “Level 1” employee, installments for “Level 2”)
- **Correction:** Remove forms of payments, before payment event occurs, so that remaining forms are permissible
  - Remaining payment form must result in latest final payment date, or if that is not distinguishable, then keep the form that results in the latest possible commencement date
  - One-Year Rule applies
    - If voluntary separation from service within one year of correction and results in the avoidance of a pre-amendment form of payment, employee includes 50% of the amount deferred in income and pays the 20% additional tax (but not additional interest tax); employer reports amount on Form W-2



## Notice 2010-6: Examples

### Notice 2010-6 – Impermissible Payment Events and Schedules (cont.)

- **Failure:** Plan gives employer or employee discretion to change time and form of payment following a permissible payment event
- **Correction:**
  - Is there a default time/form rule? If so, delete discretion
  - If not, add the time/form rule that would result in the latest final payment date; if multiple forms yield same latest date, keep form with the latest possible commencement date
  - One-Year Rule applies
    - If payment event occurs within one year of correction, employee includes 50% of the amount deferred in income and pays the 20% additional tax (but not additional interest tax); employer reports amount on Form W-2



## Notice 2010-6: Examples

### Notice 2010-6 – Impermissible Payment Events and Schedules (cont.)

- **Failure:** Employer has impermissible ability to accelerate payment regardless of whether a payment event has occurred
- **Correction:**
  - Remove discretion/make acceleration permissible under §409A
  - Adopt change before earlier of (1) the date the employer irrevocably exercises discretion to accelerate payment or (2) the date discretionary acceleration payment is actually made
  - No One-Year Rule
- Not available if employee has discretion to accelerate
  - Example: plan allows acceleration with a “haircut”



## Notice 2010-6: Examples

### Notice 2010-6 – Impermissible Payment Events and Schedules (cont.)

- **Failure:** Plan provides for impermissible reimbursement or in-kind benefits (*e.g.*, reimbursement of country club dues upon termination for a specified amount over multiple years)
- **Correction:** Amend plan before event that would trigger the reimbursement (*i.e.*, termination) to be compliant, including that the specified amount be allocated ratably over the number of years for which the employee may receive reimbursements
  - One-Year Rule applies
    - If employee is eligible for the reimbursement or in-kind benefits within one year of correction, employee includes 50% of the amount deferred in income and pays the 20% additional tax (but not additional interest tax); employer reports amount on Form W-2



## Notice 2010-6: Examples

### Notice 2010-6 – Failure to Include Six-Month Delay

- **Failure:** Plan fails to include the requisite 6-month delay period for specified employees
- **Correction:** Amend plan before payment subject to 6-month delay to add 6-month delay.
  - Delayed payments cannot be made before the later of
    - 18 months following the correction and
    - 6 months following the payment date
  - One-Year Rule applies – If separation of service occurs within one year of correction, and 6-month rule applies, employee includes 50% of the amount deferred in income and pays the 20% additional tax (but not additional interest tax); employer reports amount on Form W-2



## Notice 2010-6: Examples

### Notice 2010-6 – Impermissible Initial Deferral Elections

- **Failure:** Allow noncompliant initial deferral election (e.g., defer before beginning of each month)
- **Correction:** Remove impermissible deferral election
  - Relief is only available if the impermissible deferral is not applied, or if it is applied, it is revoked in advance of the applicable initial deferral election deadline under §409A
  - Amendment must be adopted no later than the end of the employee's second taxable year immediately following the taxable year during which the deadline for making an initial deferral election under §409A occurs
  - No One-Year Rule



## Notice 2010-6: Added Requirements

### Notice 2010-6 – Additional Requirements for Relief

- Information and reporting requirements
  - Employer and employees required to disclose correction of document failure pursuant to Notice 2010-6 by attaching statement to their tax returns for the year of correction
- All plans with substantially similar failures must be corrected
  - The employer is required to take commercially reasonable steps to identify all other nonqualified deferred compensation plans with document failures that are substantially similar to the failure identified and corrected and correct all such failures in accordance with Notice 2010-6



## Notice 2010-6: Examples with Flexibility

### Notice 2010-6 - Flexibility to Utilize Other Provisions of Final Regs

- Nothing in Notice 2010-6 prohibits the ability to include certain payment events (i.e., death, disability, unforeseeable emergency)
  - Example: consider adding death as payment event when fixing failure to include 6-month delay period
- Nothing in Notice 2010-6 precludes use of exceptions to rule prohibiting accelerated payments
  - Example: due diligence in deal uncovers impermissible and permissible payment events - fix document and add change in control acceleration provision



## Notice 2010-6: Alternate Theories & Risk Tolerance

### Alternate Theories for Correcting §409A Failures & Risk Tolerance

- Alternate theories exist regarding the use of general tax principles to address §409A failures
  - Doctrine of rescission – disregard a transaction or payment by restoring parties to their original position as in effect prior to the transaction within the same taxable year
  - “Scrivener’s error” – intent was to draft plan one way and ultimate plan language did not appear that way
  - Claim of right – excluding excess payment amounts based on consensual recognition of repayment obligation
- Evaluate your risk tolerance before relying on these theories

## §409A Correction – What To Do Now

### §409A Follow up – What to Do When You Get Back to Your Office

- Sooner is always better when it comes to correcting §409A failures, particularly this year for document errors (2010 corrections are critical in light of transition relief)
- Review all arrangements for compliance & flag issues
  - How many “plans” are there?
  - Find employment agreements
    - Watch out for “we don’t have employment agreements”
    - What about offer letters or other communications that are not viewed as official “employment agreements”?
  - What type of errors are there?
    - Operational vs. Document
    - Ambiguous plan terms



## §409A Correction – What To Do Now

### §409A Follow up – What to Do When You Get Back to Your Office

- Fix all errors in accordance with guidance
  - Some errors are correctible under IRS guidance
  - Some errors can be fixed outside the guidance or without official IRS correction filings
- Keep good records
  - What errors were found? Document correction or lack of need for correction
  - Remember to attach statements to tax returns and provide relevant statements to employees as necessary



# It's A New Day With §409A: Notice 2010-6

## Your Questions??

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