

# CLIENT ACTION Bulletin

Employee Benefits

## IRS Announces Voluntary Correction Relief for NDCP Documents

**SUMMARY** Nonqualified deferred compensation plan (NDCP) sponsors can now correct certain *unintentional document failures* of the requirements of tax code section 409A, under a new self-correction program recently announced by the IRS. *Notice 2010-6* provides guidance on eligibility requirements, types of correctable documentary failures, information and reporting requirements, and transition relief. It is intended to work in tandem with the previously released 409A guidance (*Notice 2008-113*) for correcting certain operational errors (see *Client Action Bulletin 08-25*). The 409A requirements apply to NDCPs beyond deferred compensation arrangements for executives, extending broadly with only limited, specified exclusions (e.g., 457(b) plans).

### DISCUSSION Purpose and Effect of the Notice

The corrections program is aimed at encouraging NDCP sponsors to review their plans to identify noncompliant provisions and correct such failures promptly, while also not providing an advantage to participants in NDCPs that initially fail to comply over participants in NDCPs that were originally drafted in full compliance with 409A. Accordingly, the Notice:

- **clarifies that certain ambiguous language** commonly included in plan documents (e.g., “distribution will be made as soon as administratively possible” following an applicable payment trigger) will not automatically cause a document failure if, among other requirements, such ambiguity was not intentional and the plan is operated in compliance with 409A;
- **offers full relief** — i.e., without triggering current income inclusion and the additional adverse tax consequences imposed under 409A — for the correction of specified document failures, provided (1) in certain circumstances, where an event that would be affected by application of the corrected plan provision does **not** occur within one year following the date of the correction, or (2) if the plan is the sponsor's first plan of this type (disregarding any plans not subject to 409A or any plans under which all deferred amounts have previously been paid or forfeited) and the failure is corrected within a limited period following adoption of the plan;
- **grants partial relief** — i.e., limits the amount currently includible in income and the additional adverse tax consequences imposed under 409A — for certain document failures if an event that would be affected by the application of the corrected plan provision **does** occur within one year after the date of the correction; and
- **provides transition relief** permitting corrections of certain document failures without triggering current income inclusion or additional taxes under 409A, if the document failure is corrected by Dec. 31, 2010, and any operational failures resulting from the document failure are also corrected by Dec. 31, 2010, in accordance with *Notice 2008-113*.

*Notice 2010-6* also clarifies some aspects of the 409A operational corrections described in *Notice 2008-113*, including the application of the “subsequent year” correction method to late payments of amounts deferred; and the calculation of amounts that must be paid or repaid to a participant as a correction of a late or early payment of an amount deferred under an NDCP, if such a payment would have been made in property (e.g., shares of stock).

### Permissible Corrections

Only certain types of document failures are eligible for relief. Among these are:

- **Missing or Inadequate Definitions**, such as either failing to define or improperly defining otherwise permissible payment events (e.g., “termination of employment,” “disability,” “separation from service,” “change in control,” or “acquisition”).

- **Problematic Payment Periods**, such as a plan provision that provides that payment will be made following a permissible event under 409A, but designates an unacceptable period (e.g., later than 90 days and earlier than 366 days) for the commencement of payment, or designates a payment period that is conditioned upon the participant completing certain employment-related actions (e.g., executing a noncompetition or nonsolicitation agreement or a release of claims).
- **Unacceptable Alternative Payment Schedules**, such as impermissible alternative payment schedules that apply depending on which payment trigger occurs (e.g., participants who involuntarily separate from service receive lump sums while participants who voluntarily separate from service receive annual installments).
- **Problematic Payment Events**, such as permitting payment upon an initial public offering (that does not otherwise constitute a change in control under the 409A regulations) or enrollment of a child in college.
- **Excessive Discretion** given to the sponsor or participant to: (a) change the time or form of a payment that is due (e.g., discretion to pay in a lump sum or annual installments); (b) delay payments if certain cash-flow targets are not met; (c) make subsequent deferral elections; or (d) accelerate payment events (e.g., discretion to pay before the participant separates from service, even though the plan provides for payment upon separation from service).
- **Unacceptable Reimbursements or In-Kind Distributions**, such as reimbursing country, health, or similar club dues or making stock distributions after separation from service in a manner that is not compliant with the 409A rules governing such payments.
- **Not Including the Mandatory Six-Month Delay** for payments to “specified employees” of public companies.
- **Mistimed Initial Deferral Elections**, such as applying the election deadline for performance-based compensation to a bonus that does not qualify as such.

### Eligibility for Correction

In addition to specifying the requirements for correcting document failures, the Notice includes certain information and reporting requirements for both NDCP sponsors and participants. The burden of demonstrating eligibility for the program, as well as satisfaction of the requirements, rests with the taxpayer seeking relief. The NDCP sponsor also must take “commercially reasonable” steps to identify and correct all of its other NDCPs that contain a similar failure. The relief only applies to failures that are inadvertent and unintentional; no relief is available if the failure: (a) applies to stock rights; (b) relates to the linkage of the NDCP to another NDCP (with a limited exception for corrections made before Dec. 31, 2011) or a qualified plan; (c) directly or indirectly relates to participation in any tax avoidance transaction; or (d) in general, if prior to the date the failure is corrected, the sponsor or participant comes under IRS examination regarding nonqualified deferred compensation.

### ACTION

A failure to comply with 409A can result in severe penalties (i.e., immediate income inclusion and thus taxation of all amounts deferred, plus a “premium interest tax,” plus an additional 20% tax penalty on the participant). The new document corrections program affords NDCP sponsors and participants a valuable opportunity to review all NDCPs that provide for deferral of compensation — whether they are executive-only deferred compensation arrangements, employment contracts, supplemental executive retirement plans (SERPs), excess benefit plans, or shareholder agreements — and take corrective steps to avoid or at least reduce the potentially expensive consequences of 409A noncompliance. Prompt action is recommended, because the IRS has begun a major 409A compliance audit campaign that targets both corporate and individual tax returns, and the opportunity to correct is lost once the NDCP sponsor or participant comes under examination. In addition, the new guidance indicates that the sooner plan document failures are identified and corrected, the more likely that income inclusion and penalties can be avoided. Given that the corrections procedures are complex and may call for specific reporting requirements, NDCP sponsors should consult with qualified counsel in 409A matters as soon as possible.

For additional information about the IRS’s voluntary NDCP document corrections program or for assistance with establishing a correction action plan for reviewing and/or correcting your NDCPs, please contact your Milliman consultant.

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