Voluntary correction program for nonqualified deferred compensation document failures

By Marcia S. Wagner, Esq.

Highly compensated employees often seek to defer tax by entering into nonqualified deferred compensation arrangements with their employers. This often takes the form of a so-called "excess plan" that is linked to a qualified 401(k) plan in order to allow executives to defer salary beyond what the 401(k) limits on contributions or nondiscrimination testing would otherwise allow. In many cases, the provisions of these nonqualified plans mirror those of the 401(k) plan.

Deferred compensation agreements, supplemental executive retirement programs, and certain severance arrangements are regulated by Section 409A of the Internal Revenue Code. Section 409A, and the regulations promulgated thereunder, form an extraordinarily complex set of rules regulating elections to defer compensation and subsequent election changes. They also limit the events upon which deferred compensation may commence.

Because of the complexity of the rules, many deferred compensation plans and agreements inadvertently fail to comply with Section 409A. Failure to satisfy the 409A requirements has significant adverse tax consequences: amounts that are improperly deferred are currently taxable to the employee and are subject to a 20% excise tax plus interest and penalties.

A violation of Section 409A can arise due either to a failure in the operation of the plan or to a violation in the plan terms. The IRS published its long-awaited program for correcting documents that fail to satisfy Section 409A. This guidance, set forth in Notice 2010-6, provides employers and employees with a program under which they may bring their nonqualified deferred compensation agreements into compliance. IRS Notice 2010-6 establishes a voluntary correction program for *plan document errors* under Section 409A. This correction program follows earlier correction programs established by the IRS for *operational errors* under Section 409A. Notice 2010-6 allows sponsors to correct plan language defects and limits or eliminates the application of the Section 409A penalties to participants in such plans.

Under the Notice, certain document failures may be corrected without having to pay any taxes, provided that the corrected plan provision does not affect the operation of the plan within one year following the date of the document correction. If the corrected plan provision does affect plan operation within one year, the Notice provides limited relief, reducing but not totally eliminating the taxes otherwise applicable to a Section 409A document failure.

The types of plan document failures that may be corrected under this program include impermissible payment events, incorrect definitions of events that are acceptable payment events, impermissible discretion to modify a payment schedule, impermissible discretion to accelerate payment events, and impermissible initial deferral elections.

In order to qualify for relief under the Notice, neither the employer nor the employee may already be under audit for the item, the employee must pay any reduced taxes that are due under the program, and the parties must satisfy certain disclosure requirements. Relief under the Notice is not available for a document failure unless, in addition to properly correcting the failure, the employer takes commercially reasonable steps to identify and correct *all* other nonqualified deferred compensation plans that have a substantially similar failure.

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Special attention is required in the case of a linked plan where the amount deferred or the time or form of payment under the nonqualified plan is determined by the amount deferred or the time or form of payment under another plan. Where the other plan is a 401(k) plan, the IRS thinks that there is no true lock-in of the time or method of payment under the nonqualified plan. Because of its view that linkage to a qualified plan gives the employee too much discretion, there is no fix under the notice when a nonqualified plan is linked to a 401(k) plan or other qualified plan, although the American Bar Association has requested that this position be reconsidered. Where a nonqualified plan is linked to another nonqualified plan, the notice specifies that document failures due to the linkage may be corrected by December 31, 2011, provided that the time and form of payment under the two linked plans are made identical.

The Notice includes a transition rule whereby corrections that otherwise would have resulted in reduced taxes may be corrected by December 31, 2010, without the payment of *any* tax or penalty.

Note: (1) Employers and employees who maintain deferred compensation arrangements should review them to determine if there are any deficiencies that should be corrected under the Notice. This would include reviewing

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separate deferred compensation plans and agreements, as well as employment agreements that incorporate compensation deferral features. (2) The IRS commenced audits of Section 409A plans in 2009. The IRS has recently announced that it will review executive compensation arrangements, including nonqualified deferred compensation arrangements, for 6,000 taxpayers. Employers should take the opportunity to review plan documents now and make any needed corrections. (3) If nonqualified benefits remain unvested through the end of 2010, employers may be able to make corrections by means of a 2010 plan amendment outside of the correction procedure described in the notice. This can be helpful in avoiding onerous aspects of the notice, such as information reporting. ❖

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