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How to Correct Plan Document Errors in Nonqualified Deferred Compensation Plans

Market Trend: An IRS program permits certain plan document failures under Section 409A of the Internal Revenue Code to be corrected with reduced tax costs, if timely identified and fixed.

Synopsis: Section 409A of the Internal Revenue Code subjects nonqualified deferred compensation plans to strict rules regarding the timing of deferral elections, as well as the permitted time and form of benefit payments. These payment rules must be clearly set forth in writing as part of the plan document. Failure to properly document the plan can trigger significant tax costs for participating employees, including accelerated income recognition and a 20% additional tax. Even minor document failures can trigger these adverse tax results. The IRS, however, provides a special correction program in which certain document failures can be fixed at no, or substantially reduced, tax cost. The sooner the error is corrected, the better chance that there will be no tax cost associated with the correction under the IRS program. This article summarizes several common document failures under Section 409A and how those failures can be corrected under the IRS program.

Takeaways: Sponsors of nonqualified deferred compensation plans should identify which of their plans are subject to Section 409A and carefully review them to ensure that the plan document satisfies all of Section 409A's document requirements. If a document error is identified, however, a fairly simple correction may be available under the IRS correction program that could significantly reduce the cost of the error.

WHY COMPLIANCE WITH 409A IS IMPORTANT

Nonqualified deferred compensation ("NQDC") plans come in a variety of shapes and sizes, including plans that allow participating employees to electively defer payment of salary or bonuses, plans that make up for missed employer contributions to tax-qualified retirement plans due to IRS limits and

supplemental executive retirement plans that provide enhanced retirement benefits to select executives. Even non-retirement plans, like severance arrangements and certain equity compensation awards, can be a type of NQDC plan. However, each of these NQDC plans share an important trait – each must comply with the stringent requirements of Section 409A ("409A") of the Internal Revenue Code (the "Code").

Under 409A, NQDC plans must:

- include specific rules for the timing of elective deferrals for plans that permit elective deferrals;
- fix the time and form of payment upfront when amounts are initially deferred;
- require payments to commence only upon certain specified events, such as death, disability, separation from service, a fixed date or schedule or a change in control;
- prohibit acceleration or further deferral of payments once the time and form of payment is set (subject to limited exceptions); and
- for public companies, delay payments triggered by a separation from service for certain "specified employees" – generally, the top fifty most highly compensated officers – until six months after the separation from service.[1]

A NQDC plan must comply with 409A's requirements both in form and operation.[2] A failure, either in form or operation, may result in significant adverse tax consequences under 409A, particularly for plan participants.[3] When a 409A failure occurs, income is accelerated on the participant's vested benefits to the year of failure, and the participant must pay an additional tax equal to 20% of that income, as well as an increased interest-based tax due on the compensation.[4] The failure applies not only to the specific amount involved for the participant, but all amounts due to the participant under the plan and any other plans of the employer that are required to be aggregated under 409A (referred to as the "plan aggregation rule").[5]

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[1] *See* Treas. Reg. § 1.409A-3(i)(2)(i); Treas. Reg. § 1.409A-1(i)(1)

[2] See our prior article about correcting 409A operational errors "*Whoops – What to Do When You Discover an Operational Error in a Non-Qualified Deferred Compensation Plan*" in the Finseca Resource Library.

[3] The employer also faces certain consequences for a 409A failure, especially certain reporting obligations to the IRS and withholding on accelerated amounts, and the employer can face certain penalties if it fails to properly report and withhold. But these consequences are generally not as severe as those faced by the participant. Employers may also face potential employee relations-related backlash, especially if any employee must pay significant additional taxes due to a 409A failure for an operational error that they did not cause.

[4] *See* I.R.C. § 409A(a)(1)

[5] See Treas. Reg. § 1.409A-1(c)(2)(i); common categories of plans that must be aggregated include all elective account balance plans, all non-elective account balance plans, and all non-account balance plans in which a participant has a benefit.

A NQDC plan must be set forth in writing and include all the material terms necessary for compliance with 409A. A failure to properly draft the NQDC plan can trigger the adverse tax consequences noted above. As a result, even minor, scrivener's errors can potentially create 409A tax liabilities, in addition to creating issues on audit or during due diligence for companies undergoing a sale.

IRS PROGRAM FOR CORRECTING 409A DOCUMENT ERRORS

Given the strict nature of the 409A documentary compliance requirements, employers should identify which of their NQDC plans are subject to 409A and meticulously review those plans to ensure they have been properly drafted to clearly comply with 409A. That being said, given the complexity of 409A's requirements, drafting mistakes happen. Thankfully for employers and participants alike, in the event that a 409A document failure occurs, the IRS offers a program to correct certain failures. Under Notice 2010-6 (the "Notice"), as later supplemented by IRS Notice 2010-80,[6] the IRS sets forth procedures for taxpayers to correct certain inadvertent 409A documentary failures.

General Requirements for Corrections under the Notice

Generally, in order to qualify for correction under the Notice, three preliminary requirements must be met: (1) the plan sponsor of the NQDC plan cannot already be under examination by the IRS; (2) the error must be unintentional; and (3) the plan sponsor must make a good faith effort to identify and correct all of its NQDC plans with the same error.

The Notice sets forth the types of errors eligible for correction and the requirements for correcting each. In some cases, the correction will not require any additional tax costs. In other cases, the correction may require income to be recognized and a reduced 409A tax to be paid. A number of the corrections trigger an additional (but reduced) tax cost only if a problematic event occurs within one year after the correction, thereby encouraging taxpayers to identify and correct errors sooner rather than later. Even where there is an additional tax cost to the correction, the Notice provides that the 409A plan aggregation rule does not apply, so that the correction costs relate only to the plan with the failure being corrected. We review a number of the key categories of errors and corrections below.

Additionally, for certain errors, the Notice requires the plan sponsor to provide the NQDC plan participants with a written statement about the correction that the participants are required to file with their individual tax returns. The plan sponsor must also file a similar written statement with its own tax return. Additional details about these written statements are provided below.

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[6] *See* I.R.S. Notice 2010-6, 2010-3 I.R.B. 275.

Common Document Errors and Corrections

The following is a summary of a number of the most common types of document failures addressed by the Notice. However, please note that this is not intended to be a comprehensive summary of all categories of document failures the Notice addresses.

Ambiguous Plan Provisions	
Description	The NQDC plan includes provisions that do not clearly comply with 409A, but also are not clearly a violation.
Example(s)	- The NQDC plan states that payments will be made "as soon as administratively practicable" after a permitted 409A payment event but without specifying any latest payment date. - The NQDC provides for payment upon "termination of employment" but without specifying that the payment event must qualify as a "separation from service" as defined under 409A. - The NQDC provides for payment upon a "change in control," "acquisition," "sale," or similar term without specifying that the event must be a 409A "change in control event."
Correction	No 409A failure as long as (1) the NQDC plan is administered consistently with 409A and (2) the ambiguity was unintentional. To correct, the plan sponsor must amend the NQDC plan to remove the ambiguity.
Cost	No additional cost to correct.

Permitted Payment Trigger with Non-compliant Definition	
Description	The NQDC plan correctly requires payment upon a permissible 409A payment event, but the definition of that payment event in the NQDC plan does not comply with the requirements of 409A.
Example(s)	- Payment triggered by "separation from service," but the NQDC plan would treat "separation from service" to occur even if the employee continues to provide substantial services as a consultant. - Payment triggered by a "change in control" that includes a threshold level of change in ownership lower than that permitted by 409A. - Payment triggered by a "disability" that is defined differently than the 409A required definition.
Correction	To correct, amend the NQDC plan to provide for a compliant payment event definition. In case of "disability," the NQDC plan could also be amended to remove "disability" as a payment event.

Cost	For a correction related to "separation from service" or "change in control," if no event occurs within a year after the corrective amendment, there is no additional cost. However, if an event occurs within a year that would have been a payment event under the prior, non-compliant definition, a portion of the NQDC plan benefit for the participant has to be included in income and treated as a 409A failure in that year with the 20% additional tax applied on that amount. The portion of the NQDC plan benefit treated as a 409A failure is 50% in case of a "separation from service" correction and 25% in case of a "change in control" correction. For a "disability" correction, there is generally no additional cost (unless the correction is made after a payment was made based on an impermissible definition).

Impermissible Payment Periods Following Permissible Payment Events	
Description	The NQDC plan correctly requires payment upon a permissible 409A payment event but provides discretion to make the payment more than 90 days after the event.
Example(s)	- The NQDC plan permits payment to be made within 120 days after a 409A separation from service. - The NQDC plan provides that payment will be made after a separation from service and within 30 days after a release of claims provided by the participant becomes effective, but without limiting the time for the release of claims to become effective in relation to the 409A separation from service.[7]
Correction	To correct, amend the NQDC plan to require payment no later than a time permitted by 409A (*e.g.*, no more than 90 days after the payment event, so long as the employee cannot pick the year of payment). For a correction related to impermissible participant discretion as to the timing of payment based on a release of claims requirement, special rules for the correction may apply (such as requiring payment in the later of two years if a release consideration period crosses two years).
Cost	Generally, there is no additional cost for the correction. But if the correction is made within 90 days after the applicable payment event (rather than before the payment event), 50% of the payments are treated as a 409A failure and subject to the 20% additional tax on that amount.

[7] This potential failure related to the timing of a release of claims caught many taxpayers off guard when announced by the IRS and still can seem non-intuitive. The IRS' concern is that an employer and/or former employee will have impermissible discretion in deciding the year of payment by deciding how long the employee will be given to execute the release.

Plan Includes Both Permissible and Impermissible Payment Events	
Description	The NQDC plan includes one or more payment events that are not permitted payment events under 409A, but also includes payment events that comply with 409A.
Example(s)	The NQDC plan provides for payment on the earliest of a separation from service, change in control, or initial public offering ("IPO"); an IPO is not a 409A permitted payment event.
Correction	To correct, amend the NQDC plan to remove the non-compliant payment event. In the example above, this would mean removing the IPO payment event, resulting in payment on the earlier of separation from service or change in control.
Cost	Generally, there is no additional cost for the correction. But if the non-compliant payment event (such as the IPO in the example) occurs within a year after the correction, 50% of the NQDC plan benefit for the participant has to be included in income for that year and treated as a 409A failure with the 20% additional tax on that amount.

Plan Includes More Than One Possible Payment Schedule for Single Payment Event	
Description	The NQDC plan includes more than one possible payment schedule – *e.g.*, a lump v. installments – for a single 409A payment event. This issue is sometimes referred to as the "toggle rule." The concern is that the design provides impermissible "back-end" discretion in selecting the period over which payments are made.
Example(s)	- A NQDC plan provides for installment payments over five years in case of a voluntary separation from service and an immediate lump sum payment in case of an involuntary separation from service. - A NQDC plans provides for installment payments over five years in case of separation from service, provided that if the separation from service is due to "disability" (not defined in accordance with the 409A required definition), the payment is in a lump sum.
Correction	To correct, amend the NQDC plan to keep only the longest of the payment schedules – *e.g.*, in the examples above, by having payments always made in annual installments over five years.
Cost	Generally, there is no additional cost for the correction. But if a payment event that had the problematic payment schedules occurs within a year after the correction, 50% of the NQDC plan benefit for the participant has to be included in income for that year and treated as a 409A failure with the 20% additional tax applied on that amount.

Plan Includes Impermissible Discretion to Accelerate or Delay Payments	
Description	A NQDC plan provides either the employer or the employee with discretion to change an otherwise compliant payment schedule, to either defer or accelerate payments.
Example(s)	- A NQDC plan allows a participant to elect payments upon separation from service to be in either a lump sum or installments over five years, although if no election is made, payments will be in a lump sum. The election can be made at the time of separation from service. - A NQDC plan provides for payment upon a 409A change in control in either annual installments over five years or a lump sum, as determined by the employer at the time of the change in control.
Correction	The NQDC plan should be amended to remove the impermissible discretion. If the NQDC plan includes a default payment schedule (such as in the first example), the amendment should fix the payment schedule to match the default rule (*e.g.*, the lump sum payment in the first example) and eliminate the discretion to pick an alternative schedule. If the NQDC plan does not include a default payment schedule (such as in the second example), the amendment should fix the payment schedule to be the longest schedule that could have otherwise applied (*e.g.*, the annual installments over five years in the second example).
Cost	Generally, there is no additional cost for the correction. But if a payment event that includes the problematic discretion occurs within a year after the correction, 50% of the NQDC plan benefit for the participant has to be included in income for that year and is treated as a 409A failure with the 20% additional tax applied on that amount.

Elective Deferral Plan Includes Impermissible Deferral Election Period	
Description	A NQDC plan that permits elective deferrals allows for deferral elections to become effective later than the latest date permitted by 409A.
Example(s)	An elective deferral plan allows an employee to elect to defer a cash bonus earned for performance during the 2023 calendar year (which does not otherwise qualify as "performance-based compensation" under 409A) by March 31, 2023. 409A requires the deferral election to become irrevocable by December 31, 2022.

Correction	Assume the employee in the example made a deferral election on December 1, 2022. If the employer catches the error before December 31, 2022, it can simply revoke the deferral election before December 31, 2022. But even if the employer catches the error in 2023, before a bonus was payable (in early 2024), the employer can revoke the deferral election effective as of December 31, 2022. The employer should amend the NQDC plan to include a 409A-compliant latest effective date for deferral elections.
Cost	There is no additional cost for the correction.

Notice Requirement to Participants and the IRS

Any time an employer corrects a 409A document failure under the Notice (other than fixing compliant provisions that are simply ambiguous), the employer must attach a statement entitled "§409A Relief under §[Section Number] of Notice 2010-6" to its timely-filed (including extensions) original federal income tax return for the taxable year in which it discovers the failure. Such statement must set forth the following information:

1. The name and taxpayer identification number of each participant affected by the failure and, for a correction in the year of the failure, whether such participant is an insider with respect to the employer. Where the same or a substantially similar document failure has occurred with respect to multiple participants, the information under #2-4 below may be supplied only once with respect to such document failure, provided that the identification of each participant affected by the failure references such information.

2. Identification of the NQDC plan with respect to which such failure occurred.

3. A statement that the document failure is eligible for correction under the Notice, which includes identification of the section of the Notice under which the document failure is being corrected. This statement must indicate that the employer has taken all required actions and otherwise met all requirements for such correction as of the last day of the employer's taxable year in which the correction is made, and also as of the last day of any subsequent taxable year during which an amount is required to be included in income under 409A by a participant as part of the correction (*e.g.*, if an event occurs within one year after the correction). Additionally, the statement should provide the date of the correction and the date of any event causing the inclusion of an amount in income under 409A by the affected participant.

4. The amount involved in each document failure and, to the extent applicable, the amount reported by the employer as includible in income under 409A as part of the correction and the percentage of the amount involved in each document failure required to be included in income under 409A as part of the correction.

In addition, not later than the date (with extensions) on which it is required to provide an information return (*i.e.,* Form W-2 or 1099) for the calendar year in which it corrects a document failure (or any subsequent year if an amount is required to be included in income under the correction), the employer must provide to each affected participant a statement entitled "§409A Relief under §[Section Number] of Notice 2010-6" setting out the following information:

1. A statement that the participant is entitled to the relief provided in §[Section Number] of the Notice with respect to a failure to comply with 409A and that the participant must attach a copy of the statement to the participant's income tax return for the taxable year in which the failure was corrected (or any subsequent year if an amount is required to be included in income under the correction).

2. The information described under #2-4 above.

Each participant must attach a copy of this statement to his or her timely filed (including extensions) original federal income tax return for the year in which the document failure was corrected, and also for any subsequent year if 409A taxis required to be included in income under the correction rules (*e.g.*, if an event occurs within one year after the correction).

Correcting Plan Documentary Errors Outside the Notice

In some cases, there may be ways to correct a 409A document failure without having to rely on the Notice. Unfortunately, many of these alternative approaches have not yet been fully tested by the IRS or the courts. There is, however, an approach that is authorized under the IRS proposed regulations related to income inclusion for 409A failures.[8] Under these proposed regulations, if an amount of NQDC is subject to a substantial risk of forfeiture (*i.e.*, it is unvested) through the end of a calendar year, and if the NQDC plan includes an unintentional 409A document failure regarding the payment events or payment schedule for a later year after the NQDC becomes vested, that unintentional document failure can be corrected without incurring 409A costs before the end of that calendar year. This opportunity presents a narrow exception, though, in practice, it arises only infrequently.

409A Saving Clauses

All NQDC plans should have a comprehensive 409A savings clause. Adding a 409A savings clause is one of the most effective correction methods available because it renders all ambiguous terms 409A-compliant and, in some cases, may even serve to override non-compliant terms with compliant terms. Accordingly, employers should review their NQDC plans to ensure they contain a 409A savings clause and, if not, amend the plan to include one. Further, when drafting a NQDC plan, employers can mitigate their exposure to potential documentary failures by working with their counsel to include a well-drafted savings clause in the plan.

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[8] *See* Prop. Treas. Reg. § 1.409A-4(a)(1)(ii)(B).

CONCLUSION

Documentary compliance with 409A presents numerous potential traps for the unwary. Employers should clearly identify all arrangements that qualify as NQDC plans under 409A and have those arrangements reviewed by specialists to ensure they comply with 409A. Employers who discover 409A document errors should explore correcting those errors as soon as possible under the Notice in order to limit the potential costs of correction.

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