Pension Analyst

Compliance Bulletin

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IRS modifies correction guidance for nonqualified deferred compensation plans

These correction procedures are available to sponsors of and participants in nonqualified defined benefit or defined contribution plans that provide for the deferral of compensation (section 409A plans), including section 457(f) plans. For purposes of this publication, we will refer to these plans as "nonqualified deferred compensation plans."

Background and summary

The American Jobs Creation Act of 2004 (AJCA) created Internal Revenue code section 409A providing new rules for the administration of nonqualified deferred compensation plans. Since the enactment of the law, the IRS has published proposed and final regulations and other guidance covering a variety of issues, including rules for deferral elections, distributions, funding arrangements and tax reporting. These new rules required changes to most nonqualified deferred compensation plans. If these rules are violated, participants are taxed immediately on the amounts they have deferred. They are also subject to a 20% penalty and interest as if the deferred compensation had been included in their income.

Recognizing the difficulty that plan sponsors were experiencing in attempting to comply with the complex new rules and the heavy penalties imposed on plan participants when plan sponsors failed to comply with these rules, the IRS developed some special correction procedures. In December 2008, the IRS provided guidance for correcting certain 409A operational failures. In January 2010, the IRS provided guidance for correcting certain document failures by nonqualified deferred compensation plans.

More recently, the IRS issued Notice 2010-80, modifying some provisions of the original correction procedures and providing additional relief for employers that voluntarily correct failures. Specifically, Notice 2010-80:

- Clarifies that the types of plans eligible for the document correction program include nonqualified plans linked to a qualified plan or another nonqualified plan;
- Expands the types of plans eligible for the document correction program to include certain stock rights;
- Provides an additional correction method for certain failures involving payments at separation from service;
- Provides relief from the employer information reporting requirements under the document correction program; and
- Provides relief from the requirement that employers provide certain information to employees under Notice 2008-113 for corrections made in the same taxable year as the failure occurs.

Eligibility requirements

Previously, the IRS provided relief from the standard tax penalties for plan document failures when all of the following conditions are met:

- Similar failures under all other nonqualified deferred compensation plans are corrected.
- Neither the employee nor the employer is under audit by the IRS for the year the document failure existed.
- The failure is inadvertent and unintentional.
- Amounts required to be included in income are included in the employee's income, and any applicable additional taxes are paid.
- Information and reporting requirements are met.

Notice 2010-80 expands and clarifies the types of plans eligible for this relief to include linked plans and certain stock rights.

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Linked plans

Linked plans are plans where the amount deferred or payment provisions are determined by the amount deferred to or payment of benefits from another nonqualified deferred compensation plan or a qualified employer plan. A linked plan is now eligible for plan document correction relief as long as the link between the plans simply changes the amount payable under the plan, but does not affect the time or form of payment.

Certain stock rights

Document correction relief is also available for certain stock rights which at the time of grant provided the recipient the right to exercise the stock right *only* upon one or more of the following:

- A fixed date or a period beginning and ending within one taxable year (generally the calendar year for individual taxpayers); or
- A permissible payment event under the 409A regulations, including a correction payment event.

Payments conditioned on employment-related actions

As a general rule, section 409A allows plans to provide for a payment period following a payment event (e.g., separation from service) that does not exceed 90 days, as long as the employee is not allowed to elect the year of payment.

Under its original plan document correction rules, the IRS provided a correction for payment periods exceeding 90 days. This correction allows the employer to amend an eligible plan provision, before the payment event occurs, to either:

- Remove the period following the payment event during which payment may be made; or
- Set forth a period immediately following the payment event that complies with the general section 409A rules.

Notice 2010-80 provides an additional method of correction for document failures involving payments that depend on the employee completing certain actions at separation from service, such as the execution of a noncompetition agreement, a nonsolicitation agreement or a release of claims.

If a plan is eligible for correction, and payments are made on or before March 31, 2011, the plan will be treated as complying with the section 409A rules and a plan amendment is not needed.

However, if payments are made after March 31, 2011, the plan must be amended to reflect that payments must be made within 90 days after the payment event. However, if the 90-day period is carried over into the next taxable year, the payment must be made in the second taxable year.

The IRS also provides transition relief through December 31, 2012, to make the correction, provided that if a payment period spans two taxable years, the payment is made in the second taxable year.

Information reporting relief

Previous IRS correction guidance generally required employers to provide information regarding corrections to affected employees and attach an information statement to the employer's tax return. Notice 2010-80 eliminates the requirement to provide information to affected employees for corrections where the new transition relief for payments conditioned on employment-related action applies. However, the employer must still attach the information statement to its federal income tax return.

In addition, the IRS originally required employers to provide an information statement to each employee affected by an operational correction if the failure was corrected in the same taxable year in which the failure occurred. Notice 2010-80 eliminates this notification requirement. However, the employer must still attach the statement to its federal income tax return.

Effective date

Employers may follow the modifications made to the operational correction rules for taxable years beginning on or after January 1, 2010. The modifications to the plan document correction rules apply for taxable years beginning on or after January 1, 2009.

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