



# Pension Analyst

Important information

Plan administration and operation

July 2010

## IRS provides document correction procedures for nonqualified deferred compensation plans

### Who's affected

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 the 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](#) included new tax laws applicable to nonqualified deferred compensation plans under new Internal Revenue Code section 409A. Since the enactment of this law, the IRS has published proposed and final regulations and other guidance that cover 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.

In December 2008, the IRS provided [correction guidance](#) regarding certain 409A operational failures in [Notice 2008-113](#). This guidance, however, did not address document failures.

In January 2010, the IRS provided relief and guidance on corrections of certain document failures by nonqualified deferred compensation plans. This document correction program, described in [Notice 2010-6](#) is intended to encourage employers to review their nonqualified deferred compensation plans, identify provisions that fail to comply with 409A, and correct those provisions promptly. Notice 2008-113 remains in effect to address the correction of 409A operational failures, with some modifications. This publication discusses the document correction procedures, as well as the modifications to correction guidance for operational failures.

### Action and next steps

Employers that sponsor nonqualified deferred compensation plans and their legal counsel may wish to familiarize themselves with this IRS guidance and decide whether to review plan documents to determine if they meet IRS requirements. If document failures have occurred, employers should discuss the correction options described in this *Pension Analyst* with their legal counsel to determine if any are appropriate for their situation. If amendments are needed, employers should expedite corrections during 2010 in accordance with transition relief to avoid or reduce penalties where possible.

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**Related documents**

[Glossary of special terms](#)  
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Since the enactment of the American Jobs Creation Act of 2004, the IRS has published a series of complex rules, which employers that sponsor nonqualified deferred compensation plans must follow. Nonqualified deferred compensation plans were required to have their plan documents in compliance with these rules by January 1, 2009. To assist employers and participants, the IRS has now provided procedures for correcting certain document failures. If these procedures are followed, the immediate taxation and 20% penalty that would normally apply to affected participants may be reduced or avoided altogether.

**Eligibility requirements**

Generally, relief for document failures is available if the following conditions are met:

- Similar failures under other nonqualified deferred compensation plans are corrected. The employer must take “commercially reasonable” steps to identify and correct all other nonqualified deferred compensation plans and arrangements subject to section 409A, not just those covering the same employees as the plan in question.
- 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.

Relief is not available for:

- Failures directly or indirectly related to participant in an [abusive tax avoidance transaction](#);
- Failures involving stock rights; and
- Linked plans, except as provided in a special transition rule. Linked plans are plans where the amount deferred or payment provisions are determined by the amount deferred or payment provisions of another nonqualified deferred compensation plan or a qualified employer plan.

The taxpayer requesting the relief (the employee, the employer, or both) has the burden of demonstrating to the IRS that he is eligible for relief and the IRS may audit any request for this type of relief.

**Procedures for correction**

An employer must take the following steps to correct a failure of a document to comply with section 409A.

*STEP 1: Determine if the identified failure can be corrected under IRS Notice 2010-6.*

In general, the following types of failures are eligible for correction:

1. Impermissible definitions of otherwise permissible payment events.
2. Impermissible payment periods following a permissible payment event.
3. Certain impermissible payment events and payment schedules.
4. Failure to include six-month delay of payment for specified employees
5. Provisions providing for impermissible initial deferral elections.
6. Document failures for an employer’s initial plan.

*STEP 2: Use the IRS method of correction.*

Specific correction methods must be used for each of the covered operational failures. The correction methods and resulting relief are described in the document titled [Eligible document corrections under Notice 2010-6](#).

*STEP 3: Comply with the IRS and Employee Notification Requirements*

Except for situations involving “certain ambiguous plan terms,” an employer must comply with notice and reporting requirements. An employer that makes a correction according to these procedures must attach a special statement to its federal income tax return for the tax year it corrects the failure. The employer must also attach this statement to its tax

return in a later tax year if an employee is required to include an amount in income during a later year to be eligible for relief. The statement must contain the following information for each corrected failure:

- The name and taxpayer identification number of each employee affected by the document failure. Where the same or substantially similar document failure has affected multiple employees, the notice may be supplied only once for each failure, as long as the identification of each affected employee references that information;
- Identification of the nonqualified deferred compensation plan;
- A statement that:
  - The document failure is eligible for the correction under Notice 2010-6, identifying the section of the Notice under which the document failure is corrected, and
  - The employer has taken all actions required and otherwise met all requirements for such correction on the last day of the employer's tax year in which the correction is made, and any later tax year an amount required to be included in income by an employee as part of the correction.

This statement must also provide the date of correction and the date of any event causing the inclusion of an amount by the affected employee; and

- The amount involved in each failure, and if applicable, the amount reported by the affected employee and the percentage of the amount involved in each document failure request to be included in income as part of the correction.

In addition, the employer must provide the following information to each employee affected by the correction:

- A statement that the employee is entitled to relief under IRS Notice 2010-6, and that the employee must attach a copy of that statement to his tax return for the year the failure was corrected and also any later tax year in which an amount is included in income as part of the correction;
- The information required to be provided in the statement the employer attaches to its tax return, but only if that information relates to the deferred amount of that employee.

The employee must attach to his tax return a copy of the statement the employer provided with respect to the document failure. If an employee has included an amount in income to be eligible for relief under this notice, and that inclusion in income occurs in a year after the year the plan was corrected, the employee must include the statement with the returns for both the year of the correction and the year of income inclusion.

## Transition relief

Notice 2010-6 provides a special transition rule for any document failures that are corrected in accordance with the procedures described in this Notice by December 31, 2010. These failures will be treated as though the corrections occurred on January 1, 2009. As a result, corrections made by December 31, 2010 will avoid the income inclusion under section 409A. For this transition relief to apply, any amounts that were erroneously paid or not paid under a provision that is later corrected under the Notice 2010-6 procedures must be treated as an operational failure that also must be corrected under Notice 2008-113 by December 31, 2010.

Document failures due to linked plan designs may be corrected by December 31, 2011. To correct such failures under Notice 2010-6, the time and form of payment under the two linked plans must be made identical.

In addition, transition relief applies for corrections made by December 31, 2011, of payment schedules that are determined by the timing of payments received by the employer, and in certain instances where the employer is under audit.

## Modifications to Notice 2008-113

Notice 2010-6 also clarifies certain provisions of Notice 2008-113. For instance, if a condition for relief under Notice 2008-113 requires an employee to repay amounts, the employee may repay the net amount received after withholding to the extent the employer made a tax correction to recover the amount of taxes withheld on the amount erroneously paid. The Notice also addresses how to determine repayment amounts for operational failures that involve amounts that were erroneously paid or deferred in the form of property (such as stock). The amount must be repaid at fair market value of the property at the time of the erroneous payment. Any difference between the fair market value of the property at the time of the erroneous payment and the time of the repayment is treated as earnings and losses.

The Notice also clarifies that an "excess deferred amount" corrected in the tax year following the year of failure not only includes amounts that should not have been deferred under the plan terms or applicable deferral election, but also includes amounts that should have been paid to an employee during a tax year, but were erroneously missed.

## Effective date and next steps

The guidance in Notice 2010-6 is effective for tax years beginning on or after January 1, 2009. The modifications to Notice 2008-113 relating to operational corrections are effective January 1, 2010, but may be relied on by employers for tax years beginning before January 1, 2010.

Employers should consider reviewing plan provisions to ensure compliance with section 409A. If document failures have occurred, employers should discuss the guidance described in this *Pension Analyst* with their legal counsel to determine if the approved correction method is appropriate for their situation. If amendments are needed, employers can take advantage of the special transition relief to reduce or eliminate penalties by correcting plans before December 31, 2010.

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