



## IRS Establishes Corrections Program to Cure Deferred Compensation Defects Under Code Section 409A

February 1, 2010

On January 5, 2010, the IRS issued Notice 2010-6 (the “Notice”), which establishes a corrections program for certain inadvertent instances of documentary noncompliance involving deferred compensation arrangements subject to Section 409A of the Internal Revenue Code (“Section 409A”). The Notice complements and clarifies certain aspects of the IRS’ previously issued Notice 2008-13, which provided a means for correcting certain operational failures under Section 409A. Additionally, the Notice provides that certain ambiguous terms contained in deferred compensation arrangements will not automatically be regarded as a documentary failure and generally may be clarified without penalty. Finally, the Notice provides transition relief for certain types of corrections until December 31, 2010 and December 31, 2011, depending on the type of defect being corrected. While the correction methods described under the Notice provide a mechanism for correcting documentary failures with reduced penalties (or no penalties, in some cases), some taxpayers may still be reluctant to utilize the Notice in light of its requirements to notify the IRS of the defects.

### AMBIGUOUS TERMS IN DEFERRED COMPENSATION ARRANGEMENTS

The Notice acknowledges that certain types of ambiguous terms may be prone to reasonable interpretations that, in many instances, have the potential to produce both consistent or inconsistent positions under Section 409A. So long as the employer or other service recipient sponsoring such an arrangement administers it (and any other plans or arrangements containing similar ambiguous terms) in a manner that complies with Section 409A, the Notice effectively gives taxpayers the benefit of the doubt that the ambiguous terms were intended to be interpreted in a manner consistent with Section 409A. The Notice lists three specific examples of ambiguous terms:

1. *Payments that are due “as soon as reasonably practicable” following a stated time or event.* A provision requiring payment of deferred compensation “as soon as reasonably practicable” (or with similar words to that effect) following the occurrence of a Section 409A compliant payment event or specified date generally can be reasonably interpreted in a manner that would require payment to be made within the permissible payment window period under Section 409A (e.g., payment to be made by the later of the end of the calendar year or within 2½ months following the designated normal payment date). For example, a plan that provides for payments to be made “as soon as reasonably practicable” following an employee’s separation from service may be regarded as compliant with Section 409A so long as the employer does not have a pattern or practice

of making late payments that do not fall within the Section 409A permissible payment window periods.

2. *Payments due upon "termination of employment".* Often, deferred compensation arrangements (including employment agreements with payments potentially subject to Section 409A) will provide for payments to be made upon an employee's "termination of employment", without specifically referencing a "separation from service" within the meaning of Section 409A. While Section 409A permits deferred compensation arrangements to provide for payment to be made upon the employee's or other service provider's "separation from service", the regulations under Section 409A specifically define the term "separation from service" to include or exclude certain situations. For example, an employee whose status changes to an independent contractor, but who continues to provide more than 50% of his historical services, generally will not be deemed to have had a "separation from service" within the meaning of Section 409A. The Notice provides comfort that use of the term "termination of employment" may be interpreted as intending to refer to a "separation from service" within the meaning of Section 409A, subject to the consistency in application requirements described above.
3. *Ambiguous references to a "change in control".* The Notice provides that if an arrangement states that deferred compensation will be paid upon an "acquisition" of the employer, without specifically defining that term in a manner that complies with the permissible types of "change in control" events described under the Section 409A regulations, the term may be interpreted as intending to refer to Section 409A permissible change in control events, subject to the consistency in application requirements described above.

The Notice also permits (but does not require) employers to amend ambiguous terms to clarify the ambiguities in a manner consistent with Section 409A, subject to certain limitations intended to prevent misuse of "clarifications" to change payment terms. Unlike amendments to correct documentary failures (as described below), amendments to clarify ambiguities do not require IRS notification. Moreover, if a deferred compensation arrangement includes Section 409A "savings language" expressing an intent for provisions to be interpreted in accordance with Section 409A, the Notice states that the use of terms that might otherwise have been considered ambiguous will not be considered ambiguous for purposes of the Notice.

## CORRECTING DOCUMENTARY FAILURES

For provisions that are not merely ambiguous, but in fact are inconsistent with Section 409A, the Notice provides different means for correcting some of the more common types of documentary failures. While not all documentary violations are correctable under the Notice, the following types of errors (so long as they are inadvertent) generally may be corrected, subject to compliance with the reduced penalty and notification requirements set forth under the Notice:

- Impermissible definitions of otherwise permissible payment events (e.g., noncompliant definitions of "separation from service", "change in control" or "disability");

- Payment window period of longer than 90 days (but no more than one year) following a permissible payment event;
- Improper linkage of timing of payments to post-employment actions, such as the signing of a release of claims by an employee;
- Impermissible payment events or schedules (including impermissible “toggles” of payment schedules depending on the occurrence of particular types of payment events);
- Failure to include a plan provision requiring a 6-month delay of payments for specified employees as defined under Section 409A; and
- Plan provisions providing for impermissible initial deferral elections.

The correction methods under the Notice vary depending on the type of document failure. In all cases, the correction methods require both the employer and the affected employees or other service providers to submit filings with the IRS describing the documentary failure and the corrections undertaken in reliance upon the Notice. Additionally, in most cases, a reduced Section 409A penalty will apply if the event that is covered by the documentary failure occurs within one year following the date of the correction to the arrangement, while penalties may be avoided if the event does not occur within such one year period. Generally, the reduced penalties (when applicable) require the affected employees or other service providers to include as income on an accelerated basis either 25% or 50% (depending upon the circumstances) of the deferred amounts that were subject to the documentary failure, and to pay the Section 409A additional 20% penalty tax (but not the additional interest under Section 409A) on such amounts.

## OTHER MEANS OF CORRECTION

Importantly, the Notice does not preclude taxpayers from continuing to rely on the proposed income inclusion regulations under Section 409A, which generally permit taxpayers to avoid income inclusion and penalties under Section 409A if a failure (whether operational or documentary) is corrected before the year in which the employee or other service provider obtains a vested right to the deferred amounts. Additionally, taxpayers may continue to rely on Notice 2008-13 for purposes of correcting operational failures under Section 409A.

## TRANSITION RELIEF

The Notice provides special transition relief for certain types of corrections to deferred compensation arrangements, including the following:

- Documentary failures generally may be corrected on or before December 31, 2010 without incurring even the reduced penalties described above, although to the extent that the amendment results in a payment being made, or not made, during 2010, the correction will be treated as an “operational failure”, to which the rules of IRS Notice 2008-13 would apply.

- Documentary failures resulting from certain deferral arrangements with payment schedules impermissibly linked to other deferral arrangements or to when the employer or other service recipient receives payments (which might, for example, include certain types of “back-to-back”, phantom incentive or “phantom carry” arrangements) may be corrected without penalty, subject to certain limitations, until December 31, 2011.
- Newly established deferred compensation arrangements that are discovered to contain Section 409A documentary failures generally may be corrected prior to the end of the calendar year or, if later, the 15<sup>th</sup> day of the third calendar month, following the establishment of the plan (assuming the employer or other service recipient did not previously have in place any similar types of plans that would be aggregated with the newly established plan under the Section 409A plan aggregation rules).

Please note that the use of any transition relief is conditioned upon compliance with the IRS notification requirements generally applicable to corrections to the arrangements under the Notice, as described above.

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