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Subject: **IRS Establishes a 409A Document Correction Program**

Major References: [IRS Notice 2010-6](#)

Prior AALU Washington Reports: 08-108

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THE CONCLUSION OF THIS WASHINGTON REPORT.**

The Internal Revenue Service has finally established a document correction program under Revenue Code section 409A. The program was established through the issuance of IRS Notice 2010-6, which prescribes the rules and procedures under which nonqualified deferred compensation documents can be modified in certain cases without incurring the full sanctions that otherwise would be imposed under section 409A.

A nonqualified deferred compensation plan must comply with section 409A in both form and operation. In Notice 2008-13 (see our Bulletin No. 08-108), the IRS established rules for certain operational corrections that could be made to avoid heavy sanctions under that section. The Service then also announced that it was considering a limited document correction program for nonqualified plans. (The IRS has an elaborate correction program for qualified plans, known as the employee plans correction resolution system or EPCRS). Some at the IRS questioned whether that agency had the authority to develop a nonqualified plan correction program in light of the rigid section 409A rules.

After a lengthy delay, the Revenue Service has decided to establish a limited document correction program, but has made it clear that the program is available only for the specific corrections specified in Notice 2010-6. Any other document failure will trigger section 409A's full impact i.e., generally full, immediate income inclusion, a 20% additional tax and interest during the deferral period. Because the

Notice's rules are detailed and specific timing requirements are imposed, it is critical that it be applied carefully and with great attention to detail. A thorough knowledge of the intricacies of section 409A and its regulations is also essential.

The Notice, which is 85 pages in length, has four major parts. The first provides certain transition relief, the second provides a "remedial" amendment period for certain new plans, the third provides guidance regarding ambiguous plan terms, and the fourth part describes the ongoing correction program, including the eligibility rules and the specific methods of correction.

Transition Relief

Section XI of the Notice provides transition relief. Any document failure that the Notice otherwise allows to be corrected (even if a penalty would be required in connection with that correction, as described below) must be so corrected on or before December 31, 2010. If that dating requirement is met, no penalty will apply and the document will be treated as having been corrected on January 1, 2009. However, if a payment is made that should not have been made or *vice versa*, that payment or nonpayment must be treated as an operational failure and corrected under the operational correction rules (Notice 2008-13).

Two additional transition rules are available until December 31, 2011 for certain linked plans and for certain failures in connection with fixed payout schedules.

Remedial Amendment Period for New Plans

Section X of the Notice provides a "remedial" amendment period for certain new plans. That section allows plan sponsors to correct certain document failures within a limited period of time following a plan's initial establishment. This concept is similar to the remedial amendment period prescribed by statute for qualified retirement plans. Under the Notice, the remedial amendment period applies only if the plan is the first plan of the same type (*e.g.*, account balance, non-account balance, split-dollar) established by the employer. For purposes of determining whether a plan is the first plan of a particular type, plans which are not subject to 409A (*e.g.*, grandfathered plans) or under which all deferred amounts have previously been paid or forfeited are not taken into account. If the remedial amendment period applies, any document failure that could otherwise be corrected under the Notice can be corrected no later than the end of the calendar year in which a new plan is established or, if later, the 15th day of third calendar month following the date the plan is established. Similar to the transitional rules discussed above, if any payments were made before the document correction that should not have been made, or *vice versa*, the payments or nonpayments must be treated as an operational failure and corrected under the operational correction rules (Notice 2008-13).

Ambiguous Terms

Another part of the Notice (Section IV) contains rules relating to two types of ambiguous terms that can be corrected under this program. One relates to the fairly common provision that payment will be made "as soon as practicable" following certain events, and the other involves payment upon certain events the meaning of which may not be clear. Section 409A requires that precise payment rules be satisfied and failure to specify the rule which is being satisfied is an automatic violation, even if payment is made at the correct time. For example, section 409A generally requires use of the defined term "separation from service" in lieu of the term "termination of employment", but the latter term could be interpreted to apply to only the situations allowed by section 409A.

In general, so long as these ambiguous terms are interpreted to have the meaning required under section 409A, they will not cause a document failure under the Notice and the document will not have to be modified. If, however, payments are improperly made under these terms, then they must be treated as

operational violations of section 409A and appropriate corrections will need to be made, including amending the document before the end of the year in which the operational violation is corrected.

Document Corrections

Most Sections of the Notice (Sections V-IX) deal with document corrections. Only the document failures listed in the Notice may be corrected. Further, those corrections are allowed only if certain conditions are satisfied. For example, the correction program is not available if either party (employer or employee) is "under examination" by the IRS or if any listed transaction (within the meaning of the "tax shelter" rules) is involved. The specific conditions for correction must be met and must be applied consistently to correct all other plans that have a substantially similar defect. Although the correction must be noted on both the employer's and employee's tax returns, this is entirely a self-correction; that is, the correction is not approved in advance by the IRS.

The general approach of the IRS in allowing document corrections is that a document can be corrected without penalty if the plan provision is not operational (*i.e.*, has not adversely affected the plan from complying operationally with section 409A), the amendment is in writing, effective immediately, and does not have any impact on distributions or other requirements of section 409A for the next year. If, for example, the amendment is made within a year of an event that would cause an operational compliance problem with the section (such as making or not making a required payment), then generally a partial application of section 409A is required. That might mean that 50% or 25% (depending on the violation) of the section 409A sanction will be imposed.

The chart below highlights some of the sanction rules and lists the document corrections that are permitted.

	<i>Correctable Document Violation</i>	<i>Sanction if One Year Rule is Violated</i>
1.	Impermissible definition of Separation From Service	50% of amount deferred compensation
2.	Impermissible definition of Change of Control	25% of amount deferred compensation
3.	Impermissible definition of Disability	n/a
4.	Payment period longer than 90 days	50% of amount deferred compensation
5.	Payment that requires noncompete	n/a
6.	Impermissible & permissible payment events	50% of amount deferred compensation
7.	Only impermissible payment events	50% of amount deferred compensation
8.	Impermissible alternative payment schedules	50% of amount deferred compensation
9.	Impermissible payment discretion	50% of amount deferred compensation
10.	Impermissible acceleration authority	n/a

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| 11. | Impermissible reimbursement | 50% of amount deferred compensation |
| 12. | Failure to include 6-month delay for specified employees | 50% of amount deferred compensation |
| 13. | Impermissible deferred elections | n/a |

The Notice contains many detailed rules and requirements that must be satisfied to fully correct the permitted document failures. Any document "corrections" outside of these strict rules are not permitted and will not correct section 409A plan document failures.

Any AALU member who wishes to obtain a copy of Notice 2010-6 may do so through the following means: (1) use hyperlink above next to "Major References," (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* with your last name and birth date and select *Current Washington Report* for linkage to source material or (3) email Anthony Raglani at raglani@aalu.org and include a reference to this *Washington Report*.

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