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Correcting Document Failures of Plans with Nonvested Deferred Compensation Under Proposed §409A Regulations

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INTRODUCTION

The Proposed Regulations

Editor's Note: On January 20, 2017, President Trump's Chief of Staff, Reince Priebus, issued a memo informing department and agency heads that regulations that have been published in the Federal Register but are not yet effective will be postponed 60 days. De-

partment and agency heads were instructed to consider proposing for notice and comment a rule to delay the effective date for regulations beyond that 60-day period.

On June 21, 2016, the Treasury Department and the Internal Revenue Service released proposed regulations (REG-123854-12)¹ ("Proposed Regulations") proposing amendments to certain final regulations² and replacing some previously proposed rulemaking³ with new proposed regulations under §409A of the Internal Revenue Code of 1986, as amended ("§409A").⁴ Section 409A imposes restrictions on the timing and manner of payment of amounts under non-qualified deferred compensation ("NQDC") plans.⁵ These plans, as defined under §409A, provide compensation to executives that is awarded in one year but is includible in income in a subsequent tax year of the employee.⁶ Immediate inclusion in income, additional tax or interest for violating §409A document or

¹ 81 Fed. Reg. 40,569 (June 22, 2016), corrected by 81 Fed. Reg. 51,413 (Aug. 4, 2016).

² See 72 Fed. Reg. 19,234 (Apr. 17, 2007).

³ See Prop. Reg. §1.409A-4, REG-148326-05, 73 Fed. Reg. 74,380 (Dec. 8, 2008). All section references are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder, unless otherwise specified.

⁴ See Prop. Reg. §1.409A-4, REG-123854-12, 81 Fed. Reg. 40,569 (June 22, 2016) (any referenced Proposed Regulations including the accompanying preamble cited hereinafter to "REG-123854-12").

⁵ See §409A(a).

⁶ Reg. §1.409A-1(b)(1). Contemporaneously with the Proposed Regulations, the IRS issued proposed regulations under, among other provisions, §457(f) applicable to NQDC under certain "ineligible plans" sponsored by certain governmental or tax-exempt entities. See §457(f)(1) (general rule for timing of inclusion in income upon vesting of the deferred amounts and accruals under an ineligible plan); Reg. §1.457-1(e) (2003) (definition of "eligible employer"); REG-147196-07, 81 Fed. Reg. 40,548 (June 22, 2016). Section 409A applies to NQDC plans separately and in addition to §409A. Reg. §1.409A-1(a)(4); Prop. Reg. §1.409A-1(a)(4), REG-123854-12. Generally, these proposed regulations address the definition of an ineligible plan, the definition of a SRF of amounts under an ineligible plan and the rules for inclusion in

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operational requirements do not apply to deferred amounts that are subject to a substantial risk of forfeiture (“SRF”) or, in other words, are nonvested for the tax year of the plan participant in which the plan failure occurs.⁷

The Proposed Regulations amended the anti-abuse rule for preventing avoidance of §409A tax or penalties with respect to nonvested deferrals.⁸ NQDC subject to SRF would be deemed as vested and therefore subject to §409A tax consequences if any of the following three prongs applied: (1) the service recipient amends a plan provision concerning the time or form of payment without a reasonable, good faith determination that the change was necessary to correct a §409A(a) failure; (2) facts and circumstances, some of them enumerated, show a pattern or practice whereby the service recipient effectively drafts and approves noncompliant plan documents only to make “correcting” amendments in future tax years, which in substance would be impermissible changes to the time or form of payment of a deferred amount; or (3) the correcting amendment is inconsistent with correction methods (but not certain other unrelated requirements, such as income inclusion or information reporting) set forth in applicable IRS guidance.⁹ Making correcting amendments in compliance with the proposed anti-abuse rule would require bifurcating the NQDC plan for vested and nonvested amounts, if applicable, and treating the correcting amendment as applying with respect to deferrals that are subject to SRF on the date of the amendment.

Taxpayers may rely on the proposed income inclusion regulations, as amended, for purposes of calculating the amount includible in income under §409A(a) until further guidance is issued, to comply with §409A.¹⁰ Thus, taxpayers may rely on the proposed amendments for purposes of the identification and treatment of amounts subject to SRF.¹¹ The IRS stated it will not assert positions with respect to any tax periods until final regulations are published that

income of deferrals subject to §457(f). *See generally* Prop. Reg. §1.457-12, 81 Fed. Reg. at 40,562–40,568; *see also id.* at 40,550–40,557 (sections of preamble describing proposed rules applicable to ineligible plans). These proposed regulations generally do not provide any exceptions to the proposed anti-abuse rule for correcting ineligible plan document failures. But close scrutiny of these proposed regulations would be necessary to determine any potential or actual applicability to correcting any ineligible plan document failures.

⁷ §409A(d)(4); Reg. §1.409A-1(d)(1).

⁸ Prop. Reg. §1.409A-4(a)(1)(ii)(B), REG-123854-12 (June 21, 2016) (new proposed anti-abuse rule); Prop. Reg. §1.409A-4(a)(1)(ii)(B), 73 Fed. Reg. 74,380, 74,393–74,394 (Dec. 8, 2008) (original proposed anti-abuse rule).

⁹ Prop. Reg. §1.409A-4(a)(1)(ii)(B).

¹⁰ *See* Prop. Reg. §1.409A-4(a)(1)(ii)(B).

¹¹ *See id.*

are contrary to the positions in the Proposed Regulations, as amended.¹²

The Notice

Prior to the issuance of the Proposed Regulations, Notice 2010-6 (hereafter, the “Notice”) set forth methods for correction of NQDC plan document failures for vested amounts under the auspices of a voluntary correction program (hereafter, used interchangeably with the Notice, the “VCP”).¹³ The Notice appeared to exclude NQDC plans with respect to nonvested deferred amounts.¹⁴ The rationale was, there was no inclusion in income and no imposition of penalties or interest on deferred compensation subject to SRF for the taxable year in which the plan failed to comply with §409A.¹⁵

Rather, as a general rule, the plan could be corrected to comply with §409A and avoid tax and penalties in a subsequent year in which the amounts vested.¹⁶ Therefore, the VCP correction methods, including reporting the correction to the IRS and in some cases including unpaid amounts in income,¹⁷ did not apply to nonvested deferrals. Plan sponsors

¹² *See id.*; Notice 2008-115, 2008-52 I.R.B. 1367 (interim guidance addressing reporting and wage withholding for employers and payers and income inclusion, tax payment and reporting requirements for service providers effective for calendar year 2008 and subsequent years until further guidance or final regulations are issued; providing that compliance with the provisions of the proposed regulations with respect to the calculation of the amount includible in income under §409A(a) and the calculation of the additional taxes under §409A will be treated as compliance with the requirements of this notice, provided that the taxpayer complies with all the provisions of the proposed regulations).

¹³ Notice 2010-6, 2010-3 I.R.B. 275.

¹⁴ *See* §409A(a)(1)(A)(i); Notice 2010-6.

¹⁵ *See* §409A(a)(1)(A)(i).

¹⁶ Prop. Reg. §1.409A-4(a)(1)(i), 73 Fed. Reg. 74,380, 74,393 (Dec. 8, 2008) (general rule for income inclusion); 73 Fed. Reg. at 74,382 (Dec. 8, 2008) (preamble to the 2008 proposed income inclusion regulations stating that, “if all of a taxpayer’s deferred amounts under a plan are nonvested and the taxpayer makes an impermissible deferral election or accelerates the time of payment with respect to some or all of the nonvested deferred amount, the nonvested deferred amount generally would not be includible in income under section 409A(a) in the year of the impermissible change in time and form of payment (although if there were vested amounts deferred under the plan, such amounts would be includible in income under section 409A(a)). In the subsequent taxable year in which the service provider becomes vested in the deferred amount, the plan might comply with section 409A(a) in form and in operation, so that under the general rule no income inclusion would be required and no additional taxes would be due for that year as a result of the late deferral election or acceleration of payment.”); Notice 2010-6.

¹⁷ *See* Notice 2010-6 §I (overview referencing limited current inclusion in income where document failure affects the operation of the plan within one year following the date of the correction), §XII (information reporting requirements for correcting document

could correct the documents internally without disclosure to the IRS or inclusion in income by the executive.

The Prior Anti-Abuse Rule for Nonvested Deferrals

Treasury and the IRS incorporated an anti-abuse rule in the 2008 proposed income inclusion regulations under §409A.¹⁸ The IRS would disregard the SRF of nonvested deferrals if facts and circumstances demonstrated that the service recipient made impermissible changes in the time or form of payment of nonvested NQDC.¹⁹ The amounts also would be deemed vested if the service recipient was found to engage in a “pattern or practice” of making such impermissible changes that affected the nonvested amounts.²⁰

However, the anti-abuse rule was relatively broad and practitioners had significant leeway in determining which failures could be corrected for nonvested NQDC amounts and the nature of the correcting amendments. The IRS sought to close the loopholes that may have allowed practitioners liberties in amending noncompliant plans with nonvested amounts inconsistent with §409A regulations and IRS guidance.²¹ The general rule was not intended “to allow service recipients to change time or form of payment provisions that otherwise meet the requirements of §409A(a) in a manner that fails to comply with §409A(a).”²²

In particular, the IRS meant to preclude service recipients from creating “errors in nonqualified deferred

failures with respect to vested deferred amounts).

¹⁸ See generally §409(e)(5) (authorizing legislative regulations “disregarding a substantial risk of forfeiture in cases where necessary to carry out the purposes of” §409A); see Prop. Reg. §1.409A-4(a)(1)(ii)(B), 73 Fed. Reg. 74,380, 74,394 (Dec. 8, 2008).

¹⁹ *Id.*

²⁰ *Id.*; 73 Fed. Reg. at 74,382 (Dec. 8, 2008) (“In proposing to adopt this interpretation of the statute, the Treasury Department and the IRS do not intend to create an opportunity for taxpayers who ignore the requirements of section 409A(a) with respect to nonvested amounts to avoid the payment of taxes that would otherwise be due as a result of such failure to comply. To ensure that this rule does not become a means for taxpayers to disregard the requirements of the statute, the proposed regulations would disregard a substantial risk of forfeiture for purposes of determining the amount includible in income under section 409A with respect to certain nonvested deferred amounts.”)

²¹ See Matthew R. Madara, *Questions Raised About Proposed Nonqualified Deferred Comp Regs*, Tax Notes Today (Sept. 19, 2016) at *1 (summarizing a discussion at a Practising Law Institute conference, quoting Treasury benefits tax counsel Robert Neis as saying, *inter alia* “that the focus of section 409A is to prevent taxpayers from shifting the year in which they include amounts in income”).

²² REG-123854-12 (preamble to 2016 amendments to proposed

compensation plans with respect to nonvested amounts with the intention of using those errors as a pretext for establishing or changing a time or form of payment in a manner that fails to comply with section 409A(a).”²³ Thus, executives would not avoid inclusion in income, penalties or interest on nonvested deferred pay that otherwise would have been imposed on vested NQDC absent a correcting IRS submission.²⁴ To achieve this status quo, the IRS set forth the requirements for correcting document failures, which originally were excluded from the Notice with respect to nonvested NQDC, in the §409A proposed regulations.²⁵

The Proposed, Expanded Anti-Abuse Rule

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The Proposed Regulations expanded the anti-abuse rule (used interchangeably hereafter, the “proposed anti-abuse rule” or the “proposed anti-abuse test”) by treating nonvested deferred amounts as vested and immediately includible in income under §409A(a) if any of the three conditions described above applied.²⁶ The IRS did not specify any of the applicable correction methods for purposes of the third prong of the proposed anti-abuse test.²⁷ The IRS also did not define precisely the scope of the VCP requirements that do not apply to nonvested amounts.²⁸

Generally, NQDC plans subject to §409A may be amended to change the definition of a payment event or the time or form of payment only by complying with the requirements set forth in Treasury regulations.²⁹ Failure to comply with §409A would result in

income inclusion regulations).

²³ *Id.*

²⁴ See Notice 2010-6 §XII.

²⁵ Prop. Reg. §1.409A-4(a)(1)(ii)(B); Notice 2010-6.

²⁶ REG-123854-12.

²⁷ See Prop. Reg. §1.409A-4(a)(1)(ii)(B)(3).

²⁸ See REG-123854-12.

²⁹ See generally §409A(a)(3)–§409A(a)(4)(C); Reg. §1.409A-2(b); §1.409A-3(j).

immediate tax and penalties on vested amounts.³⁰ However, nonvested amounts are not includible in income under §409A.³¹

The first prong of the proposed anti-abuse rule is designed to preclude circumvention of §409A requirements by making impermissible amendments while the deferrals are nonvested.³² Thus, the first prong of the proposed anti-abuse rule permits amendments outside the regulations with respect to nonvested amounts only if, absent the change, the plan provision fails to comply with §409A(a) requirements.³³

Not just any change is permitted. The third prong of the proposed anti-abuse rule requires plan sponsors to follow certain correction rules prescribed in the Notice for plans with vested deferrals.³⁴ The application of these methods may not be selective and vary from plan to plan. Instead, substantially similar document failures in other NQDC plans of the employer must be corrected in substantially the same manner.³⁵ Even these uniformly applied procedures are limited. The second prong of the proposed anti-abuse rule requires vesting if the plan sponsor intentionally allows the similar failures under one or more plans with nonvested amounts, yielding tax deferral benefits for participants.³⁶

To correct the document failures for vested amounts, the Notice may require inclusion in income of a portion of the deferred amount under §409A(a).³⁷ But if the plan sponsor engages in a prohibited pattern or practice under the proposed anti-abuse rule, some requirements under the Notice may ensure the newly vested amounts do not qualify for VCP relief.³⁸ Thus, the proposed anti-abuse rule may subject nonvested NQDC of an executive to vesting, inclusion in income and the additional tax and interest under §409A(a).³⁹

Executive Summary

Service recipients (hereafter, interchangeably “plan sponsors” or employers”) may discover from time to time that one or more of the provisions in an NQDC plan results in its failure with respect to one or more service providers (hereafter, interchangeably “employees,” “participants” or “executives”) to comply with §409A(a) rules. At the time the document failure

is discovered, the plan may provide solely for deferred amounts that remain subject to SRF or for a combination of amounts, including some nonvested, some vested and paid and others vested but not yet distributed to the participant or beneficiary. Following the issuance of the proposed regulations, sponsors of NQDC plans and their advisers must know three important concepts to avoid income inclusion, additional tax and interest on any nonvested amounts under a plan in the event a document failure is found.

First, a service recipient must know which correction methods are mentioned in the generally applicable VCP guidance, and therefore must be applied to the nonvested deferred amounts. Second, the employer must know which timing and other eligibility requirements in the VCP guidance are excluded for correcting amendments with respect to nonvested amounts. Third, the plan sponsor must understand the resulting practical application of one or more of the correction methods prescribed under the VCP in order successfully to correct a document failure with respect to NQDC subject to SRF and therefore outside the original authority of the Notice.

This article gleans the applicable correction requirements in Notice 2010-6 for plan document failures to comply with the proposed anti-abuse rule with respect to nonvested cash deferrals. Stock rights and other equity-based NQDC also are subject to these requirements but are outside the scope of this article. For each document failure, in Parts I and II, the article discusses the applicable general and specific eligibility requirements, respectively, for correcting amendments under the proposed anti-abuse rule. In Part III, the article discusses and compares the technical application of some of the resulting applicable correction methods before and after the issuance of the proposed anti-abuse rule, and outlines some practical compliance steps.

I. Applicability of General Eligibility Requirements to Nonvested NQDC

The preamble to proposed regulations (hereafter, the “Preamble”) explains that a service recipient must correct a document failure with respect to a nonvested amount using a correction method or methods if any prescribed for such failure under generally applicable guidance.⁴⁰ But the proposed anti-abuse rule says, “the requirements under applicable correction guidance with respect to eligibility, income inclusion, additional taxes, premium interest, and information re-

³⁰ §409A(a)(1)(A)(i).

³¹ §409A(a)(1)(A)(i)(II).

³² See Prop. Reg. §1.409A-4(a)(1)(ii)(B)(1).

³³ See *id.*

³⁴ See Prop. Reg. §1.409A-4(a)(1)(ii)(B)(3).

³⁵ *Id.*

³⁶ See Prop. Reg. §1.409A-4(a)(1)(ii)(B)(2).

³⁷ See Notice 2010-6 §I.

³⁸ See, e.g., Notice 2010-6 §III(B), (D).

³⁹ See §409A(a)(1).

⁴⁰ Prop. Reg. §1.409A-4(a)(1)(ii)(B)(3) (prohibiting correction of a plan with respect to a nonvested amount that “is not consistent” with an applicable correction method if one exists set forth in applicable IRS guidance); REG-123854-12 (explanation in the preamble of the above rule).

porting by the service recipient or service provider do not apply.”⁴¹ As the Preamble expounds, a service recipient is not required to comply with any VCP requirement “that is unrelated to the method for correcting the failure, such as general eligibility requirements, income inclusion, additional taxes, premium interest, or information reporting.”⁴²

It is unclear whether any requirements under the VCP guidance other than the categories specifically excluded in the proposed anti-abuse rule⁴³ do not apply to nonvested amounts due to being unrelated to the correction method.⁴⁴ Furthermore, there appears a conflict between the language of the proposed anti-abuse rule and the language of the Preamble. The proposed anti-abuse rule states that eligibility requirements do not apply.⁴⁵

But the Preamble refers only to “general” eligibility requirements as being unrelated to the correction method and therefore not applicable with respect to nonvested amounts.⁴⁶ Thus, the Preamble suggests there may be eligibility requirements under the Notice, which are not general and which are applicable with respect to nonvested deferrals by being related to the correction method.⁴⁷ Such an interpretation would be necessary to encompass all requirements under the Notice that were related to the particular correction method.

Income inclusion, additional taxes, premium interest and information reporting requirements relatively are self-explanatory as being unrelated to the correction method for a nonvested amount.⁴⁸ But the Preamble does not define the scope of the excluded “eligibility requirements.”⁴⁹ The Preamble suggests that the service recipient may exclude an eligibility requirement if it is “general” and “unrelated to the method for correcting the failure” with respect to nonvested compensation.⁵⁰

The general eligibility requirements mentioned in the Preamble appear to be only a subset of the “eligibility requirements” referenced in the proposed anti-abuse rule.⁵¹ The Preamble seems to refer to the threshold requirements set forth in section III of the Notice in order to qualify for relief under sections V

through XI of the Notice.⁵² Otherwise, the IRS has not specified which of the numerous requirements under the VCP are with respect to eligibility, whether or not general, and unrelated to the method for correcting the failure.⁵³

Excluded General Eligibility Requirements

This subsection discusses the requirements under the Notice, which appear to be general eligibility requirements not applicable with respect to nonvested amounts. First, a service recipient or service provider may not be under examination with respect to NQDC on the date of the plan correction for any taxable year in which the document failure occurred.⁵⁴ In addition, the document failure may not be due to the amount deferred being determined by or the time or form of payment being affected by the amount deferred under or a provision of a linked NQDC or qualified plan.⁵⁵ Also, the VCP relief does not apply to a stock right.⁵⁶

Each of these criteria appears in section III of the Notice, “Eligibility Requirements and Effect of Correction.”⁵⁷ This section sets forth the conditions “for the relief provided in §§V through XI” of the Notice.⁵⁸ Therefore, each of the requirements described in section III of the Notice applies generally, irrespective of the specific document failure.⁵⁹ Accordingly, the above three criteria appear to fit within the meaning of a general eligibility requirement for purposes of the third prong of the proposed anti-abuse rule. Moreover, the regulation does not incorporate expressly any of these requirements.⁶⁰ Therefore, these criteria may be deemed not to apply to nonvested NQDC.

General Eligibility Requirements that Apply

Under the Notice, the failures being corrected must be inadvertent and unintentional.⁶¹ As another requirement, a service recipient must take commercially reasonable steps to identify all other NQDC plans that have a document failure that is substantially similar to the document failure initially identified and corrected.⁶² This general requirement applies even if the service provider at issue does not participate in any of

⁴¹ Prop. Reg. §1.409A-4(a)(1)(ii)(B)(3).

⁴² REG-123854-12.

⁴³ See Prop. Reg. §1.409A-4(a)(1)(ii)(B)(3).

⁴⁴ See REG-123854-12.

⁴⁵ Prop. Reg. §1.409A-4(a)(1)(ii)(B)(3).

⁴⁶ REG-123854-12.

⁴⁷ See *id.*

⁴⁸ See REG-123854-12.

⁴⁹ *Id.*

⁵⁰ REG-123854-12.

⁵¹ See Prop. Reg. §1.409A-4(a)(1)(ii)(B)(3).

⁵² See Notice 2010-6 §III.

⁵³ See Prop. Reg. §1.409A-4(a)(1)(ii)(B)(3).

⁵⁴ Notice 2010-6 §III(C).

⁵⁵ Notice 2010-6 §III(G).

⁵⁶ *Id.*

⁵⁷ Notice 2010-6 §III.

⁵⁸ Notice 2010-6 §III(A).

⁵⁹ See Notice 2010-6 §III.

⁶⁰ See Prop. Reg. §1.409A-4(a)(1)(ii)(B)(3).

⁶¹ Notice 2010-6 §III(D).

⁶² *Id.* §III(B).

these other plans.⁶³ Second, the service recipient must correct the substantially similar failure in all such plans in a manner consistent with the Notice.⁶⁴ Both of these general eligibility requirements are reflected in the proposed anti-abuse rule applicable to nonvested NQDC.⁶⁵

Thus, the third prong of proposed the anti-abuse rule requires that the failure be “corrected in substantially the same manner as a substantially similar failure affecting a nonvested deferred amount under another plan sponsored by the service recipient.”⁶⁶ Separately, the second prong of the proposed anti-abuse rule prohibits a service recipient from engaging in a pattern or practice of permitting substantially similar failures to comply with §409A(a) under one or more NQDC plans while the deferrals are nonvested.⁶⁷ Furthermore, the second prong prohibits the nonvested amounts from being affected by such pattern or practice.⁶⁸

A fact that “the service recipient has taken commercially reasonable measures to identify and correct the substantially similar failures promptly upon discovery” indicates absence of such prohibited pattern or practice.⁶⁹ Other factors indicating absence of abuse are “whether the failures appear intentional, are numerous, or repeat one or more similar past failures that were previously identified and corrected.”⁷⁰ Thus, inadvertent and unintentional failures are a VCP prerequisite with respect to vested amounts. But with respect to deferrals subject to SRF, this element is a part of a facts-and-circumstances analysis in the proposed anti-abuse test, failure of which could result in immediate vesting and inclusion in income under §409A(a).

II. Applicability of Specific Eligibility Requirements to Nonvested NQDC

Compliance With Specific Eligibility Requirements for Nonvested NQDC

In addition to the general eligibility requirements described in section III of the Notice, timing and other eligibility requirements apply for correcting specific document failures with respect to vested deferrals.⁷¹ The Notice refers to these criteria as “the require-

ments of the particular section in §§V through XI of this notice providing the correction method and relief applicable to the document failure.”⁷² Thus, by contrast to general eligibility requirements, these factors appear to be related to the particular correction method and therefore applicable to nonvested deferrals.⁷³

Moreover, under the Notice, a plan has the burden to demonstrate eligibility for relief and that each of the requirements have been met.⁷⁴ But eligibility for VCP relief is not final and is subject to IRS examination.⁷⁵ In this manner, the IRS retains broad discretion to interpret further the applicability of the eligibility requirements under the VCP. The broad administrative authority indicates that the eligibility requirements with respect to nonvested NQDC likewise may be subject to further interpretation by the IRS.

Reporting requirements do not apply to nonvested amounts, meaning that a significant amount of time could elapse before a potential IRS review of the internal correction procedures.⁷⁶ During this period, significant tax, penalties and interest could accrue in the event of a future IRS examination and adverse determination with respect to the nonvested deferrals.⁷⁷ Such a possibility of significant liability in the future highlights the importance for plan sponsors to define the scope and substance of the eligibility requirements for correcting document failures with respect to nonvested NQDC.

Timing Requirements: Background

The Notice includes various criteria the meeting of which is based on whether or not a certain event occurred⁷⁸ or on whether or not a service recipient, ser-

⁷² *Id.*

⁷³ See REG-123854-12. Arguably, a narrow reading of the third prong of the proposed anti-abuse rule may result in none of the requirements in the Notice being applicable other than the specific language that must be included to correct the document failure. However, under the Proposed Regulations, the correction may not be inconsistent with an applicable correction method in the guidance, if it exists. This narrow reading would result in even the descriptions of the specific document failures being deemed as inapplicable requirements (assuming each condition for eligibility for relief is a “requirement” for relief). In this case, it would be impossible to connect the document failure with the applicable correction method in the VCP. The application of such a narrow interpretation of a VCP requirement being related to the correction method with respect to nonvested amounts is outside the scope of this discussion.

⁷⁴ Notice 2010-6 §III(A).

⁷⁵ *Id.*

⁷⁶ See Prop. Reg. §1.409A-4(a)(1)(ii)(B)(3).

⁷⁷ See §409A(a)(1).

⁷⁸ See, e.g., Notice 2010-6 §IV(A)(2) (with respect to a plan that provides for a payment upon a permissible payment event or

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ See Prop. Reg. §1.409A-4(a)(1)(ii)(B)(2)–§1.409A-4(a)(1)(ii)(B)(3).

⁶⁶ Prop. Reg. §1.409A-4(a)(1)(ii)(B)(3).

⁶⁷ Prop. Reg. §1.409A-4(a)(1)(ii)(B)(2).

⁶⁸ See *id.*

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ See Notice 2010-6 §III(A).

vice provider or other party took a certain action.⁷⁹ These criteria collectively may be deemed as “timing requirements” (hereafter, alternatively “timing criteria” or “timing rules”) based on the plain meaning of the term. The IRS did not say whether such timing requirements would apply to nonvested amounts.

The Preamble says that a service recipient “may amend a noncompliant plan term in a manner permitted under applicable correction guidance even though the failure may not have been eligible for correction under that guidance (for example, due to applicable timing requirements).”⁸⁰ Thus, the IRS refers to “applicable timing requirements” as examples of eligibility requirements that do not apply under the proposed anti-abuse rule.⁸¹

By inference, then, under the Preamble, an applicable timing requirement would be an eligibility requirement “unrelated to the method for correcting the failure,” with which a plan sponsor would not have to comply with respect to a nonvested deferral.⁸² But some timing requirements may be deemed related to the applicable correction method.⁸³ Also, it is unclear if all timing requirements are exempt “applicable timing requirements” or whether the IRS requires plan sponsors to comply with at least certain timing requirements for nonvested deferrals.

Separately, the third prong of the proposed anti-abuse rule exempts expressly “the requirements under applicable correction guidance with respect to. . . in-

“as soon as reasonably practicable” thereafter or contains similar language, providing that generally there is no §409A(a) violation if payment is made timely in accordance with §409A(a) requirements). See §409A(a)(2) (stating generally that a plan must designate distributions to be made not earlier than a specified event or at a specified time or pursuant to a fixed schedule set forth in the plan at the date of the deferral of the compensation). A payment made as soon as practicable may fail to be made in compliance with these timing requirements. See *id.* In this case, the payment also is an action taken by the service recipient. See n. 79, below.

⁷⁹ See, e.g., Notice 2010-6 §IV(B)(2) (with respect to correcting an ambiguous definition of a permissible payment event, if the particular provision has been interpreted by the service recipient or by a court with jurisdiction over the plan, the service recipient is not eligible to use the correction method to amend the plan with respect to vested amounts under the VCP to comply with §409A(a)). The distinctions discussed in this note and n. 78, above, text are devised by the author for the sake of clarity and are not mentioned expressly in the Proposed Regulations or IRS guidance.

⁸⁰ REG-123854-12.

⁸¹ See *id.*

⁸² See REG-123854-12.

⁸³ See, e.g., Notice 2010-6 §IV(B)(1) (relief not available after ambiguous definition of a permissible payment event was interpreted by the service recipient or a court of competent jurisdiction).

come inclusion.”⁸⁴ The IRS has not explained the meaning of an exempted Notice requirement being “with respect to” income inclusion.⁸⁵ Timing requirements may be deemed to be with respect to income inclusion.

Under such an interpretation of the Proposed Regulation, a timing requirement with respect to income inclusion would not apply for correcting plan document failures for nonvested NQDC, irrespectively of whether or not it is related to the correction method. Due to these apparent inconsistencies, IRS guidance has not clarified whether plan sponsors may face certain deadlines under the Notice for correcting document failures with respect to nonvested NQDC.

The Rule for Applicability of Timing Requirements for Nonvested NQDC

The analysis in the narrative and Table 1 below demonstrates that each specific timing requirement on Line 1 demarcates a deadline for amending a plan to avoid income inclusion resulting from the document failure.⁸⁶ Therefore, these timing requirements in the Notice may be deemed as *requirements with respect to income inclusion* exempt from compliance for nonvested amounts.⁸⁷ Construing the rule in this manner would eliminate the conflicting treatment of otherwise exempt “applicable timing requirements,” which nevertheless may be related to the correction method and therefore seemingly applicable under the Preamble.⁸⁸

Accordingly, these timing requirements do not appear to apply with respect to nonvested amounts under the authority of the proposed anti-abuse rule and the Preamble.⁸⁹ Rather, as discussed below, there is a general rule for amending plans with respect to nonvested amounts some time prior to vesting,⁹⁰ subject to compliance with the other elements of the proposed anti-abuse rule, which involves a facts and circumstances analysis.⁹¹

However, as described on Line 2, not all timing requirements described in Table 1 below are with respect to income inclusion.⁹² Therefore, employers must take these timing requirements into account when making a correcting amendment for nonvested

⁸⁴ Prop. Reg. §1.409A-4(a)(1)(ii)(B)(3).

⁸⁵ See *id.*

⁸⁶ See n. 123, below.

⁸⁷ See Prop. Reg. §1.409A-4(a)(1)(ii)(B)(3).

⁸⁸ See REG-123854-12.

⁸⁹ See Prop. Reg. §1.409A-4(a)(1)(ii)(B)(3).

⁹⁰ See n. 103, below.

⁹¹ See Prop. Reg. §1.409A-4(a)(1)(ii)(B)(1)–§1.409A-4(a)(1)(ii)(B)(3).

⁹² See below, Table 1, line 2 (timing requirement applicable with respect to correcting document failure for nonvested deferrals but only to determine applicable correction method).

deferrals. In addition, plan sponsors and practitioners must be aware of the apparent inapplicability of certain deadlines not contingent on and preceding a payment under the plan (“pre-payment” or “pre-distribution” timing requirements) for nonvested NQDC. The pre-payment timing requirements, as well as deadlines that coincide with a payment event or even in some instances follow a payment event, each are designated accordingly in Table 1.⁹³

Thus, the discussion below illustrates that some correction deadlines coincide with a distribution and therefore align with the general rule for amending plans with respect to nonvested amounts prior to vesting.⁹⁴ Meanwhile, other timing requirements, which precede a payment of deferred compensation, are with respect to income inclusion and therefore are excluded under the third prong of the proposed anti-abuse rule.

The IRS may issue additional guidance clarifying that correction deadlines, which precede a payment and are with respect to income inclusion, do not apply for nonvested amounts, so long as the other prongs of the proposed anti-abuse rule are met. In furtherance of compliance with the proposed anti-abuse rule, the analysis and Table 1 below set forth a roadmap for plan sponsors and their advisers in determining appropriate timing of correcting amendments with respect to nonvested NQDC.

Types of Timing Requirements Under the Notice

Timing Criteria Requiring Compliance Prior to Correcting Amendment

The Notice sets forth certain timing requirements among the eligibility requirements described in subsection 1 and certain other timing requirements in the correction procedures described in subsection 2 for each type of document failure.⁹⁵ Generally, eligibility for plan correction is based on the facts and circumstances prior to the correcting amendment, such as existing plan language.⁹⁶ These prerequisites for relief,

⁹³ See discussion below in section III.

⁹⁴ See, e.g., Notice 2010-6 §V(B)(2) (requiring correcting amendment before an impermissible change in control event occurs resulting in an operational failure; aligning to some extent with the general rule for correcting amendments with respect to nonvested amounts, since deferrals would vest upon occurrence of an event that is a payment event under the pre-correction plan provision, but not if it is a deemed payment event only under §409A and not under the pre-correction plan provision).

⁹⁵ See, e.g., Notice 2010-6 §V(A)(1) (eligibility criteria for correcting an impermissible definition of separation from service); §V(A)(2) (correction procedures for a plan provision containing an impermissible definition of separation from service).

⁹⁶ See, e.g., Notice 2010-6 §IV(B)(1) (to qualify for relief, requiring definition of a permissible event, such as separation from

some of which may include an element of timing,⁹⁷ identify the factors that must be present with respect to a document failure in order for the correction method to apply. However, if a timing element is present in the specific eligibility requirement, generally it is an indication that the requirement is with respect to income inclusion and therefore not applicable for nonvested amounts.

Timing Criteria Requiring Compliance After Correcting Amendment

By contrast, some timing requirements in the correction procedures involve subsequent events, such as the correcting amendment not affecting the operation of the plan within one year following the date of correction.⁹⁸ Timing requirements that are based on events after the correcting amendment generally would trigger inclusion in income, not failure to qualify for correcting relief.⁹⁹ Nonvested amounts may not be includible in income under §409A(a).¹⁰⁰

Thus, under the VCP, such a post-correction timing requirement technically would not be relevant or applicable with respect to a nonvested deferral. Moreover, a timing requirement dispositive to determining income inclusion under the VCP, whether pre- or post-correction, is “with respect to income inclusion” and therefore exempt for nonvested deferrals under the proposed anti-abuse rule.¹⁰¹ Taking into account these distinctions, the discussion below identifies and analyzes the timing requirements in the Notice and their respective applicability to nonvested NQDC.

Applicability of Timing Requirements in Notice Sections IV Through IX

The Notice categorizes certain types of document failures by the corresponding section, and one or more

service, to be ambiguous but stating the provision must not explicitly include impermissible payment events or explicitly exclude events that would be required for the payment event to comply with §409A(a).

⁹⁷ See, e.g., Notice 2010-6 §V(A)(2) (to correct impermissible definition of separation from service, requiring plan to be amended before an operational failure occurred, meaning either no payment was made upon occurrence of a separation from service within the meaning of the term under §409A regulations or a payment was made upon occurrence of an event that is an impermissible separation from service under the regulations).

⁹⁸ See generally Notice 2010-6 §I; see, e.g., Notice 2010-6 §V(A)(2), §V(B)(2) (requiring income inclusion if within one year of correcting amendment the corrected provision was applied to avoid a payment or to provide for a payment that would not have been required under the prior language).

⁹⁹ Notice 2010-6 §I (general reference to one-year rule); see, e.g., Notice 2010-6 §V(A)(2), §V(B)(2). But, as discussed below, pre-correction timing requirements mostly also are with respect to income inclusion and therefore not applicable for nonvested NQDC.

¹⁰⁰ See §409A(a)(1)(A)(i).

¹⁰¹ See Prop. Reg. §1.409A-4(a)(1)(ii)(B)(3).

subsections address variations of the overarching document failure. The discussion below analyzes the applicability of categories of the timing requirements set forth with respect to each document failure in Notice sections IV through IX. Individual timing requirements under the Notice for nonvested amounts are presented in detail in the accompanying Table 1.

Notice section X is not discussed because it addresses the generally applicable period for correcting amendments following initial adoption of the NQDC plan by a service recipient. Likewise, Notice section XI is omitted because it provides transition relief for compliance with the Notice and thus does not address any specific document failures.

Correction Before a Payment Event

The Notice requires correcting amendments for some document failures to be made prior to a payment or other event upon the occurrence of which the deferrals would vest or already would be vested.¹⁰² The discussion below analyzes whether a deadline for correction that corresponds to a payment or other applicable event upon which the amounts would be vested applies with respect to nonvested amounts.

Timing Requirement, Which Includes a Payment Date. On the date a payment is made, compensation no longer would be subject to SRF and therefore would be outside the reach of §409A.¹⁰³ A deferred amount also would cease being NQDC subject to §409A following a payment to the executive or beneficiary.¹⁰⁴ Therefore, following a distribution the deferred amounts would be outside the scope of the proposed anti-abuse rule applicable to nonvested NQDC.

Thus, correction with respect to NQDC only would be subject to the proposed anti-abuse rule prior to the date of the earlier of vesting or payment. The Notice originally applied only to vested NQDC, so vesting without payment is not an event addressed in the Notice. Accordingly, document failures with respect to nonvested amounts may not be corrected past a deadline under the Notice that corresponds to a distribution event. Moreover, for income inclusion purposes the deferred amounts would be deemed vested for the taxable year of the executive during which the SRF of the amounts lapsed.¹⁰⁵ Thus, it would be too late under the proposed anti-abuse rule to amend the plan with respect to nonvested amounts in the tax year in which the deferrals vest. Therefore, any correcting

amendment under the Notice with respect to a nonvested amount would have to be made by the last day of the taxable year of the employee immediately preceding the taxable year of vesting.¹⁰⁶

No Correction Prior to Payment Date if Pattern or Practice of Late Payments (Line 2). There is an exception to the general rule for nonvested deferrals of correcting the failure in the tax year preceding the tax year in which vesting occurs. This exception applies to correcting an ambiguous payment period following a payment event under Notice §IV(A).¹⁰⁷ Such a plan provision would permit a distribution outside a short-term deferral period following the payment event, resulting in a document failure.¹⁰⁸ However, if the service recipient has a pattern or practice of making impermissible late payments, the plan and any other plan of employer containing similar language would be treated as failing to set a permissible payment date in violation of §409A(a)(2)(A).¹⁰⁹

In that case, an ambiguous payment period would be a document failure that may not be corrected under the Notice. The making of late payments would not be a pattern or practice of permitting substantially similar failures “while amounts deferred under the plans are nonvested” under the proposed anti-abuse rule.¹¹⁰ However, the employer may use the ambiguous payment period to retain discretion to make the late payment until the date of the payment event set forth in the plan. At the same time, the employee would be able to defer the tax event until the end of the permissible payment period.

This arrangement, instead of late payments, could be viewed under the proposed anti-abuse rule as a prohibited pattern or practice while the amounts remain nonvested. In this circumstance, the impermissible payment period provision would trigger §409A tax and penalties under the proposed anti-abuse rule. Thus, the ambiguous payment period would neither avoid document failure status nor be correctible under the Notice prior to the date of the payment event with respect to any nonvested deferrals.¹¹¹

Correction Before an Operational Failure

The occurrence of a payment or other event with respect to amounts vested upon the occurrence of the

¹⁰² See §409A(d)(4) (general definition of substantial risk of forfeiture for purposes of §409A, the lapse of which with respect to deferred amounts also generally is “vesting”).

¹⁰³ See §409A(d)(4) (defining generally a substantial risk of forfeiture).

¹⁰⁴ See Reg. §1.409A-1(b)(4).

¹⁰⁵ See §409A(a)(1)(A)(i); Reg. §1.409A-1(d)(1).

¹⁰⁶ See §409A(a)(1)(A)(i).

¹⁰⁷ Notice 2010-6 §IV(A)(2).

¹⁰⁸ Reg. §1.409A-1(b)(4)(i), §1.409A-3(b).

¹⁰⁹ Notice 2010-6 §IV(A)(2).

¹¹⁰ Prop. Reg. §1.409A-4(a)(1)(ii)(B)(2). This scenario reflects the pattern discussed at n. 127, below, where in general, timing requirements are not applicable for nonvested NQDC but non-compliance with other elements of the proposed anti-abuse rule would result in vesting and tax sanctions for the deferred amounts.

¹¹¹ See Reg. §1.409A-1(b)(4)(i).

event may result in the failure of the plan to comply with the operational requirements under §409A(a).¹¹² Vested amounts that are not correctible would have to be included in income in the tax year of the employee in which the failure occurs.¹¹³ Generally, an operational failure would remove the vested NQDC from the scope of the Notice and would require the service recipient to seek relief under Notice 2008-113.¹¹⁴

The IRS has not defined an operational failure to comply with §409A. Notice 2008-113 states merely that it applies to “certain failures of a nonqualified deferred compensation plan to comply with §409A(a) in operation (an operational failure).”¹¹⁵ Notice 2008-113 addresses in general only failures to pay deferred compensation that “otherwise would have been paid”¹¹⁶ or erroneous payments of compensation that should have been deferred until a later date.¹¹⁷

Neither of these situations would apply to nonvested amounts. An executive would have a legally binding right to nonvested NQDC.¹¹⁸ However, if the NQDC is subject to SRF, the deferrals are not payable or may not be paid or included in income until the SRF lapses.¹¹⁹

Thus, operational failures described in Notice 2008-113 may not occur with respect to nonvested amounts. Therefore, under the Notice, the occurrence of an operational failure is not a timing requirement that would be relevant to nonvested NQDC. Instead, a correcting amendment must be made with respect to NQDC under the Notice in the tax year preceding the tax year of the executive in which the compensation vests or is paid.¹²⁰ In turn, upon vesting or payment, there may or may not be an operational failure to comply with §409A.

¹¹² See generally §409A(a)(1)(A)(i)(II) (referring to a plan that “is not operated in accordance with” the requirements under §409A(a)(2), §409A(a)(3) or §409A(a)(4)).

¹¹³ §409A(a)(1)(A)(i).

¹¹⁴ Notice 2008-113, 2008-51 I.R.B. 1305; see, e.g., Notice 2010-6 §V(A)(2) (correction required before a payment event under the plan or a separation from service event under §409A that would result in an operational failure).

¹¹⁵ Notice 2008-113 §I.

¹¹⁶ See, e.g., Notice 2008-113 §IV(C)(2).

¹¹⁷ See, e.g., Notice 2008-113 §IV(A)(2), - (B)(2).

¹¹⁸ See Reg. §1.409A-1(b)(1) (plan treated as providing for a deferral of compensation generally if, under the terms of the plan and the relevant facts and circumstances, the service provider has a legally binding (or, in other words, contractual) right during a taxable year to compensation that, pursuant to the terms of the plan, is or may be payable to or on behalf of the service provider in a later taxable year).

¹¹⁹ See §409A(a)(1)(A)(i) (amounts includible in gross income to the extent not subject to a substantial risk of forfeiture if, in part, plan not operated in accordance with §409A(a)).

¹²⁰ See n. 103, above.

Correction Before Certain Events Not Resulting in Payment

The timing requirement under the Notice for some correcting amendments may be an event that would not trigger payment of a nonvested deferral. The correction deadline also may not result in an operational failure that would remove the amount from the scope of the Notice.¹²¹ Generally, the purpose of timing requirements for correcting amendments in the Notice is to signify avoidance of inclusion of a certain amount of vested NQDC in income in connection with the document failure.¹²² Nonvested amounts are not includible in income under §409A. Thus, under the Notice, there would not be any economic consequences for amending a plan with respect to nonvested NQDC later than such pre-distribution deadlines.

Also, these pre-distribution timing rules may be deemed requirements with respect to income inclusion exempt under the proposed anti-abuse rule for nonvested NQDC.¹²³ For example, a noncompliant plan may provide for a permissible and an impermissible payment event. In this case, the plan sponsor must amend the plan with respect to vested NQDC before the election to defer the amount until the impermissible payment event becomes irrevocable.¹²⁴ If the employer fails to remove the impermissible payment event before this deadline, the service provider may have to pay tax and penalties on 50 percent of the deferrals under the one-year rule discussed below.¹²⁵ Thus, amending the plan before the impermissible election becomes irrevocable would avoid the potential income inclusion. Accordingly, this timing requirement is with respect to income inclusion and not applicable for nonvested NQDC.¹²⁶

For these reasons, a plan sponsor would not need to comply specifically with these pre-payment timing requirements for correcting amendments with respect to

¹²¹ See Notice 2010-6 §IX(2) (correction before end of taxable year of service provider immediately following the tax year in which a timely initial deferral election must be made); §VII(D)(2) (correction if the discretion to change the time or form of payment is not exercised or is exercised and then revoked more than a year before the payment event); §VII(A)(2) (correction before election to defer an amount with respect to an impermissible payment event becomes irrevocable or the impermissible payment event provision otherwise applies). Also, as discussed below, with respect to nonvested amounts, by definition there may not be an operational failure.

¹²² See, e.g., Notice 2010-6 §V(A)(2) (correcting amendment before operational failure). But see Notice 2010-6 §IV(B)(2) (purpose of timing requirement to determine appropriate correction method).

¹²³ See *id.*

¹²⁴ See Notice 2010-6 §VII(A)(2); text below in Table 1, line 1(j).

¹²⁵ See n. 135, below.

¹²⁶ See Prop. Reg. §1.409A-4(a)(1)(ii)(B)(3).

nonvested deferrals. Instead, the general rule for correcting amendments made in the tax year prior to the year of vesting would continue to apply.¹²⁷ However, facts and circumstances surrounding the correcting amendment may form the basis for a violation of some other elements of the proposed anti-abuse rule.

Under the Notice, the employer must take commercially reasonable steps to identify and correct the substantially similar provisions in other plans of the employer, whether or not an impermissible election had been made under those plans.¹²⁸ This general eligibility requirement does not apply directly with respect to a nonvested amount. However, the second and third prongs of the proposed anti-abuse rule incorporate the general eligibility requirement applicable in these circumstances.¹²⁹

Under the second prong of the proposed anti-abuse rule, the presence of a prohibited pattern or practice of permitting substantially similar failures under §409A while the amounts are nonvested and which affect the deferred amounts would result in vesting of the NQDC.¹³⁰ Intent is a factor in finding a prohibited pattern or practice under the second prong.¹³¹ Also, under the third prong, the service recipient must correct substantially similar failures in substantially the same manner.¹³² Failure to meet these requirements under the proposed anti-abuse rule would result in vesting of the deferred amounts and consequent income inclusion and additional taxes under §409A(a) if there is no relief under the VCP. Consistently, if vesting is triggered, timing requirements under the VCP for correction of document failures would become applicable to the deferred amounts.

One-Year Rule and Amendment Effective Immediately Requirement

For certain document failures under the Notice, the correcting amendment must be effective immedi-

ately.¹³³ This timing requirement commonly is accompanied by a variation of an income inclusion rule as follows.¹³⁴ Generally, inclusion in income is required if, within one year of correction a certain event occurs that results in avoiding a payment or requiring a payment that would or would not have been due, respectively, under the pre-correction provision.¹³⁵ In that case, a percentage of the total deferred amount subject to the corrected provision is includible in income under §409A.¹³⁶

A primary purpose of the amendment being effective immediately is to trigger the one-year time period during which the event may occur.¹³⁷ In addition, an amendment may be required to be effective immediately in order to ensure that the correction is made before an operational failure occurs requiring the service recipient to seek relief under Notice 2008-113, which likewise may require inclusion in income.¹³⁸ However, nonvested amounts are not includible in income under §409A due to document failures.

Accordingly, the one-year rule does not apply to nonvested deferrals.¹³⁹ Likewise, the requirement for an amendment with respect to nonvested deferrals to be effective immediately does not apply. Rather, as a general rule, nonvested amounts must be corrected by the end of the tax year immediately preceding the tax year of the executive, in which the deferrals vest.¹⁴⁰ Incorporating the applicability rules derived in this section for the various categories of timing requirements, the Table below summarizes the applicability of each individual timing requirement to nonvested amounts.

¹³³ See Notice 2010-6 §V(A)(2), §V(B)(2), §V(C)(2), §VII(A)(2), §VII(C)(2), §VII(D)(2), §VII(F)(2), §VIII(2).

¹³⁴ See Notice 2010-6 §V(A)(2), §V(B)(2), §V(C)(2), §VII(A)(2), §VII(C)(2), §VII(D)(2), §VII(F)(2), §VIII(2).

¹³⁵ See, e.g., Notice 2010-6 §V(A)(2).

¹³⁶ See *id.*

¹³⁷ See, e.g., Notice 2010-6 §V(B)(2).

¹³⁸ See generally Notice 2008-113; Notice 2010-6 §V(B)(2).

¹³⁹ See Prop. Reg. §1.409A-4(a)(1)(ii)(B)(3) (income inclusion requirements not applicable to nonvested amounts); n. 100, above.

¹⁴⁰ See n. 103, above.

¹²⁷ See n. 103, above.

¹²⁸ See Notice 2010-6 §III(B).

¹²⁹ Prop. Reg. §1.409A-4(a)(1)(ii)(B)(2)–§1.409A-4(a)(1)(ii)(B)(3).

¹³⁰ Prop. Reg. §1.409A-4(a)(1)(ii)(B)(2).

¹³¹ See *id.*

¹³² Prop. Reg. §1.409A-4(a)(1)(ii)(B)(3).

Table 1. Timing Requirements for Correcting Plans with Respect to Nonvested NQDC

Line no./ § of the Notice	Document Failure	Timing Requirement for Correction	Applicability to Correcting Amendments With Respect to Nonvested Amounts
1.a IV(A)(2) Timing requirement (in other words, the deadline for the correcting amendment; hereinafter “timing requirement”) follows payment event.	Plan provision provides for a payment to be made “as soon as practicable” after a payment event, or similar language.	Correcting payment must be made before expiration of permissible payment period (including exceptions) ¹⁴¹ that followed the payment event.	<ul style="list-style-type: none"> ● Correcting amendment may not be made on or after the date of payment because on or after the payment date the amounts no longer would be nonvested. ● Correcting amendment is not required to avoid §409A(a) tax and penalties if payment is made timely. ● General Rule applies to remove impermissible payment period.
1.b IV(B)(2) Timing requirement follows vesting and/or a payment event.	Ambiguous Definition or No Definition of a Permissible Payment Event	Before the end of the taxable year of the service provider during which the operational failure (payment or failure to pay which does not comply with §409A) is corrected under Notice 2008-113.	<ul style="list-style-type: none"> ● Correcting amendment may not be made on or after the date of payment because on or after the payment date the amounts no longer would be nonvested. ● In this case, the payment or a failure to pay is treated as an operational failure eligible for relief under Notice 2008-113, but such failure would not be relevant to a nonvested amount. Thus, the deadline for making a correcting amendment before the end of the taxable year in which the operational failure is corrected is not applicable to nonvested amounts. ● A correcting amendment may be made after the date a plan fails to make a payment required to be paid to comply with §409A, if a vesting or payment event did not occur. For example, a payment was not made because the ambiguous payment event definition was interpreted not to require a payment or there was an alternative payment event under the plan. ● General Rule applies for correcting an ambiguous payment event definition.

¹⁴¹ See, e.g., §1.409A-3(d); §1.409A-3(b) (90-day period or certain number of years after payment events permissible time frames for distributions).

Line no./ § of the Notice	Document Failure	Timing Requirement for Correction	Applicability to Correcting Amendments With Respect to Nonvested Amounts
1.c V(A)(2) Timing requirement coincides with payment event.	Impermissible Definition of Separation from Service	Before occurrence of payment event that is not a separation from service under §409A.	<ul style="list-style-type: none"> ● Correcting amendment must be made before a payment event upon the occurrence of which the amounts would be vested. ● Likewise, document failure must be corrected prior to the occurrence of a payment event, which would constitute an operational failure. See Line 1(b) above. ● General Rule applies for correcting impermissible definition of separation from service.
1.d V(A)(2) Timing requirement precedes a payment under the plan.	Impermissible Definition of Separation from Service	Before occurrence of an event that is a §409A separation from service but is not a payment event under the pre-correction provision.	<ul style="list-style-type: none"> ● Deferrals may remain nonvested after a §409A separation from service occurs that is not a payment event under the plan if there is an alternative payment event that has not occurred yet. Thus, correcting amendment may be made after a separation from service under §409A that is not a payment event under the pre-correction plan. ● But other prongs of the proposed anti-abuse rule may cause vesting, inclusion in income and additional tax in the event of non-compliance. ● General Rule applies for correcting an impermissible definition of a separation from service.
1.e V(B)(2) Timing requirement coincides with a payment event.	Impermissible Definition of a Change in Control Event	Before a payment event that is not a change in control event under §409A ¹⁴² occurs.	<ul style="list-style-type: none"> ● Amounts would be vested upon a payment event under the plan that is not a change in control event under §409A. ● Therefore, such vested amounts no longer would be subject to the proposed anti-abuse rule, provided there is no subsequent, alternative payment event. ● Also, the payment event may constitute an operational failure not subject to relief under the Notice. ● Accordingly, a correcting amendment under the Notice must be made before such payment event. ● General Rule applies for correcting the impermissible change in control event definition.

¹⁴² See Reg. §1.409A-3(a)(5).

Line no./ § of the Notice	Document Failure	Timing Requirement for Correction	Applicability to Correcting Amendments With Respect to Nonvested Amounts
1.f V(C)(2) Timing requirement coincides with a payment event.	Impermissible Definition of Disability	Before a payment event occurs that is not a disability under §409A.	<ul style="list-style-type: none"> ● Amounts would be vested upon the occurrence of the impermissible payment event (which would be an operational failure) and therefore not subject to the proposed anti-abuse rule. ● Therefore, correcting amendment must be made before the payment event, assuming there is no subsequent, alternative payment event under the pre-correction plan. ● General Rule applies for correcting the impermissible definition of disability.
1.g VI(A)(2) Timing requirement coincides with a payment event.	Payment Period Following a Payment Event Longer Than 90 Days and Not Within the Same Taxable Year ¹⁴³	Before the occurrence of the permissible payment event.	<ul style="list-style-type: none"> ● Amounts would be vested upon the occurrence of the permissible payment event. ● Therefore, correcting amendment must be made before the payment event. ● General Rule applies for correcting the impermissible payment period.
1.h VI(A)(2) Timing requirement follows a payment event.	Payment Period Following a Payment Event Longer Than 90 Days and Not Within the Same Taxable Year	Within a reasonable time following the permissible payment event.	<ul style="list-style-type: none"> ● Amounts would be vested following the permissible payment event. ● Therefore, correcting amendment may not be made following the permissible payment event.
1.i VI(B)(2) Timing requirement coincides with a payment event.	Payment Period Following a Payment Event Dependent on Discretionary Action of Service Provider, Such as Executing a Release of Claims	Before the occurrence of the permissible payment event.	<ul style="list-style-type: none"> ● Amounts would be vested upon the occurrence of the permissible payment event. ● Therefore, correcting amendment must be made before the permissible payment event. (Also, failure to pay timely would be an operational failure outside the scope of the Notice.) ● General Rule applies for removing the impermissible discretion.

¹⁴³ See Reg. §1.409A-3(b).

Line no./ § of the Notice	Document Failure	Timing Requirement for Correction	Applicability to Correcting Amendments With Respect to Nonvested Amounts
1.j VII(A)(2) Timing requirement pre- cedes a payment event under the plan.	Plan Providing for a Permissible and an Im- permissible Payment Event	Before a deferral election by the service provider with re- spect to an impermissible pay- ment event or before the im- permissible payment event provision otherwise becomes applicable to the deferrals of the service provider.	<ul style="list-style-type: none"> ● The election of an impermissible payment event or the impermissible payment event provision otherwise applying does not result in vesting, payment or an operational failure. An impermissible deferral election is a document failure.¹⁴⁴ ● Therefore, the correcting amendment may be made to remove the impermissible payment event even after the election has been made irrevocably¹⁴⁵ or the impermissible payment event provision otherwise applies to the deferrals of the service provider, but before the amounts vested. ● But other prongs of the proposed anti-abuse rule may cause vesting, inclusion in income and additional tax in the event of non-compliance.¹⁴⁶ ● In addition, the General Rule applies for correcting an impermissible payment event.
1.k VII(A)(2) Timing requirement coin- cides with a payment event.	Plan Providing for a Permissible and an Im- permissible Payment Event	Before the date any of the impermissible payment events occur.	<ul style="list-style-type: none"> ● An impermissible payment event would result in an operational failure for which the Notice does not provide relief. ● Also, the amounts would be vested upon the occurrence of an impermissible payment event. ● Therefore, correcting amendment under the Notice must be made before the impermissible payment event. ● General Rule applies for correcting an impermissible payment event.
1.l VII(B)(2) Timing requirement coin- cides with a payment event.	Plan Providing for Only an Impermissible Pay- ment Event	Before the impermissible pay- ment event occurs.	<ul style="list-style-type: none"> ● See Line 1.k above (General Rule applies).

¹⁴⁴ See §409A(a)(4)(B).

¹⁴⁵ See Reg. §1.409A-2(a)(1) (addressing an election becoming irrevocable as resulting in a contractual commitment to defer the compensation); §1.409A-2(a)(2) (discretion being exercised by service recipient with respect to service provider election to defer indicating the election being revocable).

¹⁴⁶ See Notice 2010-6 §III(B), §VII(A)(2).

Line no./ § of the Notice	Document Failure	Timing Requirement for Correction	Applicability to Correcting Amendments With Respect to Nonvested Amounts
1.m VII(C)(2) Timing requirement coincides with a payment event.	Impermissible Alternative Payment Schedule	Before a separation from service or other applicable payment event occurs.	<ul style="list-style-type: none"> ● The amounts would be vested upon the occurrence of a payment event. ● Therefore, correcting amendment under the Notice must be made before the payment event. ● General rule applies for correcting the impermissible toggle.
1.n VII(D)(2) Timing requirement precedes a payment event under the plan.	Impermissible Discretion with Respect to a Payment Schedule Following a Permissible Payment Event (Including Subsequent Deferral Elections)	<ul style="list-style-type: none"> ● Before service recipient or service provider exercise discretion to change the time or form of payment; or, ● If the discretion is revoked more than one year before the payment event occurs. 	<ul style="list-style-type: none"> ● There is no document failure, and therefore, no correcting amendment is required if the discretion is not exercised or is revoked more than one year prior to the payment event if the plan provision includes a default time or form of payment, discretion to change the time or form of payment is not exercised, and there is no discretion under the plan to change the time or form of payment after the payment event occurred. ● If the discretion is revoked one year or less before the payment event, a document failure would occur. But the document failure would not result in vesting or payment of nonvested amounts, and would not be an operational failure outside the scope of the Notice.
			<ul style="list-style-type: none"> ● Thus, correcting amendment may be made if the discretion to change the time or form of payment was exercised and revoked a year or less before the payment event. ● But other prongs of the proposed anti-abuse rule may cause vesting, inclusion in income and additional tax in the event of non-compliance. ● General Rule applies for removing the impermissible discretion.
1.o VII(D)(2) Timing requirement coincides with a payment event.	Impermissible Discretion with Respect to a Payment Schedule Following a Permissible Payment Event (Including Subsequent Deferral Elections)	Before payment event occurs.	<ul style="list-style-type: none"> ● Amounts would be vested upon the occurrence of the payment event. ● Therefore, correcting amendment must be made before the payment event. ● General Rule applies for removing the impermissible discretion.

Line no./ § of the Notice	Document Failure	Timing Requirement for Correction	Applicability to Correcting Amendments With Respect to Nonvested Amounts
1.p VII(E)(2) Timing requirement pre- cedes a payment event under the plan.	Impermissible Service Recipient Discretion to Accelerate Payment Event	Before earlier of: <ul style="list-style-type: none"> ● Service recipient irrevocably exercises discretion to accelerate a payment; or, ● A payment is made pursuant to service recipient discretion. 	<ul style="list-style-type: none"> ● Irrevocable exercise of service recipient discretion to accelerate a payment under the plan is a document failure. Irrevocable exercise of discretion does not result in vesting, payment or an operational failure outside the scope of the Notice. ● Thus, correcting amendment to remove impermissible discretion to accelerate a payment or to make the acceleration permissible may be made after the irrevocable exercises of discretion to accelerate a payment. ● But other prongs of the proposed anti-abuse rule may cause vesting, inclusion in income and additional tax in the event of non-compliance. ● Amounts would be vested upon the occurrence of the impermissibly accelerated payment event and such payment event would constitute an operational failure outside the scope of the Notice. ● General Rule applies for removing the impermissible discretion.
1.q VII(F)(2) Timing requirement coin- cides with a payment event.	Impermissible Reim- bursement or In-Kind Benefit Provisions	Before an event occurs that would result in eligibility of service provider for benefits.	<ul style="list-style-type: none"> ● Under Example 16 in Notice §VII(G), an event that would result in eligibility of service provider to receive the benefits would be a payment event.¹⁴⁷ ● Correcting amendment under the Notice must be made before a payment or a vesting event. ● General Rule applies for correcting the impermissible plan provisions. ● If the event resulting in eligibility is a vesting event, then the deferrals may not remain non-vested after the eligibility event occurs and therefore, a correcting amendment with respect to nonvested deferrals must precede the event resulting in eligibility for benefits and General Rule applies for correcting the impermissible plan provisions.

¹⁴⁷ Notice 2010-6 §VII(G), Ex. 16.

Line no./ § of the Notice	Document Failure	Timing Requirement for Correction	Applicability to Correcting Amendments With Respect to Nonvested Amounts
1.r VIII(2) Timing requirement coincides with a payment event.	Failure to Include Six-Month Delay of Payment for Specified Employee	Before separation from service or if earlier death of specified employee.	<ul style="list-style-type: none"> ● Amounts would be vested upon the occurrence of a payment event such as separation from service. ● Therefore, correcting amendment must be made before the payment event. ● General Rule applies for correcting the failure to include the six-month delay.
1.s IX(2) Timing requirement precedes a payment event under the plan.	Impermissible Initial Election to Defer Compensation (Not Election as to Time or Form of Payment Eligible for Correction Under VII(D))	Before the end of the taxable year of the service provider immediately following the taxable year during which the initial deferral election must have been made.	<ul style="list-style-type: none"> ● If amounts do not vest before the end of the taxable year of the service provider immediately following the tax year during which a timely initial deferral election was due, the correcting amendment may be after the expiration of that period. ● But other prongs of the proposed anti-abuse rule may cause vesting, inclusion in income and additional tax in the event of non-compliance. ● General Rule applies for correcting the impermissible initial election to defer.
2. IV(B)(2) Timing requirement is not with respect to income inclusion.	Permissible Payment Event with No Definition or Ambiguous Definition	<ul style="list-style-type: none"> ● Before service recipient interprets the ambiguous provision setting forth the payment event so as to give rise to a pattern or practice of interpreting the term in a way that does not comply with §409A; or, ● Before a court of competent jurisdiction interprets such contractual provision, ● Either in the plan or in any other plan of service recipient with substantially similar language. 	<ul style="list-style-type: none"> ● <i>Before interpretation that creates a pattern or practice:</i> Notice §IV(B)(2) would apply but simply to determine the applicable correction method. ● The second prong of the anti-abuse rule prohibiting a pattern or practice of permitting substantially similar failures with respect to nonvested amounts, which affect the nonvested amounts may apply and would result in vesting. ● <i>Before interpretation by a court:</i> would apply but simply for the purpose of determining applicable correction method (if payment event definition is not ambiguous, Notice §V may provide relief).

III. Practical Application of Correction Methods in Notice to Nonvested NQDC

Under the proposed anti-abuse rule, the applicable correction methods in the Notice govern how plan sponsors may correct document failures with respect to nonvested amounts. Generally, the Notice provides relief for document failures concerning definitions or timing of payment events or changes to time or form of payment. As an exception, document errors, which

may result in failure to comply with §409A(a) due to the definition of a substantial risk of forfeiture would be outside the scope of the Notice. The reason is that the Notice originally applied only to vested NQDC.

The discussion below compares the manner in which some common document failures could be corrected with respect to nonvested amounts before and after issuance of the proposed anti-abuse rule. The prior anti-abuse rule did not specify the restrictions

contained in the Notice on correction methods for document failures. Thus, employers were not obligated expressly under IRS guidance to employ a particular correction method subject to these restrictions.

But correction methods outside the Notice also were not sanctioned expressly with respect to non-vested deferrals. Thus, the discussion below refers to correction procedures that were not verified for compliance with §409A as attempts by the service recipient to correct a particular document failure.

The discussion in section II of the article demonstrated the significance of the facts and circumstances surrounding the timing of correction of a document failure, especially where a pre-distribution timing requirement does not apply. Applying a prescribed correction method for nonvested NQDC likewise involves an analysis of the facts and circumstances attendant to the plan document failure in order to comply with the proposed anti-abuse rule.

Definition of a Payment Event

Ambiguous Definition of Certain Permissible Payment Events

Prior Timing of Correction. Previously, there was no applicable timing requirement in IRS guidance other than the former anti-abuse rule for correcting an ambiguous definition of a payment event. Thus, an employer could attempt to amend an ambiguous term, such as the definition of a separation from service, after having applied the term in violation of §409A to other distributions from the plan or similarly drafted plans.¹⁴⁸

Timing of Correction Under the Proposed Anti-Abuse Rule. By contrast, under the Notice, a pattern or practice of interpreting the definition of a payment event in violation of §409A precludes the service recipient from using the correction method for an ambiguous payment event definition.¹⁴⁹ Moreover, under the Notice the service recipient may not have used the ambiguous term intentionally in the plan or in any other plan with substantially similar language.¹⁵⁰

Prior Correction Method. Prior to the issuance of the proposed anti-abuse rule, a service recipient could attempt to add or delete a payment event to conform the definition of the payment to §409A requirements. The service recipient could argue the change was justified based on the relevant facts and circumstances¹⁵¹ that gave rise to the drafting ambiguity. Likewise, the

service provider could say that, based on the relevant facts and circumstances, the addition or deletion of a payment event would resolve an inconsistency of the definition with other provisions in the plan. For instance, those provisions might indicate that the parties intended the additional payment event to apply or an existing payment event under the plan to be inapplicable.

Correction Method Under the Proposed Anti-Abuse Rule. Under the Notice, the employer simply could add a qualifier that the definition is intended to be interpreted as necessary to comply with §409A.¹⁵² Alternatively, the employer could set forth a new definition of the payment event under the plan.¹⁵³ But the employer may not expand or narrow the definition to exclude an existing payment event or include a new payment event not previously set forth in the plan.¹⁵⁴ In addition, to be eligible for relief, the plan sponsor may not have intentionally used an ambiguous term for a payment event.¹⁵⁵ Finally, the plan sponsor or a court of competent jurisdiction may not have interpreted previously the ambiguous definition with respect to the plan participant or the NQDC plans of other employees.¹⁵⁶

The Notice says explicitly that only those alternative payment event designations that were “timely made and explicitly provided” in the plan would be taken into account.¹⁵⁷ Therefore, by contrast to previous potential correction methods, relevant facts and circumstances without adequate plan language may be insufficient to support an added or deleted payment event in the plan definition. However, the Notice does not appear to preclude the payment event under the corrected provision from varying from but being in the same category of a distribution event under §409A(a)(2)(A) as the pre-correction payment event.¹⁵⁸

For example, a poorly drafted plan may have set forth an unintentionally ambiguous definition of a separation from service. The plan sponsor and participant may seek to amend the definition to comply with §409A¹⁵⁹ by specifying a different separation from service event upon which a distribution would occur. In this situation, the “addition or deletion” prohibition under the Notice should not apply to preclude such a correcting amendment, as opposed to an amendment that, for example, would replace a separa-

¹⁴⁸ See Notice 2010-6 §IV(B)(1).

¹⁴⁹ *Id.*

¹⁵⁰ Notice 2010-6 §IV(B)(2).

¹⁵¹ See Reg. §1.409A-1(b)(1) (existence of deferral determined based upon plan language and the relevant facts and circumstances).

¹⁵² *Id.*

¹⁵³ *Id.*

¹⁵⁴ Notice 2010-6 §IV(B)(2).

¹⁵⁵ *Id.*

¹⁵⁶ Notice 2010-6 §IV(B)(1).

¹⁵⁷ Notice 2010-6 §IV(B)(2).

¹⁵⁸ §409A(a)(2)(A).

¹⁵⁹ See §409A(a)(2)(A)(i).

tion of service with a specified date of distribution as a payment event.¹⁶⁰ The reason is that, under the first prong of the proposed anti-abuse rule, an amendment outside the §409A regulations may be made so long as it is necessary to bring the plan into §409A compliance.¹⁶¹

The first prong of the proposed anti-abuse rule does not state expressly that only certain types of amendments are permitted in particular circumstances.¹⁶² Thus, the first prong does not expressly prohibit an amendment that creates a different type of a distribution event, so long as change would make the payment event permissible under §409A. On the other hand, changing the type of a payment event may be viewed as making an amendment that is not “necessary to bring the plan into compliance” with §409A.¹⁶³ Moreover, if the parties amended the plan in this manner with respect to only some participants, the change may violate the second and third prongs of the proposed anti-abuse rule.¹⁶⁴

In sum, it is unclear under the Proposed Regulations how the correction method for an ambiguous or undefined permissible payment event under the Notice would apply for nonvested NQDC. But under both the Notice and the proposed anti-abuse rule, facts and circumstances play a key role in applying the prescribed correction method for noncompliant definitions of payment events with respect to nonvested deferrals. Therefore, plan sponsors and executives should be cautious in tailoring the correcting amendment as closely as possible to the pre-correction plan language. In furtherance of this objective, it would seem advisable to specify a payment event under the amended provision that is of the same type under §409A as the pre-correction distribution event.

Possible Safe Harbor for Amending Ambiguous Definitions of Certain Payment Events. Such a fact-intensive application of the proposed anti-abuse rule to correcting ambiguous or undefined permissible payment events may force the parties to renegotiate compensation arrangements, potentially increasing the cost of NQDC awards. As an economic burden passed to the shareholders, these restrictions may not be appropriate for compensation before the executive actually has earned the award. In these instances, there is no guaranteed payment of compensation and therefore less potential for abuse.

To ease these apparent compliance burdens with respect to nonvested deferrals, the IRS may issue addi-

tional guidance establishing a safe harbor for this type of a correcting amendment. The rule may clarify that an amended payment event that is in the same category under §409A as the ambiguously defined payment event in the pre-correction plan would comply with the proposed anti-abuse rule.

The safe harbor also may clarify that, in this case, the parties would not need to establish the original intent with respect to such amended, similar payment event. Likewise, the safe harbor may clarify that the amended, similar payment event was not required to have been referenced under pre-correction terms of the ambiguously drafted plan document. Such an exception would eliminate additional compliance costs in situations preceding vesting of the compensation, where the plan language is ambiguous and the plan sponsor has not yet interpreted the ambiguous provision with respect to the employee or other participants.

Some Practical Steps for Employers in Correcting Payment Event Definitions. Until any conclusive guidance in this regard is issued, it would be significant for employers correcting an ambiguous or undefined payment event internally to memorialize the scrivener’s or other type of good faith error, once discovered. For this purpose, plan sponsors may find helpful to retain on file any draft copies of the plan document and related correspondence or other writing. Plan sponsors also must ensure that any internal correcting amendments of payment event definitions are uniform across all NQDC contracts with the same executive or other employees, which contain substantially similar language.

In addition, employers must confirm that prior to correcting the document failure, the service recipient had not interpreted the similarly ambiguous or undefined payment provision with respect to NQDC of the same employee under another plan or of other employees in a manner that would be inconsistent with the contemplated correcting amendment. Employers also would find it important to correct any discovered document failures across all noncompliant plans as soon as reasonably possible. These steps would assist in demonstrating lack of intent of the plan sponsor to avoid §409A in amending the distribution provision and compliance with other requirements for such amendments under the Notice and the proposed anti-abuse rule.

Patently Impermissible Definition of Permissible Payment Events

Prior Timing of Correction. Before the proposed anti-abuse rule, impermissible definitions of certain otherwise permissible payment events including a separation from service, a change in control or a disability had to be amended prior to vesting of the

¹⁶⁰ See §409A(a)(2)(A)(iv).

¹⁶¹ Prop. Reg. §1.409A-4(a)(1)(ii)(B)(1).

¹⁶² See *id.*

¹⁶³ See REG-123854-12.

¹⁶⁴ Prop. Reg. §1.409A-4(a)(1)(ii)(B)(1)–§1.409A-4(a)(1)(ii)(B)(2).

amounts to avoid having to comply with VCP requirements.

Timing of Correction Under the Proposed Anti-Abuse Rule. If the payment event definition were not deemed ambiguous or absent from the plan document under the Notice, impermissible definitions of a separation from service, a change in control or a disability each would have to be corrected prior to the earlier of vesting or payment under the proposed anti-abuse rule.¹⁶⁵

Prior Correction Method. Similarly to ambiguous or unstated definitions of a separation from service, an employer could take into account relevant facts and circumstances to determine a permissible definition of a separation from service consistent with the intent of the parties. Likewise, with respect to correcting an impermissible definition of a change in control, the parties were not restrained expressly from specifying a payment event under the amended plan based on the relevant facts and circumstances of the agreement. Similarly, if a definition of a disability did not conform to §409A(a)(2)(A)(ii) requirements, the service recipient could amend the definition to comply with §409A.

Correction Method Under the Proposed Anti-Abuse Rule. The employer and executive have some leeway in deleting a disability as a payment event or amending it to comply with §409A under the proposed anti-abuse rule before a payment event occurs.¹⁶⁶ By comparison, the proposed anti-abuse rule imposed more restrictions on permissible correcting amendments for a definition of a separation from service or a change in control.¹⁶⁷ Similarly to an ambiguous definition of a separation from service, an employer may not amend the definition under the plan to add or delete a payment event.¹⁶⁸

Likewise, to amend the definition of a change in control¹⁶⁹ to comply with §409A(a)(2)(A)(v), a service recipient may not cause an event that was not a payment event under the original terms of the plan to become a payment event under the plan.¹⁷⁰ Thus, similarly to correcting ambiguous definitions of otherwise permissible payment events, the employer and executive may not rely solely on relevant facts and circumstances to establish a compliant definition of the payment event consistent with their original intent.

¹⁶⁵ See Notice 2010-6 §V.

¹⁶⁶ See Prop. Reg. §1.409A-4(a)(1)(ii)(B)(3); Notice 2010-6 §V(C)(2).

¹⁶⁷ See Prop. Reg. §1.409A-4(a)(1)(ii)(B)(3); Notice 2010-6 §V(A)(2), §V(B)(2).

¹⁶⁸ Notice 2010-6 §V(A)(2).

¹⁶⁹ See §409A(a)(2)(A)(v).

¹⁷⁰ Notice 2010-6 §V(B)(2).

For an impermissible as opposed to ambiguous or unstated definition, the employer does not have to demonstrate under the Notice that the deficient plan provision was unintentional. Also, a plan sponsor does not have to show that an impermissible separation from service definition was not interpreted on prior occasions in a Section 409A noncompliant manner, but such a rule inherently would not be relevant to a facially impermissible provision. Thus, if the NQDC plan provides for a clearly impermissible as opposed to an ambiguous or omitted definition of a separation from service, the Notice does not require a showing of intent.

But, as stated above, intent of parties with respect to the plan document failure is a factor in determining compliance with the second prong of the proposed anti-abuse rule.¹⁷¹ Thus, practical steps other than prior interpretation of the noncompliant plan term outlined above would be useful for correcting impermissible definitions of a separation from service or a change in control.

Possible Safe Harbor for Amending Impermissible Definitions of Payment Events. To ease the administrative and economic burden on plan sponsors and participants, the IRS similarly may clarify in a safe harbor the application of the addition or deletion the rule for correcting an impermissible definition of a permissible payment event.

Thus, so long as the amended payment event is in the same category as the prior distribution event and complies with the definition of such category of distribution condition under §409A, the amendment would not violate the proposed anti-abuse rule. But the plan sponsor might do so only so long as there is (1) no pattern or practice of permitting substantially similar failures while the amounts are subject to SRF, and (2) the plan sponsor reasonably identifies and corrects all substantially similar plan failures. Similarly to a possible clarification of the rule for amending ambiguous definitions, such a clarification may be incorporated in the proposed anti-abuse rule. This additional language would help to better balance the respective interests of regulatory enforcement and private stakeholders in correcting ambiguous, omitted or impermissible definitions of permissible distribution events

Time or Form of Payment

Impermissible Toggle

An impermissible toggle results generally when a plan provides for multiple times or forms of payment upon the occurrence of a permissible payment

¹⁷¹ See Prop. Reg. §1.409A-4(a)(1)(ii)(B)(2).

event.¹⁷² Prior to the proposed anti-abuse rule, a plan sponsor could attempt to amend the plan to remove the erroneous alternative form of payment prior to vesting or payment. The employer could argue that the form of payment was included in the plan erroneously and was not intended by the parties, as demonstrated by relevant facts and circumstances or in conjunction with other plan provisions.

Under the Notice, the service recipient may correct certain impermissible toggles prior to vesting or payment by removing an alternative time or form of payment.¹⁷³ However, the Notice sets forth restrictions regarding the time or form of payment, which the plan sponsor may remove by a correcting amendment. First, the remaining payment date or schedule must be the time or form of payment resulting in or potentially resulting in the latest final payment date.

Second, if two payment dates or schedules result actually or potentially in the same final payment date, the remaining date or schedule must be that which is commencing or potentially commencing at the last possible date. Third, if both times or forms of payment commence actually or potentially at the same time, the plan sponsor must select the payment date or schedule that generally would be anticipated to result in the deferred amount being paid at later dates.

As discussed above, unlike vested compensation, remuneration subject to SRF is not guaranteed pay. Thus, by contrast to vested deferrals, the threshold question for a distribution of nonvested amounts is not when it would take place, but rather, whether the distribution would occur. Therefore, these timing restrictions may not be appropriate for deferred pay that would not be distributed necessarily to the executive.

This is especially true since, the VCP requirements for correcting toggles address only the prohibition on acceleration of payments.¹⁷⁴ Applying these Notice requirements technically may be inconsistent with the subsequent deferral election rules.¹⁷⁵ In seeking an appropriate balance between administrative enforcement objectives and limiting excessive shareholder costs, the suggestion may be to exempt toggle corrections for nonvested amounts from these technical Notice requirements.

Instead, the IRS may issue guidance permitting plan sponsors alternatively to amend payment forms or schedules for nonvested amounts based on attendant facts and circumstances used to establish the

original intent of the plan sponsor and executive with respect to the time or form of payment. The requirement under the first prong of the proposed anti-abuse rule would ensure that only amendments necessary to eliminate the toggle are made.¹⁷⁶ Consistently, determining compliance with the first prong of the proposed anti-abuse test is based on facts and circumstances. A facts and circumstances approach, evidenced by supporting documentation, may be a more appropriate correction method in some instances with respect to nonvested deferrals in the view of complying with Section 409A requirements for the time or form of payment of NQDC.

Discretion to Determine Payment Schedule After Payment Event

Prior to the proposed anti-abuse rule, a discretion to select a time or form of payment after the payment event occurred without a default payment date or schedule would have violated subsequent deferral election or acceleration of payment requirements under §409A.¹⁷⁷ A plan sponsor could attempt to delete the impermissible discretion and include a default time or form of payment while amounts were nonvested. The service recipient could argue the amendment reflected the original intent of the parties and the relevant facts and circumstances as to the time or form of distributions after a payment event, without limitation on the amended time or form of payment.

Under the Notice, the same three-point methodology applies to delete the discretion to select a time or form of distributions after the payment event occurred, if the plan does not provide a default payment date or schedule.¹⁷⁸ However, in this case, the three-point rule may be appropriate for correcting amendments for nonvested amounts. The reason is that, since the service recipient failed to state a default time or form of payment, there is a greater possibility that the parties may have intended a deferred payment arrangement that would have resulted in circumvention of §409A restrictions on timing or form of payment. Accordingly, where the plan does not set forth a default time or form of payment, removal of impermiss-

¹⁷⁶ See Prop. Reg. §1.409A-4(a)(1)(ii)(B)(1).

¹⁷⁷ See Reg. §1.409A-2(b)(1) (general requirements for subsequent deferral elections); §1.409A-2(b)(5) (coordination of certain timing requirements applicable to changing the schedule of payments under a plan with the prohibition on acceleration of payments); §1.409A-3(j)(1) (general rule for prohibition on acceleration of time or schedule of payments); §1.409A-3(j)(2) (application of prohibition on acceleration of payments to addition, deletion or substitution of a permissible payment event under the plan, requirement to comply with subsequent deferral election rules with respect to permissible addition of a payment event that would result in a payment being made at an earlier time).

¹⁷⁸ Notice 2010-6 §VII(D)(2).

¹⁷² See Reg. §1.409A-3(c).

¹⁷³ See Notice 2010-6 §VII(C)(2) (setting forth specific rules for toggles with respect to payment events arising by reason other than a separation from service being voluntary or involuntary).

¹⁷⁴ See §409A(a)(3).

¹⁷⁵ See §409A(a)(4)(C).

sible discretion of service recipient to make such a determination after distributions commence may be subject to the Notice restrictions.

Discretion of a Service Recipient to Accelerate a Payment

Prior to the proposed anti-abuse rule, a service recipient could amend a plan provision setting forth an impermissible discretion to accelerate a payment.¹⁷⁹ Similarly to the above plan document failure, an employer might have amended an existing plan by providing a new payment date or schedule that would have resulted in a prohibited acceleration of payments.¹⁸⁰ In each case, the employer could attempt to correct the document failure by removing the discretion or the amended payment schedule at any time before the payment event with respect to nonvested deferrals.

Under the Notice, an impermissible discretion to accelerate a payment may be removed with respect to vested amounts prior to the earlier of the date the discretion is exercised and becomes irrevocable or the accelerated payment date.¹⁸¹ However, with respect to nonvested amounts, irrevocable exercise of discretion by the service recipient to pay amounts on an earlier date does not result in vesting or payment of the deferrals.

Therefore, the service recipient may make the correcting amendment following the irrevocable exercise of discretion to accelerate but before the accelerated payment event. Under the Notice, the employer may correct the document failure by removing the prohibited discretion to accelerate a payment. Alternatively, the plan sponsor may conform the payment provision to comply with §409A requirements for permissible acceleration of a payment.¹⁸² Accordingly, the proposed anti-abuse rule does not impose additional restrictions on correcting an impermissible discretion of a service recipient to accelerate a payment with respect to nonvested NQDC compared to the prior anti-abuse rule.

CONCLUSION

By virtue of the proposed, three-prong anti-abuse rule under the proposed §409A income inclusion regulations, the IRS eliminated numerous timing and

other eligibility requirements for correcting plans with respect to nonvested amounts that would have applied to vested NQDC. However, the proposed anti-abuse test calls for a facts and circumstances analysis as a replacement for the eliminated eligibility requirements and to ensure proper application of the prescribed correction methods. Without further clarification, this test imposes an undue administrative burden on plan sponsors and executives, the cost of which ultimately is borne by the shareholders.

The remaining criteria with respect to nonvested NQDC under the Notice represent a divergent approach to the applicable correction methods. On the one hand, this new framework is less defined with respect to nonvested deferrals. On the other hand, based on the language in the Notice applicable to VCP submissions, the IRS has broad authority to reject the interpretation of a taxpayer of the applicable correction requirements for nonvested NQDC.

Thus, without further clarification, plan sponsors would have to tailor some correcting amendments for a payment event definition closely to original plan terms. Such revisions potentially may come at the expense of accurately reflecting the original intent of the parties in negotiating the terms of the deferred compensation arrangement. Also, employers prospectively may have to retain draft plan documents or other writing evidencing the lack of intent to circumvent §409A requirements.

Internal reviews of numerous NQDC plans of the employer may be required if a plan document failure is detected. A service recipient would have to amend promptly any noncompliant plans for the various plan participants under the weight of these restrictions. The plan sponsor may have to make conforming amendments to the NQDC plan provisions even if the facts and circumstances of each individual arrangement may not warrant conforming plan language. These are only some of the issues that could arise in complying with the proposed anti-abuse rule and applicable Notice requirements, as currently written.

The costs of these additional administrative burdens on the plan sponsors and executives ultimately would affect adversely shareholder interests. To address these concerns, it would be advisable for the IRS to promulgate additional guidance or include additional language in the income inclusion regulations identifying or clarifying as discussed in this article the specific Notice requirements for correcting document failures with respect to nonvested deferrals. Specifically, the IRS could say in the anti-abuse rule that timing requirements do not apply for nonvested amounts because they are with respect to income inclusion. Such a rule would be warranted based on the analysis of the timing requirements in this article and little potential for abuse given the uncertainty that nonvested amounts eventually would be paid.

¹⁷⁹ See Reg. §1.409A-3(j) (general prohibition on permitting to accelerate payments under plan terms or on actually accelerating payments irrespective of the plan language). *But see* Prop. Reg. §1.409A-3(j)(2).

¹⁸⁰ See Reg. §1.409A-3(j)(4) (permitting discretion of service recipient to accelerate payment under a plan only under limited conditions). *But see* Prop. Reg. §1.409A-3(j)(4).

¹⁸¹ Notice 2010-6 §VII(E)(2).

¹⁸² See Reg. §1.409A-3(j)(4).

Likewise, in determining the applicable correction methods, the IRS may include safe harbors discussed in the article that would ease the administrative and economic burden on plan sponsors, executives and shareholders in correcting ambiguous or impermissible definitions of payment events. Similarly, the IRS may incorporate in the proposed anti-abuse rule a

facts and circumstances based safe harbor for correcting impermissible alternative payment forms or schedules. This guidance or rulemaking would provide more certainty and thereby enable plan sponsors and participants to avoid potential pitfalls in complying with the new correction regime for nonvested NQDC.