

February 2010

IRS Releases 409A Document Correction Guidance

Section 409A of the Internal Revenue Code applies to non-qualified deferred compensation (NQDC) plans and to all amounts deferred after December 31, 2004, under the affected plans. Section 409A has specific requirements relating to the distribution, acceleration and election provisions in a deferred compensation plan, and initially the IRS allowed plans to make a good faith effort to comply with the new requirements. However, starting on January 1, 2009, the IRS required that both the documentation and operation of deferred compensation plans must be in full compliance with the requirements of Section 409A; if a plan is not in compliance, income deferred may be currently includible in gross income, and there may be an additional 20% excise tax as well as interest due on the taxable income.

The IRS has been working on a program that would allow plan sponsors to amend their existing deferred compensation plans to ensure that the plans comply with the requirements of Sections 409A and 1.409A-1(c). The IRS recently released Notice 2010-6, which is intended to encourage plan sponsors to review plan documents and identify and correct provisions that do not comply with Sections 409A and 1.409A-1(c). Compliance with Notice 2010-6 (“the Notice”) can also help taxpayers potentially reduce current income inclusion and additional taxes under Section 409A. Taxpayers can rely on Notice 2010-6 for tax years beginning on or after January 1, 2009. The IRS previously issued Notice 2008-113, effective as of January 1, 2009, to allow NQDC plan sponsors to correct operational failures of a plan that has not been administered in compliance with Section 409A.

Notice 2010-6

Notice 2010-6 provides plan sponsors with guidance for dealing with a variety of issues that may cause a deferred compensation plan to fail to be in documentary compliance with Sections 409A and 1.409A-1(c).

The general types of documentary failures covered by Notice 2010-6 include:

- **Ambiguous Plan Terms**
- **Impermissible Definition of Otherwise Permissible Payment Events**
- **Impermissible Payment Periods Following a Permissible Payment Event**
- **Impermissible Payment Events and Payment Schedules**
- **Failure to Include Six-Month Delay of Payment for Specified Employees**
- **Impermissible Initial and Subsequent Deferral Elections**

Eligibility for Relief. Under Notice 2010-6, to be eligible for relief, four things must happen: (a) the document failure must be corrected; (b) the appropriate correction method and relief applicable to the document failure must be selected; (c) participants must include any required amounts in income under §409A(a) and pay all applicable taxes; and (d) both the plan sponsor and participants must comply with the information and reporting requirements of the Notice.

Conditions for Obtaining Relief. Relief under the Notice isn't available if the federal income tax return of the plan sponsor or the participant is under examination with respect to NQDC for any taxable year in which the document failure existed. Relief applies only to failures that are inadvertent and unintentional, and isn't available if the failure is directly or indirectly related to participation in any listed transaction. Relief provided under Notice 2010-6 is conditioned upon the participant: (i) including the amount in income on the appropriate tax return and paying all applicable federal taxes, including the additional 20% tax under §409A(a)(1)(B)(i)(II) and (ii) complying with the information statement reporting requirements set forth in the Notice.

1. Application of Notice 2010-6 to Ambiguous Plan Terms:

Plan provisions requiring payment "as soon as reasonably practicable" will be satisfied if the payment is made by the later of 1) the end of the service provider's taxable year in which the permissible payment event occurs or 2) the fifteenth day of the third calendar month following the permissible payment event. If the payment is not made in a timely manner, the failure to pay will constitute an operational failure unless the service provider can demonstrate that the delay qualified for a timeliness exception under the regulations. The resulting operational failure may qualify for the correction of operational failures involving late payments (see Notice 2008-113).

Plan provisions that designate a payment event but do not define the payment event, or have an ambiguous definition of the payment event, such as "termination of employment," will not fail if the plan provision could reasonably be interpreted to be compliant with §409A. If an amount is paid pursuant to the provision in a manner that is not compliant with the requirements of §409A(a), that payment, or failure to make a payment, may be treated as an operational failure eligible for relief under Notice 2008-113. In order to avail itself of the relief under Notice 2008-113, the plan must be amended in accordance with §409A(a) before the end of the taxable year during which the operational failure is corrected.

Example: A plan that provides for a lump-sum payment "as soon as reasonably practicable" following the payment event does not cause the plan to fail to designate a permissible payment date under §409A and §1.409A-3(b). However, if the amount is not actually paid to the Employee by the later of the end of the calendar year in which the payment event occurs (or by the fifteenth day of the third calendar month following the payment event), and the late payment does not satisfy the requirements of a timeliness exception under the §409A regulations, the plan will have an operational failure with respect to the payment (the late payment may be eligible for correction under Notice 2008-113).

2. Application to Impermissible Definition of Separation of Service:

A plan provision containing an impermissible definition of separation from service may be corrected before 1) the date that an event occurs that would not be a separation from service under §1.409a-3(a)(1) but is a payment event under the plan, or 2) the date an event occurs that is a separation from service under §1.409a-3(a)(1) but is not a payment event under the plan. The plan may be corrected by amending the plan to provide for a payment event that satisfies the requirements of §1.409a-3(a)(1), but the amendment may not expand the definition to include any additional payment events not already included in the plan or exclude any already existing payment events, except as necessary to satisfy §1.409a-3(a)(1). The amendment must be effective immediately.

If, within one year following the date of correction, an event occurs that is not a separation from service but would have required payment under the pre-correction plan (or that is a separation from service but would not have required payment under the pre-correction plan) and results in the corrected plan provision being applied to avoid a payment that would have been due under the pre-correction plan (or to make a payment that would not have been made under the pre-correction plan), 50% of the amount deferred under the plan to which the pre-correction plan provision would have applied must be included in income by the service provider in the tax year when the event occurs.

3. Application to Impermissible Definition of Control Events:

A plan provision eligible for this section may be corrected under Notice 2010-6 before the date an event occurs that is not a change in control event under §1.409A-3(a)(5), but is a payment event under the plan. The plan must be amended to provide for a change in control event that satisfies the requirements of §1.409a-3(a)(5), and the amendment 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. The amendment must be effective immediately.

If, within one year, following the date of correction, a transaction occurs that is not a change in control event under §1.409a-3(a)(5) and results in the corrected plan provision being applied to avoid a payment that would have been due under the pre-correction plan provision, 25% of the amount deferred under the plan to which the pre-correction applies must be included in income by the affected employee in the tax year in which the event occurs.

4. Information Reporting for Correcting a Document Failure: Plan Sponsors:

Plan sponsors must attach, to their federal income tax return for the tax year in which the failure is corrected, a statement entitled “Section 409A Document Correction Under §___ of Notice 2010-6” and must set out the information required by Notice 2010-6. If the plan participant is required to include an amount in income during the subsequent tax year, the plan sponsor must attach this statement to the plan sponsor’s federal income tax return for the tax year after the year in which the correction was made.

The statement must include:

- the name and taxpayer identification number of each affected participant;
- identification of the non-qualified deferred compensation plan;
- a statement that the document failure is eligible for correction under Notice 2010-6, that the plan sponsor has taken all actions required and otherwise met all requirements for such correction as of the last day of the sponsor’s taxable year in which the correction is made, and providing the date of correction and the date of any event causing the inclusion of an amount in income under Section 409A by the affected participant;
- for each failure described in Notice 2010-6, the amount involved in each document failure, and to the extent applicable, the amount reported by the sponsor as includible in income under Section 409A(a) as part of the correction and the percentage of the amount involved in each document failure required to be included in income under Section 409A(a) as part of the correction.

Plan Participant:

Plan sponsors must provide to each participant a statement entitled “Section 409A Document Correction under §___ of Notice 2010-6” setting out the following information:

- A statement that the participant is entitled to the relief provided under Notice 2010-6 (identifying the applicable section of the Notice under which the document failure is corrected) with respect to a failure to comply with §409A, and that the participant must attach a copy of the statement to the participant’s income tax return for the taxable year in which the failure was corrected and also to the extent applicable, any subsequent tax year in which an amount is included in income under §409A by the participant as part of the correction; and
- The information described above is applicable to plan sponsors, but only to the extent that the information relates to a deferred amount of that plan sponsor.

The participant must attach a copy of the statement received from the plan sponsor to the participant’s federal income tax return. If a participant has included an amount in income to be eligible for relief under the Notice, and that inclusion in income occurs in a year subsequent to the year the plan was corrected, the participant must include the statement with the tax return for the year of inclusion as well as the year of correction.

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MLINY02021012180

