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## EXECUTIVE COMPENSATION AND BENEFITS UPDATE

# IRS Provides Important Relief for 409A Documentary Compliance Failures

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## GENERAL

On January 5, the IRS issued Notice 2010-6, which provides taxpayers with methods to voluntarily correct many common types of documentary compliance failures with reduced (or even no) tax penalties and, additionally, gives important guidance for interpreting the provisions of Section 409A of the Internal Revenue Code. Of particular note, the Notice provides for transition relief that allows for the correction of certain documentary compliance failures with no penalties if such corrections are completed on or prior to December 31, 2010. Notice 2010-6 is available at <http://www.irs.gov/pub/irs-drop/n-10-06.pdf>.

Section 409A imposes significant limitations on the design and drafting of traditional deferred compensation plans as well as many types of compensation not traditionally viewed as deferred compensation, including equity compensation, incentive bonuses, severance policies and perquisites. Under Section 409A, these arrangements must comply with the statute's requirements with respect to both the written documentation for the arrangement and the arrangement's actual operation. Failure to comply with any of the requirements of Section 409A can result in substantial adverse tax consequences to employees.<sup>1</sup>

Deferred compensation plans were required to be in full compliance with Section 409A as of January 1, 2009. While the IRS has provided a program to correct certain failures of operational compliance (*i.e.*, deferrals or payments at impermissible times), there has not, until now, been any method to correct documentary failures (*i.e.*, failures of written plan documents to conform to Section 409A).

## CORRECTION PROGRAM

The Notice provides taxpayers with the ability to correct several specified types of common documentary failures. In many cases, the correction can be made with no resulting tax penalties, except generally when a correction is made within the one-year period before the corrected provision would have become operative, in which case tax penalties apply at a reduced level. The types of corrections that can be made include:

- Non-compliant definitions of "change in control", "separation from service" or "disability";
- Failure to include the six-month delay for separation payments to specified employees; and
- Impermissible payment triggers and payment schedules.

The principal eligibility requirements are that (1) the persons involved are not under audit for Section 409A issues (or, in the case of an individual, audit for any issue), (2) the plan documents are amended in writing and (3) several information filings are made with the IRS.

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<sup>1</sup> Section 409A applies to all U.S. taxpayers regardless of whether they are employed by a U.S. entity. In fact, many common cross-border compensation arrangements, such as tax equalization, can be subject to Section 409A.

## TRANSITION RELIEF

The Notice generally allows these corrections to be made on or prior to December 31, 2010, without the payments being subject to any tax penalties, even if made immediately prior to the corrected provisions becoming operative.

## INTERPRETATIVE GUIDANCE

The Notice clarifies that the use of certain ambiguous contractual terms or the failure to define certain payment events will not by themselves violate Section 409A. Of note, the Notice clarifies that the practice of stipulating that a payment will be made “as soon as practicable” (or similar language) following a permissible payment trigger under Section 409A will not cause the payment to violate Section 409A. In addition, the Notice establishes that a plan provision designating a payment event that could reasonably be interpreted to be permissible under Section 409A, but also could reasonably be interpreted to include an impermissible payment event, can be treated as compliant with the requirements of Section 409A as long as certain conditions are met. A common example would be a provision providing that amounts will be payable upon “termination of employment” rather than “separation from service”.

## CONCLUSION

Companies should pay close consideration to this Notice, given that it creates an opportunity to correct many documentary failures without any tax penalties. The Notice will be of particular help to companies engaged in acquisitions. While most companies have already conducted wide-scale reviews of their plans and arrangements for compliance with Section 409A, there are still many companies with documentary compliance failures. These failures often turn up during the due diligence process and, prior to this Notice, little or nothing could be done to rectify them.

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