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Correcting Document Errors

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I. INTRODUCTION

Section 409A (409A) of the Internal Revenue Code (Code) requires that a nonqualified deferred compensation plan comply with the statute's payment and election rules in both form and operation.[1] This means that the failure of a plan to comply with the written plan document requirements of 409A gives rise to tax under 409A for vested compensation earned by affected participants. Document failures, however, may be hard to avoid. This is not only because of the human propensity for error but also because of guidance issued by the Internal Revenue Service (IRS) under 409A, combining strict-liability enforcement with intricate rules that are not always clear, complete, or even consistent. Accordingly, document failures may occur in the most carefully drafted plan by the most conscientious drafter.

This chapter outlines the available ways of correcting 409A document failures. The chapter discusses in detail the IRS's document correction program un-

[1] *See* I.R.C. §409A(a)(1)(A)(i) (taxation under 409A applies if a nonqualified deferred compensation plan either "fails to meet" or "is not operated in accordance with" the requirements of 409A).

der Notice 2010-6,[2] and it explores corrections available outside the formal Notice 2010-6 program. The chapter concludes with a few general points on drafting approaches to mitigate the chance of document failure. The chapter is organized as follows:

Section II. (below) of this chapter first addresses the puzzles that arise in identifying the written 409A-covered "plan." This threshold inquiry is made because, before determining whether a "failure" in the "plan document" needs to be corrected, these terms must first be defined. But, as discussed in Chapter 5 (Plan Aggregation and Other Key Rules), in many cases the definition remains surprisingly elusive. As will be seen, the difficulty of identifying the "plan" and the plan "document" (and, in some cases, the failure) is a problem besetting all four correction approaches discussed below.

Section III. (below) of this chapter discusses four specific approaches to correcting the plan document:

First, under proposed IRS regulations, document failures of *nonvested* amounts can be corrected without tax or penalty. This discussion addresses the rule's scope, in particular the most pressing open question: whether a document failure can be corrected in the vesting year, if correction is made before the actual vesting date. It is suggested that, at least pending issuance of final regulations or other guidance, the better answer is that correction may be possible until the vesting date, even if vesting occurs later in the same year.

Second, Notice 2010-6 includes some welcome provisions for correcting failures outside its formal program. Notice 2010-6 allows informal correction of certain ambiguous plan terms. This is a rule of interpretation, rather than of correction. In addition, Notice 2010-6 provides that, in a handful of circumstances, *failed election provisions* can be corrected with no tax consequences or formal filing under the Notice 2010-6 program. Although limited, this relief is helpful.

Third, Notice 2010-6 sets forth a formal correction program. Under Notice 2010-6, many document failures can be corrected in 2010 with no penalty. After 2010, most corrections of failed payment terms are subject to a "one-year rule," providing that, even after the failure is corrected, reduced penalties apply to an employee or other service provider[3] who incurs the pre-correction payment trigger within one year of the correction. When the one-year period has elapsed, no further penalty applies. As with its sister program under Notice 2008-113,[4] the structure of Notice 2010-6 makes it difficult to follow. This chapter has organized the Notice 2010-6 corrections program in what is hoped is a more user-friendly way. We discuss, in order:

1. failed payment terms subject to the one-year rule;
2. payment terms correctable *without* the one-year rule;
3. payment terms correctable but with penalty; and
4. failed *deferral election* terms, and the special rules that apply.

[2] I.R.S. Notice 2010-6, 2010-3 I.R.B. 275.

[3] Unless stated otherwise, "employee" encompasses "employee or other service provider."

[4] I.R.S. Notice 2008-113, 2008-2 C.B. 1305, *modified*, I.R.S. Notice 2010-6, 2010-3 I.R.B. 275.

The discussion of Notice 2010-6 concludes by addressing the special rules applicable to new plans, and the transition rules applicable in 2010 and 2011.

Fourth and finally, in addition to specific correction techniques, there are more fundamental questions underlying a document: If the terms of a document do not conform precisely to 409A, is there necessarily a violation of 409A? Or are there circumstances in which the plan conforms with 409A, even though the document does not? This chapter explores basic precepts of contract construction—for example, scrivener's error or "extrinsic ambiguity"—to analyze circumstances in which it may be concluded that the plan complies with 409A's formal requirements, even if some of its written terms fail to conform.

II. Open Issues in the Plan Document Rules

Regulations under 409A require that the plan's "material terms"—defined as the amount or formula for determining the amount payable under the plan, and the time and form of payment—be in writing no later than the end of the taxable year[5] in which the legally binding right arises or, if no amount is payable in the year next following that year, not later than the 15th day of the third month following the year in which the legally binding right arises.[6]

A. Basic Rules

Any deferral election must be set forth in writing before the date the election would become irrevocable.[7] For example, a provision for second elections must be in writing not later than one year before the initially specified earliest payout date.[8] The six-month rule must be set forth in writing on or before the date any participant becomes a specified employee—generally, on or before the specified employee effective date.[9]

B. Unanswered Questions

Despite the seeming precision of the regulations and the IRS Notice guidance, fundamental questions about the definition of the plan and plan document remain unanswered.

1. What Is the Plan?

As discussed in Chapter 5 (Plan Aggregation and Other Key Rules), the answer to this question is not entirely clear as it relates to 409A document failures. Final regulations sort deferred compensation into nine types, or "buckets." An

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[5] Unless otherwise specified, the term "taxable year" in this chapter denotes the taxable year of the service provider.

[6] Treas. Reg. §1.409A-1(c)(3)(i).

[7] Treas. Reg. §1.409A-1(c)(3)(ii), (iii).

[8] Treas. Reg. §§1.409A-1(c)(3)(iii), 1.409A-2(b)(1)(i).

[9] Treas. Reg. §1.409A-1(c)(3)(v), (i)(3).

aggregation rule provides that, for certain purposes, the plan is every arrangement in the same bucket covering the same service provider.[10] The aggregation rule does not apply, however, for purposes of the plan document rules.[11] Thus, for example, a document failure in a parachute plan designed as a non–account balance plan does not trigger tax under 409A in every other non–account balance plan covering the same employee.

Although it can be partly determined what the plan is not, it is not entirely clear what the plan is. Is it each identifiable promise considered alone? Or is it every identifiable promise within a single instrument? Although guidance does not address this issue, the better view is that the plan must be defined as the promise, rather than as all the promises in the single instrument. Typically, nonqualified deferred compensation plans lack the Form 5500 filings or other identifiers typical of most plans under the Employee Retirement Income Security Act of 1974 (ERISA). Few such plans have an express integration clause. It would thus be difficult to identify the instrument. Moreover, even an identifiable single instrument does not create a single 409A plan. For example, if the plan is a top-hat ERISA pension plan, an initial Labor Department filing is required, and the single instrument could arguably be identified by the filing.[12] But the same top-hat pension plan could be two or more plans for 409A purposes. For example, consider a supplemental executive retirement plan (SERP) providing wraparound benefits for both a final average pay formula and a cash balance formula under a single qualified defined benefit plan. The SERP is a single ERISA plan for top-hat filing purposes. But it is two separate plans under section 1.409A-1(c) of the Treasury regulations—an account balance plan (the cash balance formula wrap)[13] and a non–account balance plan (the final average pay formula wrap).[14] Identifying the plan by the instrument would be difficult to interpret, administer, and enforce.

To see the practical problems raised by the definition question, consider an employment agreement with two vested deferred compensation promises: (A) a fixed dollar amount payable in two years, and (B) a special payout to be made if and when the employee's *former* employer or other service recipient[15] pays certain specified bonuses. Promise A is 409A compliant; Promise B is not. If they are both part of the same plan, then 409A taxes and penalties apply to both promises; if different plans, then only to Promise B. If correction is attempted under Notice 2010-6, different corrections might apply depending on whether the two promises are one plan or two. This is because a different correction applies to a plan with no compliant payment provision (Promise B considered in isolation) than to a plan with at least one compliant payment provision (both promises considered as a single plan). The appropriate answer appears to be that there are two

[10] Treas. Reg. §1.409A-1(c)(2)(i)(A)–(I).

[11] *See* Treas. Reg. §1.409A-1(c)(3)(viii) ("The plan aggregation rules of paragraph (c)(2)(i) of this section do not apply to the written plan requirements of this paragraph (c)(3)," which requires that certain terms of the plan be set forth in writing, including the time and form of payment and the six-month delay rule for specified employees.).

[12] *See* 29 C.F.R. §2520.104-23.

[13] *See* Treas. Reg. §1.409A-1(c)(2)(i)(B).

[14] *See* Treas. Reg. §1.409A-1(c)(2)(i)(C).

[15] Unless stated otherwise, "employer" encompasses "employer or other service recipient."

plans. A different answer would produce different tax and administrative results depending on whether an economically identical arrangement was provided on one piece of paper or two.

2. What Is the Plan Document?

If each promise is the plan, the next question is: Where is the promise located? Section 409A's writing requirement means that the promise must be in writing, and parol evidence will generally be inadmissible to alter its terms.[16] But what documents constitute the writing? Regulations state that the plan need not be confined to a single document.[17] Accordingly, the 409A plan may include instruments other than the formal plan document or other agreement. But how far does this rule go? Does the plan document include, for example, e-mails, participant communications, letters of intent, the minutes of board meetings, shareholder communications? So far, there is no clear answer.

Return to Promise B, in the above example, to pay a stated amount if and when the employee's former employer pays certain bonuses. As discussed, Promise B is most reasonably viewed as a stand-alone plan. On the face of the employment agreement, Promise B has no permissible payment date. As explained below in Section III.C.7. of this chapter, under Notice 2010-6, a plan with no permissible payment trigger can be corrected before the payment trigger occurs, but only if 50% of the deferral is included in income and subject to tax under 409A. Now assume that the bonuses promised by the former employer state, in writing, that the outside payment date is December 31, 2012, and further assume that correspondence between the new employer and incoming executive reflect a shared understanding of this date. If this provision is read into Promise B, then Promise B has both an impermissible and a permissible payment date (December 31, 2012), and, thus, as described below in Section III.C.5.c. of this chapter, can be corrected with (possibly) no negative tax consequences under 409A, under a different section of Notice 2010-6.[18]

3. What Is a "Failure"?

A more fundamental difficulty is determining whether a document failure exists. This issue arises because IRS guidance is in many instances unclear, incomplete, or contradictory. One of many examples is the requirement that a six-month delay provision be included in any agreement providing for severance subject to 409A but not in those providing for severance which is a short-term deferral. As explained in Chapter 6 (Short-Term Deferrals) and Chapter 12 (Se-

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[16] *Cf.* Feifer v. Prudential Ins. Co. of Am., 306 F.3d 1202, 1210–11, 29 EB Cases 1005 (2d Cir. 2002) (statutory requirement of ERISA §402(a)(1), 29 U.S.C. §1102(a)(1), requiring that plan be a written instrument, "'essentially operates as a strong integration clause, statutorily inserted in every plan document'" (quoting *In re* New Valley Corp., 89 F.3d 143, 149, 20 EB Cases 1537 (3d Cir. 1996))).

[17] *See* Treas. Reg. §1.409A-1(c)(3)(i) ("The material terms of the plan may be set forth in writing in one or more documents.").

[18] *Compare* I.R.S. Notice 2010-6, §VII(A), 2010-3 I.R.B. 275, 284–85 (corrections of failed payment terms where plan has at least one permissible payment term), *with* I.R.S. Notice 2010-6, §VII(B), 2010-3 I.R.B. 275, 285 (correction where plan has no permissible payment term).

paration Pay Arrangements), whether severance is subject to 409A is often subject to much uncertainty. Another example is the definition of "employer stock" ("service recipient stock") for purposes of the rule exempting certain options and stock appreciation rights from 409A. Among other things, good "employer stock" may be subject to certain call rights only if the call rights involve a "lapse restriction."[19] Guidance concerning what constitutes a "lapse restriction" is sparse and inconsistent. For example, if the optioned stock is subject to a call right that lapses on a "merger, acquisition or other change in control," then under IRS guidance, the call right might be a lapse restriction or might not be a lapse restriction—meaning that the option might or might not be failed compensation under 409A.[19a]

Moreover, the ongoing release of new IRS guidance has a pattern of creating new and hitherto unknown rules, typically ones giving rise to failures where none existed before. For example, Notice 2010-6 gives rise to implied "failures" that arguably did not exist under previous guidance:

a. Failures in New Plans

Notice 2010-6 includes a formal correction method for failures arising in new plans. The correction must be made in the taxable year in which the right first arises (or 2½ months after it arises, if no amount is payable in the next taxable year); must be run through the Notice 2010-6 program; and is not available if the employer has maintained any plan in the same aggregation group or "bucket," for any service provider, in any previous year.[20] This provision is inconsistent with previous guidance. Under the regulations, the deferred compensation plan is not required to be in writing until the end of the year in which the right first arises (or 2½ months after it arises, if no amount is payable in the next taxable year) and is not subject to the aggregation rule for document failure purposes.[21] Absent the new-plan rule, it would appear that a document creating a new legally binding right to deferred compensation of any kind could be corrected without penalty until the end of the taxable year in which the right arises (or by the 2½-month deadline), because the writing would not be fixed and no failure would exist until that time. Notice 2010-6 appears to create a new category of failures that did not previously exist.

b. Reservation-of-Rights Clauses

Many deferred compensation plans state that the plan sponsor has the right to "terminate or amend" the plan, generally at any time for any reason. Under Notice 2010-6, a statement that the employer may "terminate the plan and imme-

[19] Treas. Reg. §1.409A-1(b)(5)(iii)(A).

[19a] *Compare* I.R.S. Tech. Adv. Mem. 97-44-001 (Oct. 31, 1997) (restriction that expires upon "liquidation, merger or other reorganization" is a lapse restriction), *with* I.R.S. Priv. Ltr. Rul. 93-08-022 (Nov. 25, 1992) (restriction that expires upon "change in control" or initial public offering is not a lapse restriction).

[20] *See* I.R.S. Notice 2010-6, §X, 2010-3 I.R.B. 275, 291.

[21] *See* Treas. Reg. §1.409A-1(c)(3)(i), (viii).

diately pay all amounts deferred" fails 409A as impermissible employer discretion to accelerate.[22] Notice 2010-6 raises the possibility that all "terminate or amend" clauses could give rise to a 409A failure. Plan drafters can almost certainly eliminate the uncertainty and the problem by adding a clause stating that the plan is to be construed as 409A-compliant (see discussion below in Section III.A. of this chapter). But, again, Notice 2010-6 arguably creates failures where none existed and the need for further revision where none was called for.

c. Participant Releases of Claims and Other Waivers

The Treasury regulations provide that, if a plan specifies a payout period, the period must fall within a single taxable year, or be a specified period of not more than 90 days, where the service provider has no "right to designate the taxable year of the payment."[23] Notice 2010-6 takes the position that a failure arises if payment is contingent on employee action, for example, signing a release of claims.[24] The thinking seems to be that the employee can impermissibly designate the year of payment by choosing when to sign the release. As discussed in Chapter 23 (Releases), by reading these provisions as a per se failure of the 90-day rule (rather than as a payment condition that may be implicitly bounded by other 409A-compliant payment constraints in the plan), this rule appears to go significantly beyond previous formal guidance.

d. "As Soon as Reasonably Practicable" Qualifiers

Here, in contrast with the preceding three provisions, Notice 2010-6 reverses earlier guidance in a pro-taxpayer direction. The 2007 preamble to the final regulations states that a plan providing for payment "as soon as reasonably practicable after" a payment trigger causes a 409A failure, unless an express outside payment date is stated, complying with the regulations' "payment period" rule (generally, a single taxable year or a period of not more than 90 days following a permissible payment event).[25] Notice 2010-6 states that such phrases do not automatically cause a 409A failure. Payment must be generally made by the end of the calendar year of (or by 2½ months following) the stated payment trigger—the rule applicable to specified payment dates and events.[26] IRS guidance no longer reads the phrase as creating an impermissible payment period; rather, it reads the phrase as a permissible qualifier of a provision setting forth a payment date or event. This interpretation is more sensible than the approach taken in previous guidance.

In all these cases, the underlying problem is the same. Compliance with 409A rests on precise adherence to rules that are often undefined, incomplete, or

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22 I.R.S. Notice 2010-6, §VII(E)(1), 2010-3 I.R.B. 275, 286.

23 Treas. Reg. §1.409A-3(b).

24 *See* I.R.S. Notice 2010-6, §VI(B), 2010-3 I.R.B. 275, 284.

25 *See* I.R.S., Application of Section 409A to Nonqualified Deferred Compensation Plans, Explanation of Provisions and Summary of Comments, §VII(A) (seventh & eighth paragraphs), 72 Fed. Reg. 19,234, 19,255–56 (Apr. 17, 2007).

26 *See* I.R.S. Notice 2010-6, §IV(A)(1)–(2), 2010-3 I.R.B. 275, 279–80.

ambiguous. IRS interpretation of these rules is subject to revision, clarification, even change. Employers can protect their plans in some limited ways (suggested below in Section III.D. of this chapter). Nonetheless, even with the most careful drafting, opportunities for failure abound.

III. CORRECTING PLAN DOCUMENT FAILURES

A. Correcting Document Failures for Nonvested Deferred Compensation

Document failures can be completely corrected without incurring tax under 409A, and without the correction program of Notice 2010-6, in the year in which the compensation is nonvested. This follows from three key provisions in guidance governing income inclusion under 409A (as described in Chapter 28 (Penalties)): First, a noncompliant deferred compensation plan is taxed under 409A only to the extent of amounts vested under the plan in the failure year.[27] Second, vested amounts are not taxed under 409A in a year in which they comply with 409A, even if deferred from an earlier year in which they failed 409A.[28] Third, under a year-end rule, the noncompliant vested amount includible for a taxable year is determined as of the *last day* of the year, generally as the year-end value of compensation vested as of the last day, plus distributions made during the year.[29] Taken together, these rules mean the following:

1. Correctable If Nonvested for the Entire Year

A document failure can be corrected without 409A tax and penalties, and without the program of Notice 2010-6, to the extent of compensation that is nonvested throughout the service provider's entire taxable year.

2. Correctable in the Vesting Year Before the Vesting Date

In addition, as discussed in Chapter 30 (Correcting Outside the Correction Programs), there is disagreement among practitioners as to whether a document failure in nonvested deferred compensation may be corrected, without the Notice 2010-6 program, at any time before the substantial risk of forfeiture lapses, even if the compensation becomes vested later during the same taxable year, *after* the correction date. It is not clear whether this is the correct interpretation of the current rule and, if it is, whether it will survive into the final regulations. But this appears to the chapter authors to be the preferred reading of the proposed regulation.

Because this question is far from settled, a brief discussion is warranted. If there is a failure (in either document or operation) under 409A on any date when the amount deferred under the plan is *vested*, then the vested deferred amount is

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27 *See* Proposed Treas. Reg. §1.409A-4(a)(1)(i), 73 Fed. Reg. 74,380, 74,393.

28 *See* Further Guidance on the Application of Section 409A to Nonqualified Deferred Compensation Plans, Explanation of Provisions [hereinafter Preamble to Proposed Treas. Reg. §1.409A-4], §II (second paragraph), 73 Fed. Reg. 74,380, 74,381 (Dec. 8, 2008).

29 *See* Proposed Treas. Reg. §1.409A-4(a)(2)(i), 73 Fed. Reg. 74,380, 73,394.

includible in income under 409A for that year. This is true even if, at the beginning of the year, the plan was 409A-compliant. Accordingly, states IRS guidance, if nonvested but 409A-compliant deferred compensation becomes vested and then "first fails" (in document or operation) after the vesting date, the vested amount is subject to tax under 409A for the year.[30] It follows that, if a document failure arises in deferred compensation *on or after* the vesting date, then the vested amount is subject to tax under 409A for that year, even if the noncompliant plan term is corrected before the end of the year. But this does not address the question of whether a document failure has arisen in the first instance, if the noncompliant plan term is corrected *before* the vesting date. Neither the proposed regulation nor its preamble addresses this question, as both address only cases where the failure (either in document or operation) remains uncorrected as of the date the compensation first vests.

The better reading is that the document "failure" no longer exists if the noncompliant plan term is corrected before the substantial risk of forfeiture lapses. Under this preferred reading, amending the noncompliant plan term before the vesting date is an effective "correction" of the plan document failure without the Notice 2010-6 correction program, even if the compensation vests later in the correction year. This preferred reading is consistent with the year-end snapshot approach of the proposed regulation. Moreover, the alternative reading would make corrections of noncompliant plan terms excessively contingent. If a document correction of nonvested compensation depended on its vested status at year's end, the correction's success would not be known until the end of the year, would depend in many cases on chance events, and would impose differences in the tax treatment of covered service providers for that year based solely on whether they happened to vest before the end of the year.

3. *Taint Rule Does Not Apply*

There is an important difference between corrections of operational and document failures. Any operational failure of a nonvested amount taints all deferred compensation in the same plan as defined under the plan aggregation or "bucket" rule of section 1.409A-1(c)(2)(i) of the Treasury regulations. Accordingly, if an operational failure is corrected (without recourse to the formal correction program for operational failures under Notice 2008-113[31]) with respect to nonvested compensation, all vested deferred compensation in the same bucket is generally subject to tax under 409A. This is so even though the vested deferred compensa-

[30] *See id.* ("[A]n amount may be includible in income under section 409A(a) for a taxable year even if such amount is subject to a substantial risk of forfeiture during the taxable year if the substantial risk of forfeiture lapses during such taxable year, including if the substantial risk of forfeitures lapses after the date the nonqualified deferred compensation plan under which the amount is deferred first fails to meet the requirements of section 409A(a)."); *see also* Proposed Treas. Reg. §1.409A-4(a)(2)(ii), Ex., 73 Fed. Reg. 74,380, 74,394; Preamble to Proposed Treas. Reg. §1.409A-4, §III(B)(5) (first paragraph), 73 Fed. Reg. 74,380, 74,383 (deferred compensation required to be included in income under 409A(a) "does not distinguish between amounts deferred in a taxable year before a failure to meet the requirements of section 409A(a), and amounts deferred in the same taxable year after such failure").

[31] I.R.S. Notice 2008-113, 2008-51 I.R.B. 1305.

tion is compliant and even though the operational failure in the nonvested compensation is corrected.[32] (This same rule does not apply for correction of an operational failure made under the Notice 2008-113 program, which forestalls tax under 409A for vested compensation in the same bucket, as discussed in Chapter 29 (Correcting Operational Errors).) By contrast, the plan aggregation rule does not apply to document failures.[33] Accordingly, if a document failure arises in nonvested deferred compensation, the failure does not taint vested compensation in the same bucket. Thus, correcting a noncompliant plan term in nonvested deferred compensation cures the failure outside the Notice 2010-6 correction program and results in no taxation under 409A.

One technical aside: Note that the taint rule for operational failures has no bearing on the question, discussed above in Section III.A.2. of this chapter, of whether a document failure in nonvested compensation can be corrected (without Notice 2010-6) before the vesting date if the compensation vests later in the same year. When an operational failure taints *vested* amounts in the same aggregated plan, correcting the aggregated plan before the vesting date has been made impossible, as discussed in Chapter 29 (Correcting Operational Errors). This rule is thus irrelevant to the separate question of whether a document failure disappears if corrected before the vesting date of the "plan" defined without the aggregation rule.

4. *Definitional Questions Continue to Apply*

For purposes of document failures, the "plan" is defined without regard to the plan aggregation rule. Nonetheless, document failures of nonvested amounts might still taint vested amounts in the same "plan."[34] Thus, defining the "plan" is still important. As is concluded above in Section II.B.1. of this chapter, defining the "plan" is difficult and subject to question, but the best answer is that the "plan" is each separately identified deferral promise, rather than every promise in the same instrument.

5. *Anti-Abuse Rule*

The proposed regulations provide that compensation will not be treated as nonvested for this purpose if the "service recipient has a pattern or practice of permitting impermissible changes in the time or form of payment" with respect to nonvested compensation.[35]

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[32] *See* Proposed Treas. Reg. §1.409A-4(a)(1)(i), 73 Fed. Reg. 74,380, 74,393; *see also* Preamble to Proposed Treas. Reg. §1.409A-4, 73 Fed. Reg. 74,380, 74,382, 74,383.

[33] Treas. Reg. §1.409A-1(c)(3)(viii) (plan aggregation rules do not apply to "written plan requirements of this paragraph (c)(3)").

[34] *See* Proposed Treas. Reg. §1.409A-4(a)(1)(i), 73 Fed. Reg. 74,380, 74,393 (409A income inclusion applies to excess of "total amount deferred under the plan" for taxable year, over the nonvested "portion of such amount").

[35] Proposed Treas. Reg. §1.409A-4(a)(1)(ii)(B), 73 Fed. Reg. 74,380, 74,393–94.

B. Corrections Permitted by Notice 2010-6 Outside the Formal Program

The bulk of Notice 2010-6 sets forth a program allowing corrections subject to detailed formal requirements. In addition, Notice 2010-6 sets forth a number of informal corrections effective outside the program.

1. Ambiguous Payment Terms

Section IV(B) of Notice 2010-6 provides that "ambiguous" payment terms are deemed to comply with 409A. Examples are "termination of employment" and "acquisition." This is a rule of interpretation, rather than a correction. An ambiguous payment term can be amended at any time to make it unambiguous, most simply by amending the plan to state that its terms are intended to be construed in compliance with 409A, or words to that effect.[36]

As discussed in Chapter 10 (Permissible Payments), the rule regarding ambiguous terms applies to payment provisions that could be "reasonably interpreted" to include both compliant and noncompliant payment triggers, or compliant but incomplete triggers. An example is "termination of employment," which can be read to include both events that are separations from service and those that are not (e.g., transfer to an 80% owned subsidiary) or to exclude events that are separations from service (e.g., ceasing to perform services but continuing to receive salary continuation payments for a stated period thereafter).

Notice 2010-6 defines the meaning of "ambiguous" for this purpose.[37] To be ambiguous, the term cannot expressly violate 409A. That is, it cannot expressly include events that are impermissible payment events or exclude required ones. A provision is not ambiguous if there is a pattern or practice of administering the provision in a noncompliant way. Further, a provision is not ambiguous if a court with jurisdiction over enforcement of the contract interprets the provision in a particular way. The pattern-or-practice and court-interpretation rules apply as well to any "substantially similar" provision in any other plan of the service recipient. Finally, a provision is not "ambiguous" if the plan states that its terms are to be interpreted as 409A-compliant (or a provision with the same effect). Notice 2010-6 states that a 409A interpretation clause of this kind renders the provision unambiguously 409A-compliant.[38]

An ambiguous plan term can be amended at any time to remove the ambiguity. The amendment can remove the ambiguity; however, in doing so, the plan cannot add or subtract payment events. This constraint may be a challenge, given that the original term is, by definition, ambiguous. Alternatively, the amendment can add a 409A interpretation "savings" clause, stating that the plan is intended to comply with 409A, and its terms are to be interpreted accordingly. Adding a 409A savings clause is probably the most effective, as well as the simplest, correction because it renders all ambiguous payment terms 409A-compliant. And, as is discussed below in Section III.D. of this chapter, a plan provision of this type may have broader compliance effects as well.

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[36] *See* I.R.S. Notice 2010-6, §IV(B)(1), 2010-3 I.R.B. 275, 280.

[37] *See id.*

[38] *Id.*

A non–409A compliant payment under an ambiguous payment term can be corrected as an operational failure under Notice 2008-113, as discussed in Chapter 29 (Correcting Operational Errors). In this case, however, clarifying the ambiguous payment term is mandatory by the end of the year in which the correction was made in accordance with the requirements of Notice 2008-113. Failure to clarify renders the 2008-113 correction of the operational original failure ineffective and apparently renders the ambiguous payment term no longer "ambiguous" (and, instead, noncompliant with 409A). As a practical matter, this means that clarifying ambiguous plan terms should be done as soon as possible. Over time, some kind of mistaken payment is reasonably likely to occur; clarifying now cures the need for a rushed plan amendment later.

While Notice 2010-6 does not so state, it presumably covers ambiguous terms that are amended by being clarified in a manner that takes the payments out of the ambit of 409A altogether, for example, by being made short-term deferrals. Accordingly, the rule regarding ambiguous terms may be among the most valuable correction tools of Notice 2010-6. Consider, for example, a plan providing for payment of tuition assistance when an employee's child enrolls in college. Standing alone, this payment term is an arguable 409A violation correctable under section VII(B) of Notice 2010-6 (discussed below). This provision can be corrected as an ambiguous payment term, without using the Notice 2010-6 correction program, by amending the plan to specify that payment will be made only if the employee is still employed when payment is made. This renders the provision an unambiguously compliant short-term deferral. This correction is possible, of course, only if the plan's administrative practice reflects the corrected plan terms.

2. *Noncompliant Provisions for Employee Deferral Elections*

Plan provisions allowing noncompliant service provider elections in some cases do not trigger tax under 409A for participants who do not make an election under the defective provision. This relief is narrow, however. A service provider who makes an election under a defective provision may be subject to tax under 409A even if the election itself is operationally compliant with 409A. The relief applies only to elections to defer. Provisions allowing "haircuts" and other employee accelerations may not be corrected, even under Notice 2010-6, and apparently even as to service providers who do not use them.

a. *Noncompliant Initial Deferral Election Provisions Absent an Initial Deferral Election (Section IX)*

If a plan has a failed provision for initial deferral elections, informal correction is possible in some cases. Assume, for example, a plan that allows an initial deferral election to be made at any time up to the last day of the month before the month in which the compensation is earned (instead of the last day of the year). No tax under 409A arises for a service provider if the provision has not been "applied" with respect to that service provider. Generally, this means that no tax under 409A arises for a service provider who has not made an election under the failed election provision or has made an election but revoked before it became irrevocable. Technically, the Notice analyzes such cases as non-failures, stating that the provider is "not required to include an amount in income under" 409A in such circumstances. But because the recipient would presumably attempt to correct the provision on a going-forward basis, it is helpful also to think of the case as an informal correction. For these service providers, no formal document correction under Notice 2010-6 is necessary. If the plan provision has been "applied" with respect to a service provider—that is, if the service provider has made an election under the failed election term—the Notice's deemed non-failure analysis does not apply, and formal correction is required as described below in Section III.C.8. of this chapter. This formal correction will require taking commercially reasonable steps to correct the same provision in all the service recipient's plans—including a plan not otherwise subject to formal correction because of this special rule.[39]

b. *Certain Provisions for Impermissible Discretion Following a Payment Event or Subsequent Deferral Elections (Section VII(D))*

A similar rule applies for a plan providing either service provider or service recipient impermissible discretion to change a payment schedule following a permissible payment event, including a prohibited subsequent deferral election (generally, "second elections"). There is deemed to be no 409A failure as to a service provider who does not make such an election. There are three additional conditions to the availability of this deemed no-failure treatment: the payment event must be a permissible payment event under 409A, the provision must provide a default time or form of payment, and the provision cannot provide discretion to change the time or form of payment after the payment event has occurred. If these requirements are met, no failure occurs and thus no formal correction is needed. This is the case even if the plan remains uncorrected, and it is the case even if the service provider makes an impermissible election but revokes it before it becomes irrevocable (that is, one year before the correct payment event). The same rule applies to impermissible provisions for discretion or subsequent deferral elections by the service recipient; there is deemed to be no failure as to a service provider as to whom the service recipient did not make the election or made it but revoked it before it became irrevocable.

An example of this informal correction is a plan providing for payment of deferred compensation as of age 65 and further providing that the employee may elect at any time before age 65 to defer payment by 12 months. Under Notice 2010-6, an employee who does not exercise his or her election right, and receives payment at age 65, is not subject to tax under 409A. This is the case even if the impermissible election provision was not corrected before the employee attained age 65.[40] Change the example so that the employee makes an election under the bad provision, but revokes the election before it becomes irrevocable—that is, one year before attaining age 65. The employee is not subject to tax under 409A,

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[39] *See* I.R.S. Notice 2010-6, §IX, 2010-3 I.R.B. 275, 289–90.

[40] I.R.S. Notice 2010-6, §VII(G), 2010-3 I.R.B. 275, 288, Ex. 10.

even though the noncompliant provision remains uncorrected.[41] In all other cases—for example, if the impermissible second election was not timely revoked, or if the provision does not specify a default time or form of payment—formal correction under Notice 2010-6 is required, as discussed below in Section III.C.8. of this chapter. Finally, Section VII.D.2 of the Notice has a puzzling caveat when one plan is eligible for deemed no-failure treatment, but the service provider also participates in a second plan with a similar provision for prohibited election or discretion that has in fact been exercised (by the service provider or service recipient). The Notice cautions that, in such case, to "correct" the provision under "that plan," the service recipient must correct "substantially similar" provisions in its other plans. Although far from clear, the caveat can be read two ways. First, the caveat can be read as a reminder that, for the plan where the election or discretion has been exercised (and not timely revoked), formal correction under Notice 2010-6 is required, including its requirement for correction of all similar failed provisions in other plans. Second, the caveat can be read as a warning that the deemed no-failure treatment, and its attendant informal correction, is not available a second time for similar failures that remain uncorrected in other plans maintained by the service recipient. Accordingly, an employer that is able to use this informal correction should in addition find and correct similar failed provisions in its other plans.

C. Formal Corrections Under Notice 2010-6

1. *In General*

On January 19, 2010, the IRS released Notice 2010-6,[42] providing a program for correcting 409A document errors. Generally, the corrections are effective only if detailed administrative rules are followed, including the requirement that both service recipient and service provider attach written statements to their federal income tax returns filed for the year of the correction. Notice 2010-6 thus generally follows the IRS's model for correcting 409A operational failures under Notice 2008-113, described in Chapter 29 (Correcting Operational Errors) and Appendix A (Analysis of Corrections Under Notice 2008-113). An alternative correction model was available but was not adopted for 409A purposes: the IRS's program for voluntary corrections of qualified plans, or Employee Plans Compliance Resolution System (EPCRS). EPCRS allows the plan sponsor to correct plan documents by amending, filing with the IRS, and paying a stated fee.

2. *Failures Not Correctable Under Notice 2010-6*

The correction program of Notice 2010-6 is unavailable for the following document failures:

[41] I.R.S. Notice 2010-6, §VII(G), 2010-3 I.R.B. 275, 288, Ex. 11.
[42] I.R.S. Notice 2010-6, 2010-3 I.R.B. 275.

a. Haircuts and Other Employee Accelerations (Section VII(D))

Provisions allowing a service provider to accelerate payment under the plan are not correctable.[43]

b. Stock Option and Stock Appreciation Rights (Section III(G))

Failures in option and stock appreciation right agreements are not correctable under Notice 2010-6.[44] Failures arising because the option or stock appreciation right was granted "in the money" (the stock's fair market value exceeds the strike price on the grant date) can be corrected in some cases under Notice 2008-113,[45] as discussed in Section V.D. of Chapter 29 (Correcting Operational Errors) and Section IV.E. of Chapter 30 (Correcting Outside the Correction Programs).

c. Failures in Plans Linked to Qualified Plans (and Nonqualified Plans After 2011) (Section III(G))

Failures in wraparound supplemental executive retirement plans (SERPs) and other nonqualified deferred compensation plans cannot be corrected to the extent they are caused by a linkage with the time or form of benefits paid under a qualified plan. Failures arising from a linkage of payments between a nonqualified deferred compensation plan and another nonqualified plan or any other kind of compensation arrangement—that is, "offsets"—can be corrected under a special transition rule described below until December 31, 2011, but cannot be corrected thereafter.[46]

3. Requirements for All Corrections Under Notice 2010-6

Except for the provisions described above in Section III.B. of this chapter (correction of ambiguous terms and impermissible employee deferral election provisions), all corrections made under Notice 2010-6 are subject to detailed administrative requirements.

a. Information and Reporting Requirements (Section XII)

Under section XII of Notice 2010-6, a correction is effective only if both the service recipient and the service provider attach to their federal income tax returns detailed statements describing the correction. The service recipient must attach to its federal income tax return for its taxable year of correction a statement identifying the correction as a "409A Document Correction" under the appropriate section or sections of Notice 2010-6. The written statement must provide detailed information about the failure and correction, including the name and taxpayer identification number of each affected service provider and the amount of

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[43] *See* I.R.S. Notice 2010-6, §VII(A)(1), (D)(1), 2010-3 I.R.B. 275, 284–85, 286.
[44] *See* I.R.S. Notice 2010-6, §III(G), 2010-3 I.R.B. 275, 278.
[45] *See* I.R.S. Notice 2008-113, §§IV(D)(2), V(E)(2), 2008-51 I.R.B. 1305, 1311, 1314.
[46] *See* I.R.S. Notice 2010-6, §IX(B)(1), 2010-3 I.R.B. 275, 292.

409A taxable income reported pursuant to the correction.[47] The service recipient must supply a statement to each affected service provider, containing substantially similar information.[48] The service provider must attach a copy of this statement to his or her federal income tax return for the taxable year of the correction, as well as to his or her tax return for any subsequent taxable year in which any 409A tax is due pursuant to the correction.[49]

b. Tax and Reporting (Section III(E))

Certain corrections under Notice 2010-6[50] require affected service providers to treat a portion (generally 50%) of the vested compensation deferred under the corrected plan as subject to tax under 409A.[51] The correction is not effective unless the service provider pays the tax and the service recipient reports the 409A-includible income on the service provider's W-2 or other appropriate information return. For example, as discussed in Chapter 27 (Withholding and Reporting), an employer would report the 409A-includible amount on the employee's Form W-2, in box 1 and box 12 using Code Z. In the event of an audit, each taxpayer must make "reasonable efforts" to notify the IRS agent of the correction.

c. "Substantially Similar" Failures (Section III(B))

Under section III(B) of Notice 2010-6, the service recipient must take "commercially reasonable" steps to identify and correct all "substantially similar" provisions in all of the service recipient's other 409A-covered plans.[52]

d. Audit Exclusion (Sections III(C) and XI(D)

Generally, relief is not available for a service provider with respect to a taxable year if either the service provider or the service recipient is under examination for that year with respect to 409A-covered plans.[53] For an individual, the audit net is defined widely. An individual is under examination with respect to 409A-covered plans for a year if his or her Form 1040 (or other individual federal income tax return) for that year is under audit. For any other service recipient or service provider, the audit net is defined somewhat less broadly.[54] A person other than an individual is under examination with respect to 409A-covered plans if it has received an Information Document Request (IDR) or other written notification from the examining agent specifically citing nonqualified deferred compensation as an issue under consideration.[55] The audit exclusion does not apply,

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[47] I.R.S. Notice 2010-6, §XII(A), 2010-3 I.R.B. 275, 293.
[48] I.R.S. Notice 2010-6, §XII(B), 2010-3 I.R.B. 275, 293–94.
[49] I.R.S. Notice 2010-6, §XII(C), 2010-3 I.R.B. 275, 294.
[50] I.R.S. Notice 2010-6, §III(E), 2010-3 I.R.B. 275, 277–79.
[51] *Id.* at 278.
[52] I.R.S. Notice 2010-6, §III(B), 2010-3 I.R.B. 275, 277.
[53] I.R.S. Notice 2010-6, §III(C), 2010-3 I.R.B. 275, 277.
[54] *Id.*
[55] *Id.*

however, and correction is available, if neither the service recipient nor the service provider was under examination with respect to the failure years on the date the correction is made.[56]

A transition rule provides that for corrections made before December 31, 2011, the audit exclusion is applied narrowly for a nonindividual service recipient. In this case, the service recipient is considered under examination as to any document failure only if the failure has been specifically identified by the examiner.[57]

e. Intentional Failures and Listed Transactions (Section III(D))

Corrections under Notice 2010-6 are available only for "inadvertent and unintentional" failures and are not available for failures "directly or indirectly related" to participation in a listed transaction.[58]

4. One-Year Rule

With respect to corrections made after 2010, many sections of Notice 2010-6 provide for most favorable relief upon correction of failures relating to payment events only if the impermissible payment events do not occur within a year following the correction (the one-year rule). Under the one-year rule, if a noncompliant payment provision is corrected, but the noncompliant payment event occurs within one year of the correction, the service provider treats 50% of vested compensation deferred under corrected plan as taxable under 409A. (The 50% is lowered to 25% for certain corrections of noncompliant change in control payout terms, as described below.) After the one-year period has elapsed, the provision as corrected gives rise to no further tax under 409A.

> *Example 1.* A plan provides for payment upon separation from service, where separation is defined to include transfer to an 80% controlled subsidiary in violation of 409A. The document is corrected on July 1, 2011. If on or before July 1, 2012, an employee's employment transfers to an 80% controlled subsidiary, 50% of that employee's vested compensation under the plan is subject to income tax and the additional 20% tax under 409A (but not the additional "interest" tax). (This treatment is sometimes referred to as the "50% penalty" in this chapter.) This is the case although the corrected provision applies and no payment is in fact made to the employee. The employer must report 50% of the amount deferred under the corrected plan by the employee on her Form W-2, in box 1 and box 12 using Code Z. The one-year rule applies only to occurrences of the *noncompliant* payout trigger.

Further, section III(H) of Notice 2010-6 provides that its correction procedures are not intended to "prohibit or alter the ability of the plan to . . . adopt any

[56] *Id.*

[57] I.R.S. Notice 2010-6, §XI(D), 2010-3 I.R.B. 275, 294.

[58] I.R.S. Notice 2010-6, §III(D), 2010-3 I.R.B. 275, 277. The reference is to listed transactions as described in Treas. Reg. §1.6011-4(b)(2).

of the permissible exceptions to the rule prohibiting accelerated payments" under section 1.409A-3(j)(4) of the Treasury regulations.[59] Accordingly, if the employee in the above example is required to include 50% of the deferred amount in income under the one-year rule, she is permitted to receive accelerated payment of the includible amount under section 1.409A-3(j)(4)(vii) of the Treasury regulations, which allows payment "at any time the plan fails to meet the requirements of section 409A" in an amount not exceeding the amount required to be included in income as a result of the failure.[60] As discussed in Chapter 11 (Acceleration of Payments), under the generally applicable rules of section 1.409A-3(j)(4) of the Treasury regulations, payment under this provision is permitted whether or not the plan document provides for it. Also, the provision is not required to be administered uniformly; accelerated payment may be withheld for any one failure, even if payment is made for another.[61]

> *Example 2*. Consider the same facts as in Example 1, but change the assumption so that, within one year of the correction, the employee's employment does not transfer to the 80% owned subsidiary; rather, the employee incurs a 409A-compliant separation from service. In this case, the employee's deferred compensation is not subject to income inclusion or penalty tax under 409A.

> *Example 3*. Consider the same facts as above, but the employee has no employment change until one year and one day after the correction, on which date she transfers to the 80% owned subsidiary. No 409A tax applies.[62]

IRS spokespersons have unofficially explained that the one-year rule is intended to prevent manipulation of the correction rules—to prevent, for example, a plan sponsor from deliberately drafting a plan with an impermissible payout trigger with an eye toward last-minute revision to avoid penalty.

5. *Failed Payment and Election Terms Correctable Subject to the One-Year Rule*

The following document failures are correctable under Notice 2010-6, subject to the one-year rule. In all cases, correction must be made before the impermissible event occurs, must be effective immediately, and may not expand or contract a definition except as necessary to bring the term into compliance. In all cases, the correction is subject to the rules listed above. In some cases, other rules apply as well and are noted below:

a. *Impermissible Definition of a Separation From Service (Section V(A))*

Section V(A) of Notice 2010-6 applies to a separation that includes any term providing for payment upon a change in the service relationship that is not a

[59] I.R.S. Notice 2010-6, §III(H), 2010-3 I.R.B. 275, 278.
[60] Treas. Reg. §1.409A-3(j)(4)(vii).
[61] *Id.*
[62] I.R.S. Notice 2010-6, §V(D), Ex. 1–3.

409A-compliant separation from service.[63] An example is a term defining separation from service to include transfer from one 80% owned subsidiary to another. This category also includes any provision *failing* to provide for payment upon a 409A separation from service. One possible example (not in Notice 2010-6) might be a provision providing for a separation payment to be made when the employee is taken off payroll, irrespective of the fact that a 409A separation from service has already occurred.

b. *Impermissible Definition of a Change in Control Event (Section V(B))*

An example of a change in control event under section V(B) of Notice 2010-6 is a provision for payment upon an initial public offering of 30% of the employer's stock. The relief does not cover changes in control defined in terms of "specifically identified assets."[64] For example, explains Notice 2010-6, the correction is not available for the employees of the parent corporation with respect to a change in control defined as the sale of an identified subsidiary.[65] The one-year rule applies, but with only 25% inclusion by affected service providers.[66]

c. *Permissible and Impermissible Payment Events (Section VII(A))*

One example of provisions addressed in section VII(A) is a provision for payout upon the earlier of an initial public offering (impermissible) or separation from service (permissible).[67] This correction does not extend to payout triggers that involve impermissible discretion, either by the service recipient or service provider. The correction does not extend to plans that have no permissible payment trigger.

d. *Alternative Payment Schedules Upon Voluntary Versus Involuntary Separations (Section VII(C))*

An example of provisions correctable under section VII(C) is a provision for payout as a lump sum upon involuntary separation and as 10-year installments upon voluntary separation.[68] The plan may be corrected by amending the *voluntary* payout form to equal the *involuntary* payout form.[69] In this case, the one-year rule applies if a voluntary separation occurs (but not if an involuntary separation occurs) during the year following correction. If the alternative payout schedule relates to anything other than the voluntary versus involuntary separation toggle, a different correction rule applies, described below.

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[63] I.R.S. Notice 2010-6, §V(A)(1), 2010-3 I.R.B. 275, 281.
[64] I.R.S. Notice 2010-6, §V(B)(1), 2010-3 I.R.B. 275, 282.
[65] *Id.*
[66] I.R.S. Notice 2010-6, §V(B)(2), 2010-3 I.R.B. 275, 282.
[67] I.R.S. Notice 2010-6, §VII(G), Ex. 1, 2010-3 I.R.B. 275, 287.
[68] I.R.S. Notice 2010-6, §VII(C)(2), 2010-3 I.R.B. 275, 285.
[69] *Id.*

e. Other Alternative Payment Schedules (Section VII(C))

A different rule applies to impermissible alternative payout schedules when the single payment event involves anything other than a voluntary versus involuntary separation toggle. Example 6 of section VII of Notice 2010-6 discusses a provision for payment as a lump sum if separation occurs when the employee is classified as a "Level 1" employee, and as 10-year installments when the employee is classified as a "Level 2" employee.[70] Another example (not contained in Notice 2010-6) is a provision for payment as a lump sum upon separation until age 50, as 10-year installments upon separation after age 50, and as a life annuity upon separation on or after age 65. The correction must remove all but one of the schedules, according to the following rule: The surviving payout form must be the form with the latest actual or possible *final* payment date, or, if these dates are the same, the form with the latest actual or possible *commencement* date, or, finally, if these dates are the same, the form "generally anticipated to result in the amount deferred being paid at later dates."[71] The one-year rule applies to any event that would have triggered any of the deleted payout forms under the pre-correction plan. No failure arises, and no formal correction is required, with respect to a service provider for whom a failed payment form could not possibly apply (e.g., a pre–age 50 payment to a 53-year old employee).

f. Impermissible Service Provider or Service Recipient Discretion as to Time or Form of Payment Following a Permissible Payment Event (Section VII(D))

Section VII(D) of Notice 2010-6 presents the example of a plan that provides for payment at age 65 in either a lump sum or 10-year installments at the discretion of the employer. If the provision has a default payment term, the correction consists of eliminating the form available upon exercise of discretion.[72] If the provision has no default payment term, the amendment is similar to the general correction for alternative payout schedules.[73] That is, the surviving payout form must be the form with the latest actual or possible final *payment* date, or, if these dates are the same, the form with the latest actual or possible *commencement* date, and finally, if these dates are the same, the form "generally resulting in the amount deferred being paid at later dates."[74] The limited instances of such failure correctible outside Notice 2010-6 and thus without regard to the one-year rule are discussed above in Section III.B.2 of this chapter.

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[70] I.R.S. Notice 2010-6, §VII(G), Ex. 6, 2010-3 I.R.B. 275, 288.
[71] I.R.S. Notice 2010-6, §VII(C)(2), 2010-3 I.R.B. 275, 286.
[72] I.R.S. Notice 2010-6, §VII(D)(2), 2010-3 I.R.B. 275, 286.
[73] *Id.*
[74] *Id.*

g. Impermissible Reimbursement and In-Kind Benefit Provisions (Section VII(F))

Section VII(F) of Notice 2010-6 gives the example of a plan provision for reimbursement of expense incurred for three years after separation from service, with a $100,000 cap for the entire three-year period. The provision must be amended so that the reimbursement (or in-kind benefit) is allocated pro rata over the period. If the stated period is the service provider's lifetime, the allocation must be based on the service provider's life expectancy using "reasonable actuarial assumptions."[75] If the stated period ends with a stated event, the proration period must be established based on "reasonable assumptions" for a period of at least three years.[76] The one-year rule applies if a reimbursement event occurs within one year of the correction.

h. Failure to Include Six-Month Delay of Payment Rule for Specified Employees (Section VIII)

If a plan provides for payment upon separation from service but fails to include the six-month delay rule for a specified employee (this rule is discussed in detail in Chapter 10 (Permissible Payments)), it may be amended to provide that payment to a specified employee upon separation from service will not be made until the later of "(i) 18 months following the date of correction, or (ii) six months following the [separation from service] event."[77] The one-year rule applies to an affected service provider who has a separation from service within one year of correction.

6. Failed Payment Terms Correctable Without the One-Year Rule

Certain corrections are effective without any tax under 409A if made before the payment trigger occurs, without regard to the one-year rule. In all cases, however, the corrections are subject to the generally applicable rules for a correction under Notice 2010-6 described above in Sections III.C.1–3 of this chapter.

a. Impermissible Definition of Disability (Section V(C))

An example of an impermissible definition of disability correctable under section V(C) of Notice 2010-6 is a plan provision for payment upon disability defined as inability to perform the service provider's duties for three months. The correction is relatively liberal. If the definition is corrected before the specified (but noncompliant) disability occurs, no penalty arises, even for an individual who incurs the noncompliant condition immediately after the correction.[78] Moreover, the same rule applies even to an individual who incurs the noncompliant condition before the correction. In this case, however, if the individual actually

[75] I.R.S. Notice 2010-6, §VII(F)(2), 2010-3 I.R.B. 275, 287.
[76] *Id.*
[77] I.R.S. Notice 2010-6, §VIII(2), 2010-3 I.R.B. 275, 289.
[78] I.R.S. Notice 2010-6, §V(C)(2), 2010-3 I.R.B. 275, 282.

received payment under the noncompliant disability provision, the payment must be corrected as an operational failure under Notice 2008-113,[79] as described in Chapter 29 (Correcting Operational Errors).

b. Ninety-Day Rule Failures—Noncompliant Payment Period (Section VI(A))

Correction is available for a provision that, in violation of section 1.409A-3 of the Treasury regulations, specifies a payout period of more than 90 days.[80] An example is a provision for payment "within 180 days after separation from service." The correction is not available if the specified payment period is more than 365 days. The correction can either eliminate the payment period or shorten it to fit within the permitted 90 days. The one-year rule does not apply; however, the 50% penalty applies if the payment trigger occurs before correction, but correction is made within a "reasonable time" thereafter. For example, assume that a provision for payment within 180 days after separation from service is amended to "90 days," and the correction is made on April 15. An employee who separates from service on April 16 is not subject to tax under 409A. An employee who separated from service before April 15 treats 50% of vested compensation deferred under the corrected plan as subject to tax under 409A, assuming that the April 15 correction date is within a "reasonable time" after his or her separation. In Section VI(A) of Notice 2010-6, the sole example illustrating "reasonable time" involves a separation from service on February 1, one month before the correction date of March 1.[81] If correction is made more than a "reasonable time" after separation, presumably full taxation under 409A applies to the affected service provider.

c. Ninety-Day Rule Failures—Employee Releases of Claims and Other Waivers (Section VI(B))

Regulations provide that, if a plan specifies a payout period, the period must either fall within a single taxable year of the service provider, or be a specified period of not more than 90 days, and not give the service provider the "right to designate the taxable year" of the payment. Notice 2010-6 takes the position that the 90-day rule is violated if payment is contingent on the service provider signing a waiver or on other "employment-related actions." An example is a provision for payment upon separation, contingent on the employee's signing a release of claims within 90 days after separation from service, with payment forfeited thereafter. The IRS's thinking seems to be that, even if the 90-day period is specified, for a payment event on or after early October of any year the employee can "control" the year of payout by delaying signing the waiver. This issue is discussed in detail in Chapter 23 (Releases).

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[79] *Id.*
[80] I.R.S. Notice 2010-6, §VI(A), 2010-3 I.R.B. 275, 283.
[81] I.R.S. Notice 2010-6, §VI(C), Ex. 1, 2010-3 I.R.B. 275, 284.

Correction is made by specifying a payment date, rather than a payment period. If the plan at issue specifies a payment period, the payment date must be the last day of the period. In the above example, the payment period is 90 days, so the amendment must provide for payment on the 90th day following separation. If the payment period is not specified, the plan must specify a payment date but has only two choices: either 60 days or 90 days following the payment trigger. The correction is not subject to the one-year rule. An employee who separates after the correction is not subject to 409A tax or penalties. The correction is not subject to the "reasonable time" exception applicable to 90-day rule failures under section VI(A) of Notice 2010-6. Accordingly, an employee who separates before the correction date is apparently subject to tax under 409A on all amounts deferred under the plan, even if the employee did not exercise his or her purported "right to designate" the tax year of the payment (or the 90-day period in fact fell within a single calendar year).

d. Service Recipient Discretion to Accelerate (Section VII(E))

An example of provisions correctable under section VII(E) is a provision stating that the employer may terminate the plan and pay out amounts at any time. Notice 2010-6 provides that the plan may be amended at any time before the employer exercises its discretion and makes the payout. The one-year rule does not apply. This correction is not available for service provider discretion to accelerate.

e. Service Provider Discretion to Accelerate

"Haircuts" and other employee accelerations are apparently considered within the target zone of 409A policy concerns, with no correction available.

7. Failed Payment Terms Correctable Only With Penalty

If the plan lacks any permissible payment trigger, penalty-free correction is not available. This rule puts pressure on defining the "plan," as is discussed above in Section II. of this chapter.

An example is a plan providing solely for payment of $100 upon the enrollment of a child in college or graduate school, expressly without regard to whether the employee is still employed at the time of payment. If correction is made before the payment trigger occurs, 50% of the vested amount deferred under the plan is subject to tax under 409A. This reduced penalty amount is available only if the correction follows all the procedural requirements noted above in Section III.C.3. of this chapter. No correction is available after the impermissible payment trigger occurs.

A simpler correction might be available, however. Change the assumption so that the plan provides for payment "upon enrollment" in college, without expressly stating that the employee must be employed on the date of payment. In this event—and if the plan's past administrative practice permits—it would make more sense to amend the provision as an "ambiguous payment term," by stating that the employee must be actively employed at the time of any payment, and so turning the plan into an unambiguously compliant short-term deferral. As discussed above, amending an ambiguous payment term is a complete correction, without using the formal correction program of Notice 2010-6 and without tax under 409A.

8. Failed Election Provisions—Special Rules

Correction of provisions allowing noncompliant service provider elections are somewhat different from other corrections. In some cases, a service provider who has made no election under the defective term may not be subject to tax under 409A, even if the provision is not corrected. The relief is narrow, however, and in many cases corrections must be made under Notice 2010-6 to forestall tax under 409A.

a. Impermissible Initial Deferral Elections (Section IX)

As discussed above in Section III.B.2.a. of this chapter, if the plan has a noncompliant provision for initial deferral elections, Notice 2010-6 provides that there is no document failure as to a service provider to whom the provision has not been "applied"—generally, a service provider who made no deferral election under the failed provision (or has made one and timely revoked it).[82]

If, however, the provision has been "applied" to a service provider—generally, if the service provider has made an election and not revoked it—the plan may be corrected under Notice 2010-6 by eliminating the impermissible provision from the plan by the end of the second taxable year following the taxable year in which the election became irrevocable.[83] For example, assume a garden variety deferred compensation plan (not covering performance-based compensation). The deadline for an irrevocable deferral election as to 2012 is December 31, 2011.[84] To be effective as a document correction as to compensation deferred in 2010, the noncompliant election provision must be eliminated not later than December 31, 2013. Any elections made under the noncompliant provision must be revoked and treated as operational failures under Notice 2008-113, as described in Chapter 29 (Correcting Operational Errors). That is, any amounts deferred in 2012 would have to be paid to the participant and corrected as an impermissible deferral.

b. Impermissible Discretion and Subsequent Deferral Elections (Section VII(D) and (G))

As discussed above in Section III.B.2. of this chapter, if a plan provides an impermissible subsequent deferral election by the service recipient or the service provider, or impermissible discretion following a payment event, there is deemed to be no document failure as to a service provider for whom neither the service provider nor the service recipient has exercised the impermissible election or dis-

[82] I.R.S. Notice 2010-6, §IX(C)(2), 2010-3 I.R.B. 275, 290.
[83] *Id.*
[84] I.R.S. Notice 2010-6, §IX(C)(3), Ex. 1, 2010-3 I.R.B. 275, 290.

cretion. In addition, for this no-failure treatment to apply, the provision must provide a default time or form of payment, and cannot allow an election as to the time and form of payment after the payment event. The illustrative example given in the Notice is a plan providing for payment of deferred compensation as a lump sum at age 65, where employees are allowed to further defer compensation to any future date of their choosing by so electing at any time until age 65 (in violation of the one-year/five-year rule applicable to subsequent deferral elections under 409A(a)(4)(C)). Under Notice 2010-6, there is no document failure as to an employee who does not make a deferral election under the defective provision because the plan meets the Notice's conditions for its deemed no-failure treatment. Informal correction of the provision is permitted.[85]

If the plan provision does not meet the conditions for informal correction, however—that is, if the provision does not have a default time or form of payment, or if the provision allows discretion to change the time or form of payment after the payment event—formal correction under Notice 2010-6 is required. If the plan has a default time or form of payment, the plan must be amended to remove the prohibited discretion to redefer. If the plan has no default time or form of payment, Notice 2010-6 states that the amendment must provide a payment provision similar to that required for correcting impermissible alternative payment schedules. That is, it must provide for a time or form of payment that will be the potential time or form of payment under the plan resulting in the last final payment date, and, in the event of a tie, the form of payment commencing or potentially commencing at the last possible date, and in the event of a tie, the form generally resulting in the amount deferred being paid at later dates. It is not clear how this rule would apply if no provision in the plan specified any payment date, because the latest possible payment date is death. Possibly, in such a case, this correction is not available.

Also, the Notice's deemed no-failure treatment and informal correction is not available if the service provider or service recipient has made an election under the impermissible redeferral provision and does not timely revoke it. For example, change the assumptions in the above example of a plan providing for payment of deferred compensation as a lump sum at age 65, so that the employee elects to defer payout until age 70 and does not revoke the election before it becomes irrevocable (one year before he attains age 65). Further assume that the plan remains uncorrected by the time he reaches the original payment date (age 65). The employee must include all amounts deferred under the plan as subject to tax under 409A.[86] This is apparently the case even if the employee's election is operationally compliant with the subsequent deferral election rules of 409A—that is, it was made earlier than one year before the original age-65 payment date and pushed the payment date out for five years. Moreover, under Notice 2010-6, this is the case even if the employee revokes his election before age 65, but the revocation is made after the revocation deadline (within one year before attaining age 65). The one-year rule applies to any correction made before the original payment date (after the original payment date, correction under the Notice is not

[85] I.R.S. Notice 2010-6, §VII(G), Ex. 10 and 11.
[86] I.R.S. Notice 2010-6, §VII(G), Ex. 12.

available). Change the example again so that the employee makes a subsequent deferral election and does not revoke until the date that is four months before he attains the original payment date (age 65). Correction is available under Notice 2010-6 if the employee includes 50% of the deferred amounts as subject to tax under 409A, and the employee and employer comply with the other requirements for Notice 2010-6 correction described above in this chapter.

9. Failed Terms in New Plans—Special Rules (Section X)

Newly adopted plans may be corrected not later than the later of the end of the plan year or the 15th day of the third calendar month in which the first legally binding right to deferred compensation arose under the plan. No tax or penalty applies (although operational failures made under defective provisions may have to be corrected under Notice 2008-113, as described in Chapter 29 (Correcting Operational Errors)). For purposes of this rule, the plan is defined as all plans that would be treated as one plan under the aggregation rule of section 1.409A-1(c)(2)(I) of the Treasury regulations if they covered the same service provider. This means that a plan is a new plan for purposes of the correction only if no plan in the same bucket has been adopted by the service recipient. This restriction generally makes the new plan rule useful only for new employers.

10. Transition Rules

Certain corrections made in 2010 and 2011 are subject to a relatively lenient correction regime under Notice 2010-6:

a. Significant Relief for Corrections in 2010 (Section XI(A))

If a failure correctable under Notice 2010-6 is corrected in 2010, no taxes otherwise payable under the correction will apply.[87] For example, a failed payment provision corrected in 2010 will not be subject to the one-year rule. Moreover, even if the noncompliant payment event has already occurred, correction is treated as retroactively effective to January 1, 2009.[88] Any payments made pursuant to the impermissible provision can be treated as operational errors, correctable under Notice 2008-113, as described in Chapter 29 (Correcting Operational Errors). The same rule of relief applies to corrections of provisions allowing noncompliant elections. For example, assume that an employee made a redeferral election under a noncompliant redeferral provision, and the correct (original) payment deadline has passed. If the provision is corrected in 2010 and if the election is revoked and corrected under Notice 2008-113 by December 31, 2010, no penalty tax is incurred under 409A.[89]

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[87] I.R.S. Notice 2010-6, §XI(A)(1), 2010-3 I.R.B. 275, 291.
[88] I.R.S. Notice 2010-6, §XI(A)(2), 2010-3 I.R.B. 275, 291.
[89] I.R.S. Notice 2010-6, §XI(A)(1), 2010-3 I.R.B. 275, 291.

b. Offsets Corrected on or Before December 31, 2011 (Section XI(B))

As discussed in detail in Chapter 15 (SERPs and Excess Benefit Plans), payments under a nonqualified deferred compensation plan may not be offset or reduced by amounts payable at a different time under another arrangement if the resulting "substitution" could result in a prohibited acceleration or deferral of amounts payable under the plan.[90] Under Notice 2010-6, failed offsets can be corrected until December 31, 2011, without 409A tax or penalty.[91] The correction must ensure that the timing and form of payments under the two plans are identical. As with similar corrections, the surviving payment form must be the payment form that yields the latest final payment date or, if these dates are the same, the latest commencement date or, again if these dates are the same, the schedule "generally resulting in the amount deferred being paid at later dates."[92] Any amounts actually paid or deferred under the failed offset provision can be corrected under Notice 2008-113 as operational failures,[93] as described in Chapter 29 (Correcting Operational Errors).

c. Provisions for Payments With Timing Determined Based on Payments Received by the Service Recipient Corrected on or Before December 31, 2011 (Section XI(C))

Certain payments schedules that are determined by the timing of payments received by the service recipient may be corrected on or before December 31, 2011.[94]

D. Scrivener's Error and Traditional Doctrines of Contract Interpretation

1. Threshold Question: Is Each Plan Term Confined to Its Written Expression?

The fundamental threshold issue is whether traditional doctrines of contract interpretation (including scrivener's error) may be applied to correct plan documents for 409A compliance. The traditional premise of contract construction is that the contract is the parties' agreement; the writing is only their expression of the agreement. If it can be shown that the writing, when read as a whole, does not reflect the parties' agreement—for example, there is "ambiguity" or "mutual mistake"—the instrument can be interpreted, or in some cases reformed, to reflect the parties' intent. These precepts imply that a plan—the parties' agreement to defer compensation—may conform with 409A, even if some of its written expression violates 409A.

A contrary view is that strict documentary compliance is required by 409A and the regulations. Under this contrary view, failures on the face of the document trigger penalties under 409A, even if the writing does not conform with the

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[90] Treas. Reg. §1.409A-3(f).
[91] *See* I.R.S. Notice 2010-6, §XI(B)(1), 2010-3 I.R.B. 275, 292.
[92] *Id.*
[93] *Id.*
[94] I.R.S. Notice 2010-6, §XI(C)(1), 2010-3 I.R.B. 275, 290.

parties' intent. The difference between these two views informs, for example, how one perceives the relief under Notice 2010-6 for ambiguous payment terms. Under the first view, the provision regarding ambiguous payment terms merely restates—and narrows (as discussed further below)—the applicable principles of contract law. Under the contrary view, the rule regarding ambiguous payment terms is a rule of administrative grace.

This contrary or strict-liability view would appear to be incorrect, for two reasons. First and most fundamentally, legislative history and the statute show that 409A was intended only to codify the long-standing doctrine of constructive receipt. Under the principles of constructive receipt, a deferral election by a cash-basis taxpayer is effective for tax purposes only because the obligor and obligee can enter into a contract—binding on the parties for payment purposes, and on the IRS for income recognition purposes—to defer compensation. Section 409A and regulations require that this contract be in writing. But a writing requirement does not nullify (and is indeed consistent with) the basic rule of contract law that the writing be interpreted to conform with the parties' underlying agreement. A fuller account of this constructive-receipt view of section 409A is beyond the scope of this chapter, but is set forth in greater detail in Chapter 30 (Correcting Outside the Correction Programs), Chapter 32 (Other Tax Rules: Constructive Receipt and Section 457A), and elsewhere.[95]

Second, the contrary or strict-liability view appears to be an incorrect view of the writing requirement of 409A. Generally, in applying income tax regulations and principles, contract interpretation principles apply to *any writing* expressing an agreement. For example, controversy often arises from agreements to extend the statute of limitations under Code section 6501, where the IRS agent filling out the Form 872 (consent to extend) misidentified the tax year, the taxpayer, or other needed information. If given effect, this failure on the face of the document voids the extension and typically benefits the taxpayer. The IRS takes the position that the document failures are disregarded on the grounds that the parties' real and effective "agreement" lies outside the failed documents, when such agreement is determined by applying such familiar contract precepts as "scrivener's error" and "latent ambiguity" to determine the parties' intent.[96] The courts have agreed with the IRS's position in this context.[97] In opposition, taxpayers have argued (among other things) that the statute requires "written con-

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[95] *See, e.g.*, Rosina B. Barker & Kevin P. O'Brien, *409A Failures: Correcting With and Without Notice 2008-113*, 125 TAX NOTES 557 (2009); Andrew L. Oringer, *Some § 409A Relief for the Weary—IRS Notices 2008-113 and 2010-6 . . . and More?*, 38 TAX MGMT. COMP. PLAN. J. 67 (Mar. 5, 2010).

[96] *See, e.g.*, I.R.S. Chief Couns. Adv. 2002-04-001 (Jan. 25, 2002) (mutual mistake); I.R.S. Tech. Adv. Mem. 84-35-014 (May 23, 1984) (latent ambiguity).

[97] Woods v. Commissioner, 92 T.C. 776, 784 (1989); Kelley v. Commissioner, 59 T.C.M. (CCH) 206 (1990), *aff'd*, 45 F.3d 348 (9th Cir. 1995); Buchine v. Commissioner, 20 F.3d 173, 177–78 (5th Cir. 1994); Ambur v. United States, 206 F. Supp. 2d 1021, 1025–30 (D.S.D. 2002) (citing *Woods*, applied principles of contract interpretations in holding taxpayer consented to extension of statute of limitations period); United States v. Burlington Res. Oil & Gas Co., 86 A.F.T.R.2d (RIA) 5282 (S.D. Tex. 2000) (citing *Buchine*, noting that court may consider facts beyond the four corners of the consent at issue to determine the taxpayer's intent); Atkinson v. Commissioner, 58 T.C.M. (CCH) 1257 (1990) (holding the court can look beyond the face of the Form 872-A (consent to extend) to determine the intent of the parties).

sent." Therefore, taxpayers argue, the writing itself is the agreement, rather than a mere expression of the agreement, making it impermissible to look beneath the failed writings to determine intent.[98] This argument by taxpayers has not prevailed. The Fifth Circuit, for example, disagreed with the taxpayers' position, reasoning that, even though the agreement is not a contract (rather, it is a unilateral waiver of a defense), principles of contract construction "are significant" because the statute requires that the extension be by "written agreement."[99]

That is, even when the statute provides that the agreement must be in writing, the courts have looked beyond the written instrument to determine the parties' agreement. The same principles should apply to the terms of plans governed by 409A. Even though the plan is required by regulations to be in writing, it appears appropriate to look beyond the writing when contract principles allow, to determine whether the agreement itself is compliant with 409A.

2. *Which Contract Law Applies?*

SERPs and other top-hat pension plans under ERISA section 3(2) are not subject to ERISA's fiduciary requirements, but are still ERISA plans enforceable under ERISA section 502(a)(1). Their terms are construed under the "federal common law" of contracts.[100] In arrangements that are not ERISA plans—restricted stock units, employment agreements, and option contracts, for example—state law applies.

3. *What Constitutes the Contract?*

Section II. (above) of this chapter explains the problem in determining what constitutes a plan for the purpose of a 409A document violation. Section 409A requires the plan to be in writing, but, as discussed above, it is not always clear which writings constitute the plan. These may be considered to include, for example, the plan document, participant communications, letters, shareholder agreements, compensation committee minutes, and even participants' e-mails. Or the plan may be viewed as only a subset of these. Absent more guidance, the intended scope of the contract is unclear.

4. *Section 409A Savings Clauses*

The dominant IRS concern underlying the rigidity of much of the administration of 409A is the apparent belief that executives have the ability to exercise unlimited control over the terms of their deferred compensation and that they do so by applying a finely tuned cost-benefit analysis. This apparent concern explains the one-year rule. For example, consider an executive concerned about her

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[98] *See Buchine*, 20 F.3d at 178; *see also Woods*, 92 T.C. at 783–84.

[99] *Buchine*, 20 F.3d at 179; *see also Woods*, 92 T.C. at 789 ("In determining that we can give effect to the actual agreement of the parties, we are aware that [I.R.C. §]6501(c)(4) requires that extensions be in writing. Such a requirement does not preclude reformation of a written agreement."); I.R.S. Chief Couns. Adv. 2002-04-001 (Jan. 25, 2002).

[100] *See, e.g.*, Aramony v. United Way Replacement Benefit Plan, 191 F.3d 140, 147, 149–50, 23 EB Cases 1865 (2d Cir. 1999); *In re* New Valley Corp., 89 F.3d 143, 149, 20 EB Cases 1537 (3d Cir. 1996).

status at her company. Her deferred compensation plan provides for payment upon separation from service, which, at her insistence, is defined to include demotion (a noncompliant payment trigger in the absence of a separation from service). Payment upon demotion, enforceable under the contract, is a violation of 409A but, in this putative scenario, is acceptable to her as a 20% haircut. The one-year rule does not eliminate the possibility of this manipulation but greatly increases its expected cost. Even after the definition of "separation" is amended to be 409A-compliant (again at the employee's insistence), the 50% penalty applies if the once-feared demotion event occurs within a year of the amendment. Manipulation is possible, but subject to contingent cost.

In short, the apparent policy concern about noncompliant terms is that these terms may not in fact be inadvertent, rather that these terms reflect the parties' intent. One way to clarify that any noncompliant term is not in fact intended is to include a 409A savings clause nullifying noncompliant terms, thus making them unenforceable and placing them outside the zone of 409A policy concerns.

a. *Savings Clauses to Cure Ambiguity*

Assume that a plan has a 409A savings clause—for example, "Notwithstanding any other provision of this plan, no election shall be permitted, and no payment shall be made, that would violate the requirements of or cause taxation to any person under § 409A . . . ." Regulations state that such clauses are "disregarded."[101] Informally, however, IRS spokespersons have suggested that savings clauses may be used to interpret ambiguous plan terms or otherwise inform analysis of the plan.[102] Notice 2010-6 formalizes this informal position. Section IV(B) provides that if a plan states that its terms are to be "interpreted to comply" with 409A, or words to that effect, any otherwise ambiguous payment term "*is not ambiguous* and complies with the requirement of § 409A and § 1.409A-3(a)."[103] This is an interpretive principle, rather than a correction. It appears to apply to *all ambiguous terms in a plan document*, and not merely the payment terms specifically addressed by section IV(B).[104]

Under the principles of Notice 2010-6, however, this interpretive principle can cure only terms that are ambiguous when read in isolation. It cannot override noncompliant plan terms. It cannot even introduce ambiguity into the document—thus allowing the document as a whole to be construed under normal contract principles—if the terms on their face are clear. A payment term is not "ambiguous" if it expressly violates 409A—that is, if it "explicitly includes"

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[101] Treas. Reg. §1.409A-1(c)(1) (for purposes of determining the "terms of a plan," provisions that "purport to nullify noncompliant plan terms" or to supply required plan terms, are "disregarded").

[102] *See, e.g.*, remarks of William C. Schmidt et al. as transcribed in *Annotated: Application of Section 409A to Nonqualified Deferred Compensation as of November 2008*, 239 PENS. BEN. DAILY (BNA), Dec. 15, 2008.

[103] I.R.S. Notice 2010-6, §IV(B)(1), 2010-3 I.R.B. 275, 280 (emphasis added).

[104] *Id.* If the plan includes a savings clause, "this section [relating to ambiguous payment terms] does not apply because the provision is not ambiguous," I.R.S. Notice 2010-6, §IV(B)(1), 2010-3 I.R.B. 275, 280, implying that the savings clause rule applies without regard to Notice 2010-6.

noncompliant payment events or "explicitly excludes" required ones.[105] A term is not "ambiguous" but unambiguously noncompliant, if there is a "pattern or practice" of administering it in a noncompliant way.[106] Presumably, this definition of "ambiguous" applies for the broader rule described above, as well as for ambiguous payment terms.

b. Savings Clauses to Create Ambiguity

Under the interpretive rule implied by Notice 2010-6, a 409A savings clause can cure ambiguous plan terms but has no effect on unambiguous ones. This is consistent with the IRS's view of similar clauses in wills and other testamentary documents. Savings clauses can aid in interpreting already ambiguous provisions but cannot override clear terms or even introduce ambiguity into terms that are clear when read by themselves. For example, Revenue Ruling 75-440[107] involved a will creating both a marital and a residual trust. The will enumerated a single list of powers for both trusts, including a power (to invest in life insurance policies) that, if applied to the marital trust, disqualified it from the marital deduction.[108] A savings clause stated that, "notwithstanding" any other provision of the will, any power would "be absolutely void to the extent" it jeopardized the marital deduction.[109] The ruling held that, although this clause could not void a disqualifying power, it could be used to interpret the testator's intent as to any ambiguous one. Further reasoning that the intended scope of the disqualifying power was ambiguous (both trusts or only the residual trust?), the ruling concluded that, reading all terms of the instrument together, including the savings clause, the testator intended that the disqualifying power apply only to the residual trust, thus preserving the deduction for the marital trust.[110] This use of the savings clause, cautioned the IRS, was permissible only because the intended scope of the disqualifying power was "initially unclear."[111] Other IRS rulings follow the reasoning of Revenue Ruling 75-440.[112]

As shown in the previous paragraph, the IRS's position is that savings clauses may not introduce ambiguity in the face of otherwise clear but inconsis-

[105] *Id.*

[106] I.R.S. Notice 2010-6, §IV(A)(2), 2010-3 I.R.B. 275, 280.

[107] Rev. Rul. 75-440, 1975-2 C.B. 372.

[108] *Id.* at 372–73.

[109] *Id.* at 373.

[110] *Id.*

[111] *Id.* at 374.

[112] *See, e.g.*, I.R.S. Tech. Adv. Mem. 2002-34-017 (Aug. 23, 2002) (where a will granted spouse lifetime power of appointment (in violation of I.R.C. §2056(b)(7)(B)) and also forbade trustee from administering marital trust in any manner that would disqualify from marital deduction, *Held*, marital deduction was unavailable, because savings clause is effective only to construe intent and may be used as an aid in interpreting the instrument only when "an ambiguity is present in another part of the instrument"); I.R.S. Tech. Adv. Mem. 1999-32-001 (Aug. 13, 1999) (savings clause cannot void a trustee power or direction that would otherwise disqualify trust from marital deduction but can be used as an aid in construing testator's intent); I.R.S. Tech. Adv. Mem. 91-04-003 (Jan. 25, 1991) ("savings clause" was not effective to override qualified terminable interest property (QTIP) disqualifying power; clause did not abrogate "clear unambiguous terms" of other provision, but rather provided "guidance in case the terms of the will require construction").

tent terms in a will. The courts, however, give savings clauses broader effect. Numerous cases have considered the availability of the marital deduction in wills where one provision read in isolation unambiguously grants a disqualifying power, and elsewhere the will contains a marital deduction savings clause. When the two inconsistent provisions are read together, the will is ambiguous, and the resulting ambiguity allows the court to interpret the entire document in light of the testator's intent. Using this precept, and on the basis of all the facts and circumstances including extrinsic evidence, the courts may read the disqualifying power out of the document, as inconsistent with the testator's governing intent.[113]

These cases are instructive in the 409A context. First, generally, the same principles of document interpretation are applied to contracts and wills (except that in the latter the relevant "intent" is that of the testator alone, rather than that of the parties to the agreement).[114] Second, in no case was it argued that the testator did not intend to convey the power at issue. Rather, it was held that the intended power could be ignored as contrary to the testator's intent, because it mistakenly contravened the intended tax effect (when the intended tax effect was shown as a primary purpose under the totality of the circumstances). Under similar principles, a 409A savings clause might allow a document, when read in light of the parties' intent, to be read as omitting a noncompliant provision. This would be the case even if it were undisputed that the noncompliant payment or election term itself was contemplated, if it could be shown that it was inconsistent with the parties' clearly demonstrated intent of 409A compliance. Third, it is important to note that none of the foregoing cases hold that a savings clause overrides an unambiguous disqualifying provision in the will. Rather, the courts allow the clause to introduce ambiguity; the document is then read as a whole for its legal and tax effect in light of the testator's intent based on all surrounding circumstances. Applied to 409A-covered plans, the principles of the foregoing cases do not contradict the 409A regulation disregarding plan provisions that purport to nullify noncompliant terms or to supply required ones.

A savings clause introducing ambiguity does not necessarily mean that the conflict between two inconsistent provisions (a 409A-noncompliant provision and a provision stating the intent of 409A compliance) is resolved in favor of a 409A-compliant intent. It may well be necessary to look at other intrinsic or extrinsic evidence to demonstrate the parties' intent. This evidence may be sparse

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[113] Estate of Cline v. Commissioner, 43 T.C.M. (CCH) 607 (1982) (prenuptial agreement gave widow bonds following testator's death, subject to two inconsistent conditions: (1) with "full power to consume" corpus during lifetime (qualifying for marital deduction) and (2) only for "care and support" (which would not qualify for marital deduction); court held that savings clause allowed court to read disqualifying provision out of the agreement; clause showed "overriding purpose" and allowed court to disregard "inconsistent" statement); *see also* Estate of Alexander v. Commissioner, 82 T.C. 34, 44–45 & n.11 (1984) (dictum), *aff'd mem.*, 760 F.2d 264 (4th Cir. 1985); Estate of Mittleman v. Commissioner, 522 F.2d 132, 137–40 (D.C. Cir. 1975); *cf.* Estate of Ellingson v. Commissioner, 964 F.2d 959, 962–65 (9th Cir. 1992) (marital deduction trust satisfied requirement for QTIP deduction, even though trustee had disqualifying power to accumulate income in excess of surviving spouse's need; satisfaction of "best interests" requirement of trust, in light of surrounding circumstances, required paying surviving spouse all income, in satisfaction of QTIP requirements).

[114] *See* 5 MARGARET N. KNIFFIN, CORBIN ON CONTRACTS §24.1 (Joseph M. Perillo ed., rev. ed. 1998).

in the formation of the unilateral contract that typifies a 409A plan, where there is no generally bargained-for exchange. But e-mails, written and oral employee communications, and other parol evidence, for example, explaining the plan amendments and their intent to ensure 409A compliance, may all exist and may be used to demonstrate intent.

c. *Savings Clauses to Eliminate Ambiguity by Replacing Noncompliant Provisions With Compliant Ones*

Ideally, a savings clause would not only eliminate a noncompliant plan term but also replace it with a compliant one. There are two difficulties with drafting an effective clause of this kind. First, of course, is the regulation's statement that such clauses will be disregarded. Practitioners may wish to consider including them in any case. From a policy perspective, they are not abusive. And notwithstanding the IRS's broad authority to write regulations administering 409A, it is not yet clear whether the IRS can instruct the federal courts how to interpret a contract.

The second difficulty with savings clauses is that—even assuming they can delete noncompliant provisions—it will be technically more difficult to draft them so that they insert compliant ones. For example, consider a plan stating, in violation of 409A, that amounts payable upon the employee's separation from service will paid either as a lump sum or a life annuity, at the election of the employee. Elsewhere, the plan states, "notwithstanding any other provision of this plan, no payment shall be made and no election shall be given effect if such payment or election would give rise to taxation under 409A to any person. . . ." This clause cannot be a self-executing document correction. While purporting to delete a bad provision, it fails to supply a good one and leaves the plan silent as to the form of payout upon separation from service. Accordingly, it may be ineffective to override the specific but noncompliant benefit payment provision.[115] A more detailed savings provision might further state something like "and any amount payable under such provision shall be paid on the earliest date permitted with respect to such provision by 409A, and not before such date." Under normal contract precepts, such "notwithstanding" clauses are generally effective to override inconsistent provisions[116] and, in this example, could be read to supply a compliant rule in place of a noncompliant one.

5. *Scrivener's Error*

When a term is unambiguous but 409A-noncompliant on its face (even when read together with other plan provisions), can it be argued that the failure is ineffective as a mere scrivener's error? For example, consider a payout provision

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[115] *Cf.* Aramony v. United Way of Am., 254 F.3d 403, 411–14, 26 EB Cases 1647 (2d Cir. 2001) (where SERP's introductory clause stated generally that plan was to supply benefits lost because of Code-induced limits on qualified plan benefits, and document specifically enumerated the Code-induced limits compensated for, the court held the general introductory clause could not supply Code-induced limits not specifically enumerated).

[116] *See* Morse/Diesel, Inc. v. Trinity Indus., Inc., 67 F.3d 435, 438–39 (2d Cir. 1995); Cisneros v. Alpine Ridge Group, 508 U.S. 10, 17–19 (1993).

stating that payment will be made "no earlier than" 90 days after a stated event, when "no later than" is presumably intended. Or consider a more problematic but equally black-and-white mistake, such as omission of the six-month rule. Can the omitted plan term be supplied as a scrivener's error?

Scrivener's error doctrine is used in two senses. If the written terms of an agreement are clear and unambiguous on their face, but do not reflect the parties' intent, the result is a "mutual mistake" justifying "reformation" of the instrument under long-standing principles set forth in *Restatement (Second) of Contracts* section 155.[117] Reformation is not a self-executing remedy, however, but must be undertaken by the court acting in its equitable power. This is the position of the Fourth Circuit, for example, when construing qualified pension plans and other employee benefit plans governed by ERISA's fiduciary protections. If the mistake is a "mutual mistake" in this sense, modification of the terms by the plan administrator or the employer is not permitted but may be undertaken only by the court acting in its equitable power.[118]

But a second doctrine may be available to correct a failed writing when the document is clear on its face but the writing does not reflect the parties' agreement. Under the doctrine of "extrinsic ambiguity," a mutual mistake in the document may be read out of the document in the process of contract interpretation, without equitable reformation by a court. It is this second sense of "scrivener's error"—where correction is allowed by *interpretation*, rather than by reformation—that is meant here.[119]

Interpretation, of course, is permitted only when the document is ambiguous. And the premise of this discussion is that the plan's 409A-noncompliant terms are unambiguous. When a document's terms are clear on their face, interpretation to determine whether the parties' agreement is contrary to the document is made possible by the doctrine of "latent" or "extrinsic" ambiguity. Under this doctrine, extrinsic evidence is permitted to show that the parties intended a result not reflected on the face of the document and that the document is ambiguous when read together with this external evidence.[120] Extrinsic evidence necessary to establish ambiguity in a clear document cannot be "subjective," or "self serving." Once ambiguity is shown by the introduction of objective evidence, other evi-

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[117] RESTATEMENT (SECOND) OF CONTRACTS §155 (1981).

[118] *See* Cross v. Bragg, 329 Fed. Appx. 443, 454–55, 47 EB Cases 1784 (4th Cir. 2009); *see also* Blackshear v. Reliance Standard Life Ins. Co., 509 F.3d 634, 642, 42 EB Cases 1609 (4th Cir. 2007) ("[R]eformation, whether it is based upon scrivener's error or mutual mistake, is most decidedly a remedy available *in a court of equity*."); Audio Fid. Corp. v. Pension Benefit Guar. Corp., 624 F.2d 513, 518, 2 EB Cases 1856 (4th Cir. 1980) (noting that "a court of equity can reform a contract to correct a mistake disclosed by oral proof" if "the mistake [is] mutual, or [is] accompanied by fraud on the part of [one] contracting party").

[119] *See generally* 5 CORBIN ON CONTRACTS, *supra* note 114 (for example, §§24.1, 24.18), and see, e.g., *infra* text accompanying notes 120 & 134.

[120] *See* Mathews v. Sears Pension Plan, 144 F.3d 461, 466, 22 EB Cases 1193 (7th Cir. 1998) (Posner, J.) ("doctrine of extrinsic ambiguity" allows consideration of "extrinsic evidence to demonstrate that although the contract looks clear, anyone who understood the context of its creation would understand that it doesn't mean what it seems to mean"); Rossetto v. Pabst Brewing Co., 217 F.3d 539, 543, 24 EB Cases 2089 (7th Cir. 2000) (Posner J.) ("The doctrine of latent ambiguity comes into play . . . only if someone who read the contract without knowledge of its real-world context of application would think it clear."); *see also* 5 CORBIN ON CONTRACTS, *supra* note 114, §24.7.

dence is admissible to show intent as to the contract's meaning—in just the same way as for documents where ambiguity is clear on the face of the document, or "intrinsic."[121]

The doctrine of extrinsic ambiguity has been applied by the Seventh Circuit to construe qualified pension plans and other plans subject to ERISA's fiduciary requirements. An example is *Mathews v. Sears Pension Plan*,[122] where Judge Posner sets forth the doctrine in detail.[123] *Mathews* is occasionally lumped together with the "reformation" cases involving qualified plans but is distinguishable because it is an exercise in contract interpretation. The doctrine of extrinsic ambiguity is generally part of the federal common law of contracts, and thus should be applicable to 409A-covered plans that are ERISA plans. The doctrine, however, may not be part of the contract law of all 50 states, and so may not always apply to 409A-covered plans that are not ERISA plans.

The doctrine of extrinsic ambiguity may be used to insert omitted terms to fill gaps and to override incorrect or unintended terms. In *Rossetto v. Pabst Brewing Co.*,[124] for example, the Seventh Circuit remanded a case relating to an ERISA health benefits plan to the district court to determine whether the plan could be read to allow insertion of a missing lifetime promise of health benefits.[125] In *Sharewell, Inc. v. Commissioner*,[126] the Tax Court used the doctrine to read a missing term (specifically, a covenant not to compete) into a contract, when the omitted term was necessary to give effect to the taxpayer's intended tax treatment of the document.[127] In *State Pipe & Nipple Corp. v. Commissioner*,[128] the Tax Court used the doctrine to conclude that no "purchase" was intended, when the contract unambiguously stated that the transaction was a "purchase" and the taxpayer's claimed deduction turned on the transaction not being a purchase.[129] In Technical Advice Memorandum 84-35-014, the IRS used the doctrine to correct a defective Form 872 (agreement to extend the statute of limitations) by deleting the incorrect information stated on the face of the document and re-

[121] *See Mathews*, 144 F.3d at 467–68.

[122] 144 F.3d 461, 22 EB Cases 1193 (7th Cir. 1998).

[123] *Mathews*, 144 F.3d at 466–68.

[124] 217 F.3d 539, 24 EB Cases 2089 (7th Cir. 2000).

[125] *Rossetto*, 217 F.3d at 543–47; *cf.* Boeing Co. v. March, 656 F. Supp. 2d 837, 861–63 (N.D. Ill. 2009) (allowing class of retirees and spouses to show latent ambiguity to insert lifetime promise of health benefits not otherwise found on face of plan document, but holding against class of retirees and spouses, in that no grounds for such ambiguity could be found).

[126] 78 T.C.M. (CCH) 1190 (1999).

[127] *Sharewell, Inc.*, 78 T.C.M. (CCH) 1190 (when, for purposes of claiming the benefit of amortization deductions, taxpayer argued that one-quarter of purchase price was allocable to a covenant not to compete, even though the purchase agreement failed to include the covenant, *Held*, when the contract was interpreted in light of the intent of the parties, omitted covenant not to compete was included).

[128] 46 T.C.M. (CCH) 415 (1983).

[129] *State Pipe & Nipple Corp.*, 46 T.C.M. (CCH) 415 (where taxpayer's claimed deduction turned on transaction not being a purchase by taxpayer, but a redemption by corporation, but contract "unambiguously" provided for purchase, extrinsic (parol) evidence admitted to show no purchase intended or accomplished).

placing it with the omitted but correct information.[130] In all cases, the interpretive act was not equitable reformation, but merely interpretation of the agreement.

The distinction between the two senses of the doctrine of scrivener's error—that of "mutual mistake" and that of "extrinsic ambiguity"—is explored at some length here only because in the compensation arena the doctrine has gained new salience. As noted, a number of federal courts, such as the Fourth Circuit, have invoked ERISA's policy concerns to find that mistakes in qualified plan documents (and other documents governing funded ERISA plans subject to ERISA's fiduciary rules) must be corrected only by the court as "reformation" of a "mutual mistake."[131] Not all federal circuits agree. For example, as shown above in the discussion of *Mathews* and *Rossetto*, the Seventh Circuit does not agree with the Fourth Circuit that mistakes in qualified plans must be corrected by reformation, but rather pursues correction via interpretation by applying the doctrine of extrinsic ambiguity.[132] Moreover, in other arenas the distinction may have lost its vitality.[133] In the federal income tax case law, indeed, the two doctrines appear to be sometimes conflated. For example, the Tax Court described the defect in the document in *Sharewell, Inc.*, as a "mutual mistake" that would support "reformation of a written contract under the standards of this Court."[134] But although the court discussed reformation, it applied interpretation. In practice, the *Sharewell, Inc.*, court applied the doctrine of extrinsic ambiguity to interpret the terms of a facially unambiguous agreement. In applying contract precepts to correct an unambiguously failed Form 872 (agreement to extend the statute of limitations), the IRS has invoked as virtually interchangeable both the doctrine of contract "reformation" to remedy mutual mistake[135] and the doctrine of extrinsic (or latent) ambiguity to interpret a doctrine to conform to the intent of the parties.[136] Without regard to the theory it invoked, the IRS interpreted the document (an extension of the statute of limitations) to conform to what the IRS and taxpayer purportedly thought they were doing, without undertaking the formal step of seeking reformation by the Tax Court.

IV. CONCLUSIONS

Many document failures in the 409A-covered plan may be corrected with varying degrees of administrative complexity and tax penalty. This chapter has outlined available correction approaches, both those formally recognized by the

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[130] *See* I.R.S. Tech. Adv. Mem. 84-35-014 (May 23, 1984).

[131] See cases *supra* note 118.

[132] *But see* Young v. Verizon's Bell Atl. Cash Balance Plan, 667 F. Supp. 2d 850, 882, 895–906, 48 EB Cases 1011 (N.D. Ill. 2009) (district court in Seventh Circuit, following Blackshear v. Reliance Standard Life Ins. Co., 509 F.3d 634, 642, 42 EB Cases 1609 (4th Cir. 2007), and other Fourth Circuit precedent, held that unambiguous plan provision that increased participants' accrued benefits by more than $1.6 billion over parties' expectations could be removed from the plan but only by court using its equitable power to reform document for mutual mistake).

[133] *See, e.g.*, 5 CORBIN ON CONTRACTS, *supra* note 114, §24.18.

[134] Sharewell, Inc. v. Commissioner, 78 T.C.M (CCH) 1190 (1999).

[135] I.R.S. Chief Couns. Adv. 2002-04-001 (Jan. 25, 2002).

[136] *See* I.R.S. Tech. Adv. Mem. 84-35-014 (May 23, 1984).

IRS and those covering more uncharted territory. In the uncharted terrain, it is possible that in some cases long-standing principles of contract construction may be used to show that the parties' agreement complies with 409A even if the written instrument does not. While reasonable, these precepts are, of course, untested in the 409A arena. Even outside the 409A context, it is not always easy to argue successfully that an agreement committed to writing means something other than what its terms say.

Nonetheless, some general drafting approaches suggest themselves as ways of mitigating the possibility of a 409A failure. First and most obviously, the drafting should be as simple as possible and should cross-reference 409A to the extent feasible. Second, every 409A-covered plan should have a strong 409A savings clause. At the very least, the IRS acknowledges that savings clauses are effective to the extent that they may render ambiguous terms 409A-compliant. And for the reasons discussed above, savings clauses may have effects well beyond the limited scope acknowledged by the IRS, by overriding noncompliant terms and possibly even supplying compliant ones. Third, a savings clause might be useful to document the participants' agreement or understanding that every 409A-covered plan must conform with 409A.