



Management Alert

IRS Improves §409A Correction Procedures

On November 30, the IRS issued IRS Notice 2010-80, modifying its existing procedures for voluntarily correcting failures to comply with §409A of the Internal Revenue Code. Some of the changes included in Notice 2010-80 will make the correction procedure significantly less burdensome.

Section 409A was enacted in 2004 to provide detailed rules governing the taxation of all types of deferred compensation, which is broadly defined to include many types of severance plans and severance provisions in individual employment agreements, as well as some incentive and bonus plans. The regulations implementing §409A, which were finalized in 2009, are extremely detailed and technical, and failure to comply with the regulations can result in significant tax penalties. The IRS has previously issued two correction procedures to alleviate the effect of inadvertent violations of §409A: Notice 2008-113 deals with “operational” failures - *i.e.*, failure to administer a deferred compensation arrangement in accordance with its terms, and Notice 2010-6 deals with the failure of a written plan or employment agreement to comply with the formal requirements of the §409A regulations. Notice 2010-80 modifies both procedures, although it primarily affects the documentation correction procedures of Notice 2010-6. Our previous alert on this subject can be accessed [here](#).

The principal changes made by Notice 2010-80 are summarized below. Note that although this summary refers to “employer” and “employees”, the same rules generally apply to outside directors and other independent contractors.

Payments Contingent on a Release of Claims

Many severance agreements, and some deferred compensation plans, require the employee to sign a release of claims or other agreement (such as a noncompete) in order to receive payment. Although many severance agreements are exempt from §409A, if the agreement is subject to §409A and does not specify a time period during which the release must be signed, the IRS considers this a §409A violation because the employee can determine which year the payment is made based on when he or she signs the release. Notice 2010-6 provided that in order to correct this, the agreement had to be amended to provide that the payment had to be made on a specified date, generally either 60 or 90 days after termination, and could not be paid any earlier. Notice 2010-80 allows payment to be made within a specified period, such as 90 days after termination, provided that if the payment period overlaps two years the payment must always be made in the later year. Under an extended transition period, an agreement can be formally amended at any time until December 31, 2012, to comply with the timing rules. If the employee terminates prior to that date, the payment must actually be made during a permitted payment period.

Attachment to Employee Tax Returns Not Required For Some Corrections

One of the most unpopular features of the correction procedures is the requirement that both the employer and the employee must attach statements to their respective tax returns notifying the IRS that they have relied on the correction procedures. Notice 2010-80 provides that the employee is not required to attach a statement to his or her tax return for (1) any document

correction under Notice 2010-6 that is completed in 2010, (2) any correction of the release timing rules that is completed by December 31, 2012, under the new transition rule described above, or (3) certain other technical corrections that are permitted under Notice 2010-6 to be completed by December 31, 2011. However, the employer is still required to file the attachment to its return.

Notice to Employees of Same Year Operational Corrections No Longer Required

Notice 2008-113 as originally issued generally did not require the employee to file an attachment to his or her tax return for an operational error that is corrected within the same year, but it did require the employer to formally notify the employee of the correction by January 31 of the following year. This employee notification requirement has now been eliminated. Again, however, there is no change in the requirement that the employer file an attachment to its tax return.

Limited Relief for Linked Plans

“Linked” plans, in which the amount payable under a nonqualified plan (such as a SERP) is determined by the amount payable under another plan, either qualified or nonqualified, are generally not eligible for document correction under Notice 2010-6. The IRS has now clarified that relief will be available if the effect of the linkage is unrelated to the timing of the payment under the nonqualified plan, *i.e.*, where the only effect is on the amount of the benefit. (A special transitional rule that allows two linked nonqualified plans to be corrected through the end of 2011 was not changed.)

Stock Options and SARs

Stock options and SARs are generally not subject to §409A unless granted with an exercise price below fair market value, in which case they are considered deferred compensation and must comply with §409A. Stock options and SARs subject to §409A must specify when they can be exercised in advance, and the exercise date must correspond to one of the permitted payment events under §409A, such as termination of employment. Notice 2010-6 originally provided that non-complying stock options and SARs were ineligible for correction, but Notice 2010-80 clarifies that a discounted stock option or SAR that is intended to comply with §409A may be corrected under Notice 2010-6 if the document failure involved is otherwise covered by the correction procedures.

The immediate impact of Notice 2010-80 is that employers who have been considering correcting a document failure under Notice 2010-6 will want to be sure to complete the correction by December 31, 2010, if possible, so that the affected employees will not need to attach the required statements to their tax returns. In addition, some employers may need to reconsider whether possible failures in their documents may now be eligible for correction.

If you have any questions about the possible application of the §409A correction procedures, please contact the Seyfarth attorney with whom you work, or any Employee Benefits attorney on our [website](#).



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