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IRS Issues Additional 409A Guidance on Correction of Operational and Documentary Failures

The Internal Revenue Service on November 30 issued Notice 2010-80, which provides additional guidance on the correction of certain operational and documentary failures under nonqualified deferred compensation plans subject to Section 409A of the Internal Revenue Code. The Notice modifies Notice 2008-113, the original guidance dealing with 409A operational failures, and also modifies Notice 2010-6, the original guidance dealing with 409A documentary failures.

Additional corrections relief has been widely anticipated based on informal comments from Treasury and IRS officials. The new guidance deals principally with the following matters:

- It provides an additional correction method under Notice 2010-6 for plans and agreements providing payment upon a separation from service subject to a requirement to execute a release of claims (or similar document such as a noncompetition agreement) and provides generous (but only transitional) relief for such plans and agreements that were in effect on or before December 31, 2010;
- It extends the documentary relief provisions of Notice 2010-6 to so-called "linked plans" — nonqualified plans whose benefits are determined by reference to benefits under one or more other nonqualified or tax-qualified plans — but only so long as the linkage does not affect the time or form of payments under the plans, which significantly limits the scope of this relief;
- It extends the documentary relief provisions of Notice 2010-6 to include stock rights (*i.e.*, stock options and stock appreciation rights) that are intended to be subject to but compliant with 409A, though the relief still does not apply to stock rights that are intended to be exempt from 409A (as is the case with most stock options), which also limits the scope of this relief; and
- It modifies the correction reporting requirements applicable under Notice 2008-113 and Notice 2010-6 by eliminating the requirement to notify employees upon (i) correction of most documentary failures during 2010, (ii) correction of an operational failure in the same taxable year as the failure occurs and (iii) correction of documentary failures regarding a release of claims and similar documents during a transitional period as described further below.

Because the principal importance of the Notice is in regard to the treatment of releases and similar documents, only that provision of the guidance is discussed in detail below. The Notice states that Treasury and IRS officials continue to analyze comments on the existing relief programs and that further corrections guidance is expected in the future.

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

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Relief for Releases and Similar Documents

Background. Nonqualified deferred compensation plans and agreements often provide for payment upon a separation from service subject to a requirement that the employee execute a release of claims, noncompetition agreement or similar document. In the most typical scenario, an executive is entitled to severance upon a separation from service and the severance is payable within a specified period (typically 60 or 90 days) following separation, but only if the executive executes a release of claims. The IRS takes the position that such a provision fails to comply with 409A because, if the specified period happens to span two taxable years, the employee can affect the year of payment by choosing when to execute the release. Many practitioners nevertheless believe that these types of provisions are compliant and that the IRS position is not supported by regulations.

Notice 2010-6 already provided a correction method in these circumstances, but it has been widely criticized by practitioners as cumbersome. Under the original Notice 2010-6 correction method, the offending provision had to be amended to provide for payment only upon a fixed date either 60 or 90 days after separation from service. However, if the provision already included a specified period during which the employee could execute the release, the payment date had to be the last day of that period.

New Correction Method. Notice 2010-80 provides additional correction methods so long as the correction is made prior to the separation from service. The nature of the available correction methods depends on whether the existing release provision specifies a period for payment (for instance, provides for payment within 90 days following separation from service subject to execution of a release) or does not specify a period (for instance, provides simply that payment will be made upon execution of a release):

- Where there is a specified period for payment, the correction must provide for payment on the last day of the period, except that if the period spans two taxable years, payment must be made in the later year.
- If there is no specified period for payment, the correction can be made in one of two ways:
  - By providing for payment only on a fixed date either 60 or 90 days following separation, or
  - By providing for payment during a specified period not longer than 90 days following separation, except that payment must be made in the later year if that period could span two taxable years.

Transition Relief. Notice 2010-80 provides additional (transitional) relief for plans and agreements which contain this documentary failure on or before December 31, 2010. Essentially the transitional relief:

- Forgives these documentary failures entirely where payment is triggered on or before March 31, 2011, and
- Forgives documentary failures for later payments so long as the payments are triggered on or before December 31, 2012, except that where payment can be made in either of two taxable years, the payment must either be made in the later year or, if paid during the earlier year, must be treated as an operational failure and corrected in accordance with Notice 2008-113.

If payments have not been triggered by December 31, 2012, the documentary failure must be corrected by that date to be 409A compliant. Employers that correct in this circumstance are exempted from the requirement to provide an information statement to employees, and from the requirement that the correction be reported in the employee's tax return, but employers are not exempted from the Notice 2010-6 requirement to attach an information statement to their own return.

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In light of this new guidance, employers should review their existing employment and severance agreements and, for those agreements that condition payment on action by an executive, such as a release of claims, take appropriate action to ensure that the agreements avail themselves of the transitional relief or another available correction method described above.