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Counsel

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Gerald H. Sherman William Archer
Deborah M. Beers Donald Carlson
Keith A. Mong

Ricchetti, Inc.
Steve Ricchetti
Jeff Ricchetti

Federal Policy Group
Ken Kies
Matthew Dolan

Arnold & Porter LLP
Martha L. Cochran
David F. Freeman, Jr.

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Anthony Raglani, *Asst. Dir. of Policy & Public Affairs*

101 Constitution Avenue NW, Suite 703 East
Washington, DC 20001
Toll Free: 1-888-275-0092 Fax: 703-641-8119
www.aalu.org

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Subject: **IRS Issues Additional 409A Correction Guidance, Including Transition Relief for Certain Corrections Made by the End of 2010**

Major References: [*IRS Notice 2010-80, 2010-51 IRB \(November 30, 2010\)*](#)

Related Reports: 10-07; 08-108

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The Internal Revenue Service has issued Notice 2010-80 to provide additional guidance regarding the Revenue Code Section 409A document correction program, including relief from the requirement that employees attach statements to their income tax returns for certain corrections made by the end of 2010 and additional correction options for payments that are conditioned on an employee signing a non-competition agreement, a non-solicitation agreement, or a release of claims. Employers and employees considering corrections under the 409A document correction program should take into account this new guidance to determine whether corrections should be made before the end of 2010. The notice also contains additional guidance regarding the operational correction program.

Nonqualified deferred compensation arrangements that are subject to section 409A must comply with the applicable requirements both in form and operation. If a plan does not fully comply, the employees entitled to the deferred compensation potentially are subject to three adverse tax consequences - (i) immediate income inclusion, (ii) an additional tax equal to 20% of the amount deferred, and (iii) interest during the deferral period.

Because of the complexity of the section 409A requirements and the potentially severe consequences of noncompliance, the IRS has established two limited correction programs - (i) an operational correction program under IRS Notice 2008-13 (see our Bulletin No. 08-108), and (ii) a plan document correction program under IRS Notice 2010-6 (see our Bulletin NO. 10-07).

Like the operational correction program, the 409A document correction program allows only certain document failures to be corrected. Under the general correction procedures, a plan document defect can be corrected without penalty if the defective plan provision has not become operational, the plan is amended to comply and no events occur within one year of the correction that would have caused operational violations under section 409A. The employer and all affected employees also have to attached statements to their federal income tax returns explaining the defect and the corrective actions that were taken. In addition, if an event occurs within one year of the correction that would have caused operational violations (e.g., the employee's separation from service), the 409A document correction program generally imposes a partial, or reduced, sanction (e.g., 50% or 25% of the full sanction).

Relief for Certain 2010 Document Corrections

To encourage nonqualified plan sponsors to review their documents and make any necessary changes, the 409A document correction program includes special rules for certain corrections that are made before the end of 2010. In effect, if a plan defect that could otherwise be corrected under the program is corrected before the end of 2010, generally there are no adverse tax consequences to the employee (i.e., no income inclusion and no additional 20% taxes or interest). However, if there is a related operational failure, that failure must be corrected in accordance with the operational correction program (which may require income inclusion and additional taxes).

Under the special transition rules as originally included in IRS Notice 2010-6, both the employer and employee were required to attach statements to their income tax returns disclosing that the document defects were corrected. Many employers and employees have been concerned about having to provide such statements.

To address these concerns, Notice 2010-80 provides that employees do not have to attach a statement to their income tax returns if (i) a defect is corrected under the special transition rules before the end of 2010 and (ii) they are not required to include any amounts in income.

Payments Conditioned on the Execution of Noncompetes and Releases

Many employment agreements, severance plans, and other arrangements subject to section 409A provide for payments to be made on account of an employee's separation from service, but condition the payments on the employee executing a non-competition agreement, a non-solicitation agreement and/or a release of claims within a certain time period. For example, a severance plan may provide that an employee is entitled to a payment equal to 6 months of salary if the employee is involuntarily terminated, but condition the severance pay on the employee signing a release of claims within the first 90 days following the termination of employment. In the original 409A document correction notice (2010-6), the IRS took the position that these types of conditions violate the section 409A distribution timing rules. The IRS has explained that, if the period during which he must execute the noncompete or release straddles two tax years, the employee essentially has the ability to dictate the year of payment. The employee can delay executing the noncompete or release until the second tax year, and thereby, ensure that the payment is made in that year.

In the original 409A document correction notice, the Service indicated that this document "defect" could be corrected by providing that the conditional payment would be paid only on the last day of the

designated period for signing the noncompete or release. Under this fix, the payment would be paid on the same date regardless of when the employee signs the document. Both the employer and employee would also have to attach a statement to their federal income tax returns indicating that the "defect" was corrected under the 409A document correction program. In addition, if a payment was made before the document was corrected, the "operational" defect would have to be corrected under the 409A operational correction program (which could require that some or all of the payment be included in income and subject to the 20% additional tax).

Notice 2010-80 makes three changes to the 409A document correction program with respect to payments that are conditioned on the execution of a noncompete or release. First, the Notice indicates that the provision can also be corrected by amending the plan before the distribution trigger occurs (e.g., the employee's separation from service) to provide that the payment can be made during a designated period of up to 90 days, but that if the release period straddles two tax years, the payment would always have to be made in the second tax year (as opposed to the last day of the release period in all events, which is the correction permitted originally). Second, even if a distribution trigger occurs before the plan document is corrected, the plan can still be amended by the end of December 2012 to require payment in the second tax year, provided that any affected distributions made after March 31, 2011 are actually made in the second tax year. Third, if the document is corrected before the end of December 2012, the employee is not required to attach a statement to the employee's federal income tax return explaining that the plan was corrected under the 409A document correction program.

Other Changes to the 409A Correction Programs

Under Notice 2010-6, plan document failures generally could not be corrected with respect to linked plans or stock rights (e.g., SARs and stock options). Notice 2010-80 clarifies that certain linked plans and stock rights can be corrected under the program.

For purposes of the 409A rules, linked plans are plans in which the amount paid and/or the time and form of payment is affected by the amount deferred under, or the payment provisions of, one or more other qualified or nonqualified plans. Notice 2010-6 includes a special transition rule that allows certain linked plans to be corrected by the end of 2011. However, aside from this special transition rule, linked plans generally could not be corrected under the document correction program. Notice 2010-80 modifies this treatment by providing that if a plan document defect is otherwise correctable under the program, linked plans are eligible to be corrected under the program if the linkage does not affect the time and form of payment of amounts under the plans (i.e., if the linkage only affects the amount of benefits paid under the nonqualified arrangement).

In addition, Notice 2010-80 provides that certain stock rights that were intended at the time of grant to be subject to and compliant with section 409A can be corrected under the program to the extent otherwise permitted under the rules. Note that most SARs and stock options are designed to meet the requirements to be excepted from section 409A (i.e., issued with an exercise price equal to the fair market value of the underlying stock on the date of grant with no other deferral features).

Notice 2010-6 also makes a change with respect to the original 409A operational correction notice. Under the original program, if an eligible operational defect was corrected in the same taxable year that the failure occurred, generally there were no adverse tax consequences, but the employer had to attach a statement to the employer's tax return explaining that a defect was corrected under the 409A operational correction program and also provide all affected employees with a similar statement. However, the employees were not required to attach a statement to their returns. Notice 2010-6 provides relief by eliminating the requirement to provide formal statements to the affected employees, but the employer must continue to attach a statement to the employer's tax return for the year of correction.

Please note that the 409A correction programs, including the changes just made by Notice 2010-80, contain many detailed rules and requirements that must be satisfied to fully correct the permitted operational and document failures. Any "corrections" outside of these strict rules are not permitted and will not correct the 409A failures. In addition, it is not always clear whether a particular plan provision or operation is a violation of the 409A requirements. Accordingly, before anyone attempts to correct a potential 409A failure, they should consult with someone who is well versed in the requirements under Code section 409A and the applicable correction programs.

Any AALU member who wishes to obtain a copy of IRS Notice 2010-80 may do so through the following means: (1) use hyperlink above next to "Major References," (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* with your last name and birth date and select *Current Washington Report* for linkage to source material or (3) email Anthony Raglani at raglani@aalu.org and include a reference to this *Washington Report*.

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