

Executive Compensation Alert:

Section 409A End of Year Guidance

DECEMBER 21, 2010

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On November 30, 2010 the Internal Revenue Service (“IRS”) issued Notice 2010-80 regarding corrections procedures under Section 409A and deferred compensation arrangements. The majority of the new guidance is expansion or clarification of earlier guidance in IRS Notice 2010-6 (which provided certain documentary compliance corrections procedures) and IRS Notice 2008-113 (which provided certain operational compliance corrections procedures).

Section 409A is designed to place restrictions on nonqualified deferred compensation arrangements with employees and other service providers and to subject noncompliant arrangements to a 20% additional Section 409A tax (with an additional 20% tax in California). Section 409A’s reach extends beyond traditional deferred compensation arrangements into employment agreements, severance arrangements, bonus provisions and even certain stock rights. Because the complexity and confusion of Section 409A has created inadvertent and unintentional documentary and operational errors, the IRS has allowed limited documentary corrections procedures under Notice 2010-6 and limited operational corrections procedures under Notice 2008-113.

Below is a summary of several of the different topics covered by Notice 2010-80.

Release of Claims

An employment or severance agreement often requires an employee (or other service provider) to sign a release of claims (or other type of agreement such as a noncompetition or nonsolicitation agreement) in order to receive severance-type benefits. In Notice 2010-6 the IRS expressed concern that if an agreement required a release of claims, in some situations the employee could decide which calendar year he or she could receive severance by immediately signing or delaying signing the release of claims, which discretion would result in a Section 409A violation. This discretion could be corrected under Notice 2010-6 by amending the agreement to make the payment on a specified date, 60 or 90 days after termination but not earlier than the specified date. In response to taxpayer comments regarding its complexity, the IRS has expanded this relief in Notice 2010-80 to allow payment to be made (1) on a specified date 60 or 90 days after termination, or (2) at any time within a specified period not longer than 90 days after termination, however, if such period spans two tax years the payment must be made in the later tax year. Notice 2010-80 provides a transition period for all arrangements eligible for this correction as of December 31, 2010 such that if an employee terminates employment prior to correcting a non-compliant release provision, Notice 2010-80 offers relief as long as the arrangement is paid during either of the permitted payment periods in accordance with Notice 2010-6 or Notice 2010-80 (or corrected under Notice 2008-113). However, all arrangements must be formally amended by December 31, 2012. Arrangements entered into after 2010 likely will not be eligible for this transition period and must be drafted in accordance with the guidance under the Notices.

Reporting and Notice Requirements

A burdensome condition of many of the documentary corrections under Notice 2010-6 is the requirement that the employer send a notice of the corrections to the employee, as well as the requirement that the employee and employer, respectively, attach a statement of the correction to the individual’s tax return and the employer’s tax return. Notice 2010-80 mitigates these requirements where the correction is made

before December 31, 2010 or where the correction involves the release timing issues discussed above and is corrected by December 31, 2012. The obligation of the employer to attach the required statement of correction to its tax return remains in effect, even with respect to the corrections discussed herein. The requirement that the employer provide a notice to the employee in connection with a correction under Notice 2008-113 has also been eliminated.

Stock Rights

Generally, stock options are exempt from Section 409A (unless granted at a discount). For stock options and other stock rights that are subject to Section 409A and intended to be compliant with Section 409A, Notice 2010-6 did not permit documentary correction for stock rights that nonetheless failed to be in compliance. However, Notice 2010-80 generally allows documentary correction under the principles of Notice 2010-6 for stock options and stock rights intended to be compliant with Section 409A (not stock rights that are designed to be exempt from Section 409A but fail to be exempt).

Expiring Transition Relief

Notice 2010-6 provided that corrections made before December 31, 2010 would, in most cases, be deemed to have been in place since the dates of required documentary compliance. The impact of this transition relief is that most corrections can be made more favorably before year end with little or no additional Section 409A taxes. Corrections made after 2010 may require the payment of some or all of the Section 409A taxes, and certain failures may not be able to be corrected after 2010 under Notice 2010-80 and Notice 2010-6.

Action Required

Employers should complete Section 409A corrections in 2010 if possible.

Employers should consider whether corrections are available for non-compliant provisions of agreements.

Employers should ensure that all agreements entered into after 2010 comply with Section 409A, including making sure the release language is in accordance with its guidance.

For more information, you may contact any attorney in the Executive Compensation and Employee Benefits Group.

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