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# Alert

## Internal Revenue Code Section 409A: Tax Relief for Non-Compliant Separation Pay Arrangements

### December 23, 2010

Employers and employees routinely enter into arrangements guaranteeing employees separation benefits upon the employee's termination of employment. Such agreements appear, for example, in employment agreements, severance plans, change of control agreements and separation agreements. Many of these arrangements are not covered by Section 409A of the U.S. Internal Revenue Code of 1986, as amended ("409A"), which governs nonqualified deferred compensation plans. A plan that is covered, however, must meet 409A's strict rules, or employees under the plan may be immediately taxed on vested benefits under the plan, even if they have not yet been paid the benefits, and may have imposed on them an additional 20% tax on the benefits and premium interest taxes.

The Internal Revenue Service and the Treasury Department released Notice 2010-6 (the "Notice") earlier this year, which includes an unanticipated, restrictive interpretation of 409A regarding the timing of separation payments that are conditioned on employee action, such as the execution of a release of claims against the employer. According to the Notice, a document failure in a 409A-covered plan exists if the employee, by having control over the timing of the action, is able to delay or accelerate the timing of payment. As discussed further below, a 409A-covered plan guaranteeing an employee payment of severance within 60 days following a termination without cause and without specifying the taxable year of payment, provided the employee executes and submits an effective release of claims within the 60-day period, would be considered to violate 409A.

This *Alert* summarizes guidance set forth in the Notice, as modified on November 30, 2010 by Notice 2010-80, for taxpayers who participate in 409A-covered plans conditioning separation payments on employee action and who wish to avoid immediate taxation by voluntarily correcting document failures and/or taking advantage of transition relief.

**Separation Pay Arrangements and 409A**

Many separation pay arrangements are not covered by 409A either because they meet the short-term deferral exclusion or the severance plan exemption. Under the short-term deferral exclusion — which is typically satisfied by separation agreements entered into in connection with a termination of employment — a separation pay arrangement is not covered by 409A if (1) the employee is eligible for severance pay only upon an involuntary termination (or qualifying termination by the employee for good reason); and (2) all separation payments will be made within two and one-half months after the end of the employee's taxable year in which the employee's employment terminates (*i.e.*, March 15 of the subsequent calendar year) or, if later, within two and one-half months after the end of the employer's taxable year in which the employee's employment terminates (*e.g.*, Sept. 15 of the employer's subsequent taxable year for an employer with a taxable year ending June 30). Under the severance plan exemption, a separation pay arrangement is not covered by 409A if (1) it is not possible that the aggregate separation pay could exceed (a) two times the

employee's annual compensation in the year prior to termination or (b) if less, a certain statutory limit (presently $490,000); (2) it is not possible that any of the separation pay could be paid after the second calendar year after the termination; and (3) the employee is eligible for separation pay only upon an involuntary termination (or qualifying termination by the employee for good reason). Based on these two exemptions, separation pay in many arrangements will not be covered by 409A.

Prior to the release of the Notice, many practitioners believed that a 409A-covered separation pay arrangement providing that the employee will receive the separation pay within a certain period of time following the execution of an effective release did not run afoul of 409A. The Notice clarifies, however, that a document containing such an agreement violates 409A if it gives the employee the ability to delay or accelerate the timing of the payment of the separation benefits by allowing the employee to control when he or she executes the release. Example 1 illustrates a *non-compliant* arrangement:

Example 1. *John and his employer are parties to an employment agreement entitling John to $1,000,000 upon the termination of his employment without cause. The agreement provides that the amount is payable within 60 days following the termination of employment, provided that John executes and submits an effective release of claims within such 60-day period.*

The lack of a set payment date or designated taxable year of payment in the example violates 409A's general requirement that payment of deferred compensation be made (or begin to be made, in the case of multiple payments) on a designated payment date following the termination or within a designated period not to exceed 90 days following the termination date, so long as the employee cannot designate the taxable year in which payment will be made. The arrangement is problematic because it permits John to delay the timing of payment and, potentially, to designate the taxable year of payment. For instance, if John's termination of employment occurs on December 1, 2010, and he wants to ensure payment of the severance in taxable year 2011 rather than 2010, he could delay signing the release until January 1, 2011.

Section VI.B.3 of the Notice ("Payment Periods Following a Permissible Payment Event Dependent Upon the Service Provider Completing Certain Employment-Related Actions"), as modified by Notice 2010-80, provides that John and his employer, if otherwise eligible, can correct the document failure set forth above by amending the employment agreement to ensure that payment will be made within a permissible period following the termination of employment and John will be unable to designate the taxable year of payment. Examples 2 and 3 reflect modifications rendering John's arrangement compliant:

Example 2. *John and his employer are parties to an employment agreement entitling John to $1,000,000 upon the termination of his employment without cause. The agreement provides that the amount is payable <u>on the 60th day</u> following the termination of employment, provided that John executes and submits an effective release of claims within the 60-day period following the termination.*

Example 3. *John and his employer are parties to an employment agreement entitling John to $1,000,000 upon the termination of his employment without cause. The agreement provides that the amount is payable within 60 days following the termination of employment, provided that John executes and submits an effective release of claims within such 60-day period. <u>If in any event the designated 60-day period begins in one taxable year and ends in the next taxable year, the amount shall be payable in the second taxable year.</u>*

**Eligibility for Voluntary Correction and Transition Relief**

A taxpayer generally is eligible for the relief provided for in the Notice for a document failure if he or she can demonstrate that (1) the employee and, if applicable, the employer have taken the steps required to correct the specific document failure and/or to take advantage of any transition relief, as set forth in the Notice; and (2) the employer has met the information and reporting requirements of the Notice. Further, the federal income tax return of the employee may not be under examination with respect to any matter and the federal income tax return of the employer cannot be under examination with respect to nonqualified deferred compensation for any taxable year in which the document failure existed.

Initially, the Notice required taxpayers to correct noncompliant plans on or before December 31, 2010, or the employee would be required to include in income any amount for any taxable year of the employee before the taxable year in which the document failure is properly corrected, solely as a result of the document failure

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being in the written plan during any such earlier year. Notice 2010-80, however, provides additional transition relief through December 31, 2012 for plans that contain certain failures as of December 31, 2010 involving payments dependent upon the employee completing certain employment-related actions, such as the execution and submission of a release of claims.

As modified by Notice 2010-80, the Notice now provides that a plan eligible for correction (as set forth above) on or before December 31, 2010 will not be treated as violating 409A with respect to an amount deferred under the plan and paid *on or before* March 31, 2011 without any further requirement to correct the plan. Further, a plan eligible for correction on or before December 31, 2010, with respect to an amount deferred under the plan paid *after* March 31, 2011, generally will not be treated as violating 409A, provided that (1) any amounts payable under the plan where the potential payment period spans two taxable years are actually paid in the subsequent taxable year; and (2) if any amounts under the plan remain deferred after December 31, 2012, the plan provision has been corrected in accordance with the Notice (as described above) on or before December 31, 2012. The foregoing transition relief may not be available to plans and agreements entered into on or after January 1, 2011. Accordingly, employers should review and modify form plans and agreements to comply with 409A before finalizing such documents.

Generally, to meet the information and reporting requirements, the employer must attach to its timely-filed original federal income tax return for the employer's taxable year in which it corrects the failure a statement entitled "§ 409A Document Correction under § VI.B.3 of Notice 2010-6." The statement must identify each employee affected by the document failure and the plan with respect to which the failure occurred. In addition, the statement must, among other things (1) confirm that the document failure is eligible for correction under the Notice; (2) identify the section of the Notice under which the failure was corrected (*i.e.*, § VI.B.3.); (3) confirm that the employer has taken all actions required and otherwise met all requirements for such correction by the Notice; and (4) set forth the date of correction.

The information and reporting requirements do not require, in connection with a correction of a document failure under § VI.B.3 of the Notice, that the employer make any statement regarding the correction to the employee or that the employee report the correction on his or her federal income tax return. Employers and employees must take these steps, however, in connection with the correction of document failures under other sections of the Notice.

**Note Regarding IRS Notice 2008-113**
The Notice only establishes relief for correction of *document* failures. The IRS and the Treasury Department addressed relief for *operational* failures in a previous publication, Notice 2008-113, which also was modified by Notice 2010-80.

*Authored by Mark E. Brossman, Laurence M. Moss, Ronald E. Richman, Holly H. Weiss, Susan E. Bernstein and Jaimie C. Davis.*

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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**New York**
Schulte Roth & Zabel LLP
919 Third Avenue
New York, NY 10022
+1 212.756.2000
+1 212.593.5955 fax

**Washington, DC**
Schulte Roth & Zabel LLP
1152 Fifteenth Street, NW, Suite 850
Washington, DC 20005
+1 202.729.7470
+1 202.730.4520 fax

**London**
Schulte Roth & Zabel International LLP
Heathcoat House, 20 Savile Row
London W1S 3PR
+44 (0) 20 7081 8000
+44 (0) 20 7081 8010 fax

**www.srz.com**

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