

# ERISA, Employee Benefits and Executive Compensation

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## Alert

### New IRS Position: Employment and Other Agreements With Payments Contingent Upon Execution of a Release or Other Agreement Must Be Reviewed by Year-End for Compliance with Section 409A

Robert Friedman

Meredith L. O'Leary



In Notice 2010-6 (the Notice), the Internal Revenue Service (IRS) describes various correction methods for failures under Section 409A of the Internal Revenue Code of 1986, as amended (the Code). Section 409A governs all nonqualified deferred compensation (which is defined extremely broadly). To the extent that a nonqualified deferred compensation arrangement does not comply with the provisions of Section 409A, a 20 percent penalty tax is imposed on the recipient of payments made under such arrangement, in addition to applicable federal, state and local income taxes.



In Section VI(B) of the Notice, the IRS announced a new position regarding nonqualified deferred compensation that becomes

payable only once the service provider executes a document, such as a release of claims, a non-competition or non-solicitation agreement or a similar document. As a result of the IRS's concern that service providers could control the tax year in which the compensation would become payable by choosing to sign the document in the current tax year or waiting until the next tax year, the IRS now requires that such arrangements provide for a fixed date on which the service provider must receive payment or forfeit the compensation.

#### Section 409A Violations: Two Hypotheticals

For example, an employment agreement that provides for severance payments after an involuntary termination of

employment (which qualify as nonqualified deferred compensation under Section 409A) contingent upon the employee's execution of a release of claims against the employer – but one that does not provide for a date by which this release must be executed – will now violate Section 409A; this is because the employee may choose any time to execute the document and trigger the payment. Similarly, an employment agreement that provides for severance payments contingent upon the employee's release of claims against the employer and provides payment will be made within a certain period of time following the execution of the release will now violate Section 409A as well, because the timing of the payment is triggered by the execution of the release, which the service provider controls.

#### December 31, 2010 Deadline for Amending Nonqualified Deferred Compensation Agreements

The IRS will permit service recipients to amend their nonqualified deferred compensation arrangements contingent upon the service provider's execution of a document on a one-time basis to comply with Section 409A:

- ***The arrangement must be amended in writing prior to December 31, 2010***, and neither the service provider nor the service recipient may be under audit when the amendment is made.
- In addition, the service recipient and the service provider must each attach statements to their tax returns for 2010 disclosing the amendment, and the service recipient must take reasonable steps to correct similar

provisions in all other nonqualified deferred compensation arrangements maintained by the service recipient or its affiliates.

- Finally, the amendment must be made prior to the event that triggers the payment, and: (i) if the arrangement provides for a period of time that the document may be executed, the arrangement must be amended to provide that regardless of the date of execution, the payment will be made on the last day of the time period; or (ii) if the arrangement does not provide for a period of time that the document may be executed, the arrangement must be amended to provide that the payment will be made on the 60th or 90th day following the event that triggers the payment if the document has been executed prior to such date. The amendment must provide that to the extent the document is not executed on or prior to such date, payments under the arrangement are forfeited. The amendment may not otherwise change the time or form of payment under the arrangement.

If the amendment is made after the event that triggers the payment, the IRS will honor the correction with respect to 50 percent of the payment; the other 50 percent of the payment will be subject to Section 409A and the 20 percent penalty tax.

## Exceptions to Section 409A

There are exceptions to Section 409A. Qualified plans, such as pension and 401(k) plans are excluded from Section 409A, as are welfare benefits, disability pay, death benefits, separation pay plans and collectively bargained severance arrangements. In addition, payments made within the “short-term deferral period” (two and a half months within the year in which the nonqualified deferred compensation is no longer subject to a substantial risk of forfeiture) are excluded from Section 409A. Finally, certain equity compensation, including non-discounted stock options, restricted stock and stock appreciation rights, are excluded from Section 409A.

These exceptions are important to consider when determining whether a nonqualified deferred compensation arrangement will need to be amended pursuant to the IRS position announced in the Notice.

*For more information, please contact:*

**Robert J. Friedman**

305.789.7791 | [robert.friedman@hkklaw.com](mailto:robert.friedman@hkklaw.com)

**Meredith L. O’Leary**

305.789.7437 | [meredith.oleary@hkklaw.com](mailto:meredith.oleary@hkklaw.com)

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## About the Authors

**Robert J. Friedman** is a Partner who practices in the area of ERISA, employee benefits, and executive compensation. Since 1996, he has been the head of the firm’s national Employee Benefits, Executive Compensation and ERISA practice group. Mr. Friedman’s clients include private, nonprofit and governmental employers.

**Meredith L. O’Leary** is an Associate in the Public Companies and Securities Practice. Ms. O’Leary’s practice focuses on executive compensation and employee benefits matters. She has advised a wide variety of U.S. and non-U.S. clients on executive compensation and employee benefits issues in the context of public and private mergers and acquisitions, initial public offerings and other corporate transactions.

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