
IRS Relaxes Rules on Fixing Release-Contingent Payments in Nonqualified Deferred Compensation Plans

by Susan P. Serota and Bradley A. Benedict

The Internal Revenue Service has modified its correction program for certain nonqualified deferred compensation plan ("NQDC plan") document violations under section 409A of the Internal Revenue Code of 1986, as amended (the "Code"). IRS Notice 2010-80, issued November 30, 2010, grants NQDC plan sponsors more flexibility in correcting impermissible timing provisions for payments that are conditioned on employee actions, such as execution of a general release of claims or restrictive covenant agreement, and provides transition relief for such violations. The November Notice also provides relief for certain reporting obligations under the correction program and opens the program to certain NQDC plans that previously had not been eligible.

Background

In January 2010, the IRS established a correction program in IRS Notice 2010-6 for NQDC plans that fail to comply with the documentation requirements under Code section 409A (see also our January 21, 2010, Client Alert, "[IRS Announces Correction Program for Nonqualified Deferred Compensation Plan Document Failures](#)"). The January Notice clarified that certain NQDC plan timing provisions for payments that are dependent upon the employee completing certain "employment-related actions" violate Code section 409A requirements to the extent the employee could exercise discretion that may affect the tax year in which the payment is made (such provisions are referred to herein as "Employee Discretion Violations"). Examples of such employment-related actions include signing a noncompetition agreement, nonsolicitation agreement or release of claims against the employer. Consider an NQDC plan where the employee receives a lump sum payment of compensation deferred under the plan *within* the 90-day period following a separation from service, provided that the employee executes (and does not revoke during the applicable revocation period) a general release of claims in a form acceptable to the employer. If the separation from service

occurs toward the end of a calendar year such that the 90-day period in which payment can be made crosses two tax years, then it may be possible for the employee to affect the tax year in which payment is made by timing the delivery of the general release. At the very least, the employee can ensure that payment is made in the latter year by delaying delivery of the release until January 1 (assuming the employer will not make a payment prior to the expiration of the general release revocation period).

New Amendment Option for Correction of Employee Discretion Violations

The January Notice sets forth the procedures an NQDC plan sponsor must take to correct Employee Discretion Violations, which must take place prior to the occurrence of a payment event to which the impermissible provision applies. One requirement is to amend the plan to remove the impermissible employee discretion within very strict parameters: (i) if the plan provides for payment, subject to the employee's action, within a designated period (like the 90-day period in the example above), then the amended plan must provide for payment to be made on the last day of such period, and (ii) if the plan does not provide for payment, subject to the employee's action, within a designated period, then the amended plan must provide for payment to be made on the 60th or 90th day following the occurrence of the payment event (the separation from service in the example above). Under the January Notice, if an NQDC plan having a violation covered by the correction program is corrected on or before December 31, 2010, the plan is treated as having been corrected on January 1, 2009, and the employee may avoid income inclusion and any applicable excise tax and interest penalty under section 409A.

The November Notice provides another choice for the timing of payments conditioned on employee actions. Under the new rule:

- i. If the plan provides for payment, subject to the employee's action, within a designated period, then the amended plan must provide for payment to be made (A) on the last day of such period or (B) in the second taxable year if in any event the designated period begins in a first taxable year and ends in a second taxable year.
- ii. If the plan does not provide for payment, subject to the employee's action, within a designated period, then the amended plan must provide for payment to be made (A) on the 60th or 90th day following the occurrence of the payment event or (B) during a specified period not longer than 90 days following the occurrence of the payment event, provided that if such period begins in one taxable year and ends in a second taxable year, the payment will be made in the second taxable year.¹

Additional Transition Relief

In addition, the November Notice provides transition relief through December 31, 2012, for plans containing an Employee Discretion Violation as of December 31, 2010 (that is, plans adopted on and after January 1, 2011, are expected to be compliant and are not eligible for this transition relief).

Under the transition rule, there will be no Code section 409A violation (neither a document failure nor an operational failure) as a result of an Employee Discretion Violation if payment of compensation deferred under the plan is made:

- i. on or prior to March 31, 2011; or

¹ If a plan sponsor previously amended the plan under the January Notice to correct an Employee Discretion Violation, the plan may be modified to provide for payment at the time described in clause (ii)(B).

- ii. after March 31, 2011, provided that (A) if any amounts paid under the plan pursuant to such a provision are payable during a period that crosses two taxable years of the employee, the payment is made in the second taxable year (or, if paid in the first year, such payment is eligible to be corrected as an operational failure in accordance with the rules under IRS Notice 2008-113 and is so corrected),² and (B) the plan document with the Employee Discretion Violation is corrected in accordance with the January Notice (as modified by the November Notice) prior to December 31, 2012, but this requirement is only necessary if any amounts of nonqualified deferred compensation remain deferred after December 31, 2012,³ under either the plan or any substantially similar plan of the employer with respect to another employee who commenced participation in such plan after December 31, 2010, under terms that were in effect as of December 31, 2010.

Reporting Obligation Relief for Employee Discretion Violation Corrections

Certain reporting obligations form part of the NQDC plan document correction program, but the November Notice relaxes some of these requirements. Under the January Notice, an employer correcting a plan violation must include certain information with its income tax filing for the year the correction is made and must provide certain information to the affected plan participants. (These obligations may also apply in the subsequent year for certain corrections.) In turn, the affected plan participants must include certain information on their tax returns for the year in which the correction is made (and the subsequent year in certain cases). For any correction described in the preceding section, the November Notice eliminates the employer's obligation to provide information to the employee and the employee's obligation to include information with his or her tax return. (Note that the employer is still required to include the pertinent information with its income tax filing.)

Other Relief Under the November Notice

In addition to the new rules concerning Employee Discretion Violations, the November Notice provided certain additional relief with respect to the document correction program:

- The reporting obligation relief described in the previous section also applies more broadly to any correction of a plan document violation covered by the January Notice that is completed on or before December 31, 2010.
- The correction program is open to NQDC plan document violations concerning deferred compensation in the form of stock rights to the extent that such stock rights were intended to be covered by Code section 409A.
- The correction program is open to NQDC plans that are linked to other NQDCs or qualified plans, but only to the extent that the document failure is not due to the time and form of payment being affected by the amount deferred under, or the payment provisions of, the other NQDC or to a qualified plan.

² IRS Notice 2008-113 establishes a program for the correction of certain Code section 409A operational failures (see also our December 14, 2007, Client Alert, "[IRS Announces Limited Correction Program for Nonqualified Deferred Compensation Plans](#)"); however, it is not entirely clear how the correction described herein fits within the framework of that program.

³ Without taking into account any remaining installment payments, annuities or other payments of deferred compensation that are payable as of such date.

If you have any questions about the content of this publication, please contact the Pillsbury attorney with whom you regularly work or the Executive Compensation & Benefits group.

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