A Timely Analysis of Legal Developments

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Time is Running Out! December 31 Deadline Nears for Documentary Correction of Payments Contingent on the Execution of a Release Under Section 409A

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Severance and other deferred compensation payments that are contingent on the execution of a release can in some circumstances result in a violation of Section 409A of the Internal Revenue Code.[1] Section 409A governs the timing of deferred compensation payments for tax purposes, allowing such payments only if its requirements are satisfied. Employers have until December 31, 2012, to correct non-compliant documents. The failure to make necessary corrections could result in the loss of favorable tax treatment and possible additional tax and penalties.

The Problem with Payments Contingent upon a Release

In severance and other deferred compensation arrangements subject to Section 409A, payment may commence upon a permissible triggering event. Permissible triggering events include separation from service, death, disability, financial hardship or change in control. The execution of a release is not a permissible payment trigger under Section 409A. Under these arrangements, however, the separation from service relating to the release is generally the permissible payment trigger. For this reason, the IRS takes the position that the commencement of the payment must be a fixed day or a fixed period not to exceed 90 days following the separation from service. Otherwise, according to the IRS,[2] the employee may be able to impermissibly manipulate the timing of the payment by deciding when to execute the release.

Some Examples of Non-Compliant Arrangements

Severance Agreement

A severance arrangement subject to Section 409A is non-compliant if it provides for the commencement of periodic severance payments at the end of a seven-day revocation period following the date the employee signs the release. Such a provision may violate the payment timing provisions of Section 409A because, at least theoretically, the employee could choose the

1 The same rules and correction mechanism apply for payments contingent upon the execution of a non-competition provision or a non-solicitation provision.

2 IRS Notice 2010-6 (Jan. 19, 2010).

taxable year of payment by manipulating when he or she signs the release. For example, depending upon when the separation from service occurs, by signing right away, the employee may be able to cause the payments to be taxable in one year, while, by waiting to sign the release until after the end of the year, the employee could cause the payments to be taxable in the next year.

Employment Agreement

An employment agreement provides that upon separation from service payments will be made for 18 months, beginning within 60 days of a separation from service, provided that the employee signs the release prior to the date payments begin. Assume an employee whose separation of service occurs December 1, 2010. Under these facts, the employee could sign the release on December 2, 2010, and commence payments in the 2010 taxable year, or wait until January 1, 2013, to commence payments in 2011. The IRS views this arrangement as potentially a violation of Section 409A by allowing the employee to manipulate the timing of the payment commencement, depending upon when he or she signs the release.

The Fix in Accord with IRS Guidance

According to IRS Notice 2010-80, the IRS will allow the correction of such faulty provisions by amendment to provide for one of two payment timing methods:

- Payment on a fixed date, such as on the 60th day following separation from service, provided that the employee has executed the release; or
- Payment on a date **within a period of not more than 90 days** from the separation date (*e.g.*, within 60 days following separation) where, if this period spans two calendar years, the payments must commence in the second year, regardless of when the release is executed.

These corrections are necessary even if the arrangement provides for the 45-day or 21-day period of consideration and seven-day revocation period required under the Older Workers Benefits Protection Act (OWBPA). Under these circumstances, a payment timing provision compliant with Section 409A would provide, for example, that the payments will commence on the 60th day after termination of employment, provided the employee has executed the release.

The deadline for **any such correction is December 31, 2012**, but different rules may apply depending on whether the payment was triggered before or after a noncompliant document was corrected. IRS Notice 2010-80 also provides a transition rule requiring that payments under an arrangement with a noncompliant release provision triggered between March 31, 2011, and December 31, 2012, must be administered by paying in the later taxable year where an applicable release period spans two taxable years.

> Remember: Section 409A does not apply to all severance and deferred compensation arrangements. Arrangements that satisfy the short-term deferral exception because the amounts must be paid prior to the end of the 2½ month period following the end of the year in which the payment vested are not subject to Section 409A. Further, arrangements that are "separation pay plans" within the meaning of Section 409A are also exempt. If the arrangement is exempt from Section 409A, no correction may be required.

Employers should review compensation arrangements that provide for payments contingent on the execution of a release to identify and correct any noncompliant provisions prior to the December 31, 2012, deadline.

Other Noncompliant Provisions May Also Be Fixed

The December 31, 2012, deadline also applies to other documentary provisions that may be noncompliant with Section 409A, such as certain provisions relating to so-called "linked" plans and certain stock provisions.

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