

Year-end Deadline for Correcting Section 409A Deferred Compensation Arrangements Conditioned on Employee Release or Covenant

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By December 31, 2012, all deferred compensation arrangements in which payment is contingent on employee action, such as execution of a release of claims, must either include payment-timing restrictions that comport to IRS Notice 2010-80 or satisfy an exemption from section 409A of the Internal Revenue Code (the “Code”). Employers should review all deferred compensation arrangements, especially employment agreements, severance agreements, and change-in-control agreements that require employees to execute a release of claims, non-compete covenant, or non-solicitation covenant.

Section 409A Restricts the Timing of Contingent Deferred Compensation Payments

When a payment is contingent on an employee release or covenant, the employee may be able to manipulate the payment’s tax year by strategically timing his or her execution of the release or covenant. For deferred compensation arrangements suffering this weakness, IRS Notice 2010-80 provides a Code section 409A cure.² The arrangements must be amended to specify that all contingent payments will occur :

1. On a fixed date, either 60 or 90 days after the occurrence of the event triggering payment (e.g., separation from service); or
2. During a period not longer than 90 days after the occurrence of the event triggering payment, provided that if the specified period begins in one taxable year and ends in a second taxable year, the payment will always be made in the second taxable year.

¹ Law clerk awaiting admission to the bar.

² This corrective program was first discussed in our December 20, 2010 Client Alert, [IRS Relaxes Rules on Fixing Release-Contingent Payments in Nonqualified Deferred Compensation Plans](#).

Identifying and Correcting a Typical Violation

For example, assume an employment agreement provides for a lump sum severance payment subject to Code section 409A to be made within 90 days of separation, as long as the employee executes a general release of claims. If separation occurs on December 1st, 2012, then the employee can determine the tax year for that payment by choosing whether to deliver the executed release during either 2012 or 2013. This is a Code section 409A documentary failure. Even if an opportunity for tax year manipulation never arises, the employee could face a 20% penalty tax on the deferred sum.

One solution is to amend the employment agreement to specify that, if the 90-day payment period spans two calendar years, payment will always occur in the second year, regardless of when the release is executed. Alternatively, the agreement can be amended to specify that payment will occur on the 60th day (or 90th day) after separation, provided the employee has executed the release and the period for revoking the release has expired prior to the payment date. Either type of amendment would accommodate the 21-day consideration period³ and 7-day revocation period prescribed by the Older Workers Benefit Protection Act for enforceable age discrimination waivers.

Arrangements to Review for Section 409A Compliance

Code section 409A covers a range of nonqualified deferred compensation arrangements, ranging from group plans to individualized agreements.⁴ Typical examples include:

- supplemental executive retirement plans;
- excess benefit plans;
- employment agreements;
- severance plans and individual severance agreements;
- phantom stock plans;
- restricted stock units;
- cash-settled equity awards;
- change-in-control agreements; and
- long-term bonus deferrals.

The final Code section 409A regulations issued by the IRS in 2007 did not identify contingent payment provisions as a plan failure. Accordingly, even deferred compensation arrangements previously subjected to a Code section 409A audit may require correction.



³ Note that a 45-day consideration period may apply if the release of claims is requested in connection with a group or class termination.

⁴ Code section 409A requirements do not apply to retirement plans qualified pursuant to Code section 401(a), tax deferred annuity plans authorized under Code section 403(b), and eligible deferred compensation plans authorized under Code section 457(b).

Section 409A Exempted Arrangements May Not Require Amendment

Many deferred compensation arrangements—especially bonus and severance plans—can avoid Code section 409A restrictions by satisfying either the exemption for “short-term deferrals” or the exemption for separation pay following an involuntary separation from service.

The short-term deferral exemption is available if payment will occur on or before the March 15th that follows the year in which the employee’s right to the deferred compensation is no longer subject to a significant risk of forfeiture.⁵ The separation payment exemption is available if the severance will be paid on or before the end of the second calendar year after the year in which an involuntary termination occurs and the severance does not exceed two times the lesser of the employee’s annual rate of pay or the qualified plan compensation limit (\$250,000 for 2012).

In order to satisfy either of these exemptions, however, the documentation must be clear that payment will be made before the applicable exemption’s deadline. If a deferred compensation arrangement conditions payment on the employee’s signing of a release or a covenant, and the employee can use that condition to delay payment beyond the deadline required by the exemption (this is especially a risk with the short-term deferral exemption), then the employer should amend the documentation to include a payment deadline that is compliant with the applicable Code section 409A exemption.

Taking Advantage of the Transitional Relief Program

The transitional relief offered until December 31, 2012 includes three requirements. First, the employer must use commercially reasonable efforts to identify all deferred compensation arrangements subject to Code section 409A that include employee action-contingent payments. Second, the employer must correct such arrangements to include the payment-timing restrictions provided in IRS Notice 2010-80. Third, the employer must notify the IRS of all corrections made via a statement attached to its federal income tax return.⁶ If corrections are made before the end of this year, then Code section 409A’s tax penalties may be entirely avoided and the affected employees will not need to provide any notice to the IRS of the corrections made.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the author below.

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⁵ For employers with a non-calendar fiscal year, the payment deadline may be extended until 2 ½ months after the end of the employer’s fiscal year.

⁶ Notice to the IRS must include names and taxpayer identification numbers for all affected employees, identification of the affected deferred compensation arrangements, citation to the IRS notice prescribing the utilized corrective measure, date of correction, and amount involved in the correction.

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