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Deadline Approaching for Correcting Release Timing Failures Under Section 409A

Client Alert

At a Glance

Plans and arrangements that condition the receipt of severance, change in control payments or other compensation upon the execution of a release or similar agreement, may violate Internal Revenue Code Section 409A because the employee can control the year in which the payment is made by determining when the release or other agreement is executed and submitted.

In order to avoid penalties under Section 409A, employers should amend their deferred compensation plans and arrangements on or before December 31, 2012 to correct any release timing failures in accordance with Internal Revenue Service requirements.

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Background.

Section 409A of the Internal Revenue Code ("Section 409A") imposes a number of requirements on non-qualified deferred compensation arrangements, including requirements as to the timing of payments. Section 409A defines deferred compensation broadly and, in addition to traditional deferred compensation plans and agreements, includes employment, change in control, and severance arrangements.

In previous guidance, the IRS established methods for employers to voluntarily correct many types of failures to comply with the Section 409A requirements in order to reduce or avoid penalties that would otherwise apply under Section 409A. Specifically, in Notice 2010-6, the IRS established a program that provided employers the opportunity to correct certain plan documentation failures. Following up on this correction program, the IRS, in Notice 2010-80, provided an additional method for correcting certain documentation failures and provided transition relief for the correction of these failures.

Release Timing Failures under Section 409A.

A common feature of employment, change in control, and severance arrangements is to condition the severance payments thereunder on an employee (or other service provider) executing and submitting a general release of claims, noncompetition agreement or similar document in favor of the employer (or other service recipient). The employee's ability to control when the release is executed and submitted could cause a Section 409A violation ifthe employee is able to determine the tax year in which the payment is made by delaying the execution of the release to a subsequent year or by quickly signing the release to cause payment to be made in the earlier year.

For example, assume that Employee is party to an employment agreement that entitles him to a lump-sum severance payment upon his involuntary separation from service without cause. The employment agreement provides that the amount is payable upon the execution and submission of a release of claims by Employee and expiration of a seven-day revocation period. The agreement does not, however, include any time limit for payment (e.g., payment will be made on the 60th day following separation from service). Employee is terminated by Employer on November 1, 2012, and becomes entitled to the severance payment under the agreement upon execution of a release. Because the agreement does not include a time limit for the payment of the severance, Employee, through his ability to control when the release is executed and submitted, can choose whether to receive the payment in 2012 or 2013, which is a violation of Section 409A.

Correction Methods and Transition Relief.

Notice 2010-6 provided a correction method for this type of violation by allowing the employment, change in control, or severance arrangement to be amended to provide that if the arrangement provides for payment (subject to the employee's execution of a release or similar agreement) within a designated period following separation from service, payment must be made on the last day of the designated period, and if the arrangement does not provide for payment within a designated period, payment must be made only upon a fixed date, either 60 or 90 days following separation from service. Notice 2010-80 added an additional correction method, allowing payment to be made during a specified period, generally not longer than 90 days following separation from service; provided that if the specified period spans two tax years, the payment must be made in the later tax year.

In addition to adding an additional correction method for release timing failures, Notice 2010-80 also provided additional transition relief through December 31, 2012, to correct any release timing failures that were in effect on or before December 31, 2010. Under this transition relief , to the extent amounts are paid in 2012 under a non-compliant arrangement in effect on or before December 31, 2010, the arrangement will not be treated as failing to comply with Section 409A if (a) any amounts paid under the arrangement where the potential payment period spans two tax years are paid in the later tax year or, if paid in the first tax year, are treated as an operational failure and are properly corrected under prior IRS guidance (see Notice 2008-113); and (b) if any amounts subject to the arrangement remain deferred after December 31, 2012 (other than any remaining installment, annuity, or other payments of an amount that has already become payable), the arrangement is corrected no later than December 31, 2012.

Act Now.

Employers should act now to correct any employment, change in control, and severance arrangements that contain release timing failures that were in existence on or before December 31, 2010. A failure to correct such arrangements prior to a payment-triggering event will generally result in early income inclusion and additional taxes under Section 409A. In addition, and while not subject to the transition relief under Notice 2010-80, any arrangements containing release timing failures in existence after December 31, 2010, should also be corrected now (i.e., prior to a payment-triggering event) in order to avoid penalties under Section 409A. For more information on correcting release timing failures contact a member of the Drinker Biddle Employee Benefits & Executive Compensation Practice Group or your regular Drinker Biddle attorney.