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Tax & Employee Benefits Flash

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Payments Contingent on Release: Section 409A Correction Deadline - December 31, 2012

The December 31, 2012 deadline is approaching under the IRS's voluntary compliance program relating to corrections to Section 409A compensation arrangements where an employee can accelerate or delay compensation timing by his or her actions.[1] In our experience, this ability to accelerate or delay is most common when an employer conditions a payment (e.g., severance or a transaction bonus) on the employee's execution of a release of claims against the employer. The upcoming December 31, 2012 voluntary correction deadline applies *only* to situations where a payment is conditioned on an employee's actions.

[1] For more detailed information on the IRS's voluntary compliance program under Section 409A and its position on payments conditioned on employee releases, see IRS Notice 2010-6 and IRS Notice 2010-80.

Background on Section 409A

Section 409A of the Internal Revenue Code governs the timing and method of certain deferred compensation payments. Failing to comply with Section 409A for a compensation arrangement leads to harsh tax consequences for an employee (i.e., a 20% tax penalty and acceleration of income). Although penalties fall on the employee, most employers want to avoid putting their employees at risk for these penalties.

IRS Position on Payments Conditioned on Employee Action

The IRS views the employee's ability to manipulate the timing of a payment as potentially causing a Section 409A violation. For example, if the employee must sign a release to receive a severance payment, under the IRS view, an employee who wants to defer a severance payment into the next tax year could potentially delay the delivery of a release form to the employer, causing a delay in the employee's receipt of the severance payment.

Affected Arrangements

The IRS's position on the potential delay of payments controlled by an employee's actions can affect any type of nonqualified deferred compensation arrangement, but most commonly will affect:

- Severance payments contingent upon the employee signing a release agreement or non-compete agreement prior to receive a severance payment; and
- Change of control payments contingent upon the employee signing a release agreement or non-compete agreement prior to receipt of such payment.

Certain Arrangements Exempt from Section 409A

In determining whether a correction to any employee arrangements may be warranted under the voluntary compliance program, employers must determine whether they have any arrangements which (1) are subject to Section 409A and, (2) contain provisions which allow an employee to control the timing of payments by his or her action (e.g., by making a payment conditional on a release). Many severance and change of control bonus arrangements may be exempt from Section 409A under the "short-term deferral" or "separation pay" exceptions. Generally, an arrangement provides a "short-term deferral" if the employee receives the payment within 2 ½ months after the end of the tax year in which the payment is no longer subject to a "substantial risk of forfeiture" under Section 409A standards. An arrangement generally will qualify for the "separation pay" exception from Section 409A if (1) total aggregate severance payments to the employee do not exceed the lesser of twice the employee's annual compensation or a certain statutory limit (currently $500,000), (2) the severance payments are paid before the end of the second calendar year following employment termination, and (3) the employee is eligible for the payments only upon an involuntary termination. Determining whether an arrangement is exempt or in compliance with Section 409A is complex; consequently, you should consult your tax advisor. Furthermore, even where an employer is able to determine that their arrangements are otherwise eligible for exemption from Section 409A under the "short-term deferral" or "separation pay" exceptions, if the arrangement contains payments which are contingent upon an employee signing a release, depending on the amount of time given to the employee to return the release before forfeiting the payment, a correction may be necessary to assure exemption from Section 409A.

What types of payment structures will comply with the Section 409A timing requirements on releases?

For an agreement subject to Section 409A, the payment structure will comply with Section 409A if (1) the agreement specifies a period by which the release must be returned; and (2) either (a) the payment is scheduled to be made <u>on</u> the last day of the specified period during which the release must become effective; or (b) the payment is scheduled to be made after the release becomes effective, as long as the payment must be made <u>within</u> a period of days (no more than 90) during which the release must become effective and if that period crosses two tax years, the payment must be made in the second taxable year.

How is the Correction Made?

If the arrangement is eligible for correction under the IRS procedure, the correction must generally remove the potential ability of the employee to delay or accelerate the timing of the payment through the employee's actions. The specific correction methods allowed under the IRS procedure depend upon whether the arrangement specified a time period for the contingent payment.

If the arrangement provided for payment within a specific period following an event, then the correction must provide for either (1) payment to occur on the last day of the specified timeframe or (2) payment within the next taxable year if the specific timeframe potentially spans two tax years.

If the arrangement did not specify a payment time period, the correction must provide that either (1) the payment is made on the 60th or the 90th day following the event, or (2) the payment is made within a specified period of up to 90 days after event, except the payment must be made in the later taxable year if the payment period potentially spans two tax years.

Correct Release Timing in Arrangements by December 31, 2012

In order to correct release timing issues in arrangements which were in place on or before December 31, 2010 and which have not yet triggered payments, an employer should make the corrections to its agreements on or before December 31, 2012. After the expiration of this deadline, it may still be possible to make necessary corrections under the IRS's voluntary compliance program, but the terms of the correction program are less favorable and there may be certain situations where penalties will still apply.

IRS Notification Required

An employer must notify the IRS if it corrects a compensation arrangement as outlined above. The notification must be made in the form of a disclosure document attached to the employer's tax return and should include the name and social security number of the affected employee(s).

What to Do Now

If you have not done so already, determine whether any compensation arrangements to which you are a party contain a provision for payments which are conditioned on a release (or other employee action) and whether such provision may allow for an employee to defer the receipt of payments beyond a short-period of time beyond the payment trigger (i.e., 75 days). If corrections to the payment provisions are necessary for such agreements, they should be made prior to December 31, 2012 to avoid potential penalties under Section 409A.

Questions?

For further assistance in determining whether an arrangement is eligible for and would benefit from a correction, please contact Lecia Johnson, Wendy Richards or Debra Koenig.

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