

## December 31 Deadline for Correcting Release of Claims Provisions that Fail to Comply with Section 409A

Employers preparing for year-end compliance efforts should be aware of a December 31, 2012 deadline for correcting a common problem in compensation arrangements subject to Section 409A of the Internal Revenue Code.

The problem relates to plans and agreements that condition payment on an employee-related action such as the giving of a release of claims.<sup>1</sup> Where an employee's ability to time a release may affect the timing of payments, the employee's discretion to affect payment timing may result in a violation of 409A. A violation of 409A in turn may result in early income inclusion, a 20% additional federal income tax, and other taxes and tax-related penalties.

Relief for problems arising out of this common fact pattern is available under the IRS's 409A documentary corrections program, originally published in Notice 2010-6 and subsequently amended by Notice 2010-80 (together, the "Notice"). *In some cases, however, relief from employee notice requirements is available only if action is taken by December 31, 2012.*

### Problematic Payment Arrangements

The potential issue and the relief available under the Notice arise only with respect to payment arrangements subject to 409A. Fortunately, many arrangements that provide for payment after a release are exempt from 409A (*e.g.*, short-term deferrals and certain severance obligations). Employers with agreements or plans of this type should first determine whether payments under the arrangement are subject to 409A.

### Relief Available Generally

Under the Notice, corrective amendments can generally be made without adverse 409A consequences at any time before the payment-triggering event (*e.g.*, termination of employment). Where the non-compliant arrangement specifies a designated period of not more than 90 days during which a release must be executed or become effective, the arrangement can be amended to require that payment be made either (i) on the last day of the designated period following the occurrence of the triggering event or (ii) at any time during the designated period, except that if the designated period straddles two taxable years, in the later taxable year. Similar corrections are available if no period for signing the release is designated.

This general correction method requires the employer to attach a statement regarding the correction to its tax return for the year in which the correction is made and to provide the affected employee with a statement that the employer has taken the corrective action. The employee must attach this statement to his or her own tax return.

### Transition Relief with a December 31, 2012 Deadline

A special transition rule may be available for plans and agreements that were in effect on or before December 31, 2010, *but, in certain cases, relief from employee notice requirements is available only if action is taken by December 31, 2012.* The transition rule applies to certain post-March 31, 2011 payments that are triggered on or prior to December 31, 2012 under non-compliant plan or agreement release provisions. For these,

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<sup>1</sup> Other employment-related actions (*e.g.*, an employee's being required to agree to a non-competition covenant as a condition to payment) can present the same issues, but for ease of presentation this summary uses the most common payment condition – the giving of a release of claims – as shorthand for a broader range of similar payment conditions.

depending on the circumstances, the parties may be able to treat the payments as an *operational* 409A error for which separate relief is available. It also applies to document corrections made by December 31, 2012.

For corrections under this transition rule, the otherwise applicable *employee* notice requirements (notice from the employer to the employee and inclusion of the employer's notice in the employee's tax return) are waived. Therefore, even if no amount has yet been paid under a non-compliant agreement or plan and no triggering event has occurred, many employers may prefer to make a correction by December 31, 2012 using the transition rule. (Note, however, that even under the transition rule, the employer is still required to attach a statement to its own tax return.)

In light of the approaching deadline and given that employers may not be able to identify easily all arrangements that contain problematic provisions of the type described above, employers may wish to consider whether they can instead adopt a policy prescribing the timing of payments subject to a release, recognizing that in some cases enforceability concerns associated with a unilateral policy may make an actual amendment the best course of action.

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Please feel free to contact any member of Ropes & Gray's [employee benefits](#) or [executive compensation](#) practice groups with any questions about this compliance deadline or related corrective actions.