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CODE SECTION 409A - DEFERRED COMPENSATION AND SEVERANCE AGREEMENTS, THE IRS PROVIDES A SECOND CHANCE

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Internal Revenue Code Section 409A imposes substantial restrictions on all forms of deferred compensation. In 2008, employers had to amend nonqualified deferred compensation plans, employment agreements, severance agreements and any other agreement that was affected by Code Section 409A in order to comply with the new law. As explained below, the Internal Revenue Service ("IRS") recently gave employers a chance to revisit their plans and agreements covered by Code Section 409A in order to avoid the penalties for noncompliance.

In January, 2010, the IRS released Notice 2010-06 (the "Notice") which provides a method to correct document defects in deferred compensation arrangements. It also provides new interpretations of terms and provisions. Fortunately, an employer has until December 31, 2010 in which to make document corrections without a penalty. However, operational errors are not included in that favorable transition rule. After December 31, 2010, many corrections can be made but the correction will include a penalty.

The Notice is extensive. We have highlighted two notable examples that will affect many employers.

Many severance arrangements provide for payments which are contingent upon an employee signing a release. For employees who are 40 years of age or older, those arrangements have a 21-day evaluation period and a 7-day revocation period. As a practical matter, severance payments are typically paid immediately after the conclusion of the revocation period, or in cases in which the employee is under 40, after the agreement is signed and the employment relationship ends. However, many severance agreements may not have a fixed date or time period for the payment following the effective date of the release. The IRS has insisted in the Notice that a severance agreement must have a fixed date for the severance payment after the release is effective.

Many deferred compensation plans use "separation from service" or "termination of employment" as a permissible trigger event for the payment of benefits. These terms may appear self-explanatory, but to avoid an operational failure these terms must either incorporate by reference the relevant section of the Treasury Regulations or must define the terms precisely in the plan or agreement. The terms must provide that the separation or termination must be a complete cessation of the employment relationship with no expected return. The plan or agreement can use certain exceptions such as a part-time undertaking, but it must not exceed the limit specified in the Treasury Regulations.

Please remember the breadth of the new law. As noted above, Code Section 409A even applies to that three-page severance agreement that provides for a single payment after signing a release. Fortunately, Code Section 409A provides exemptions for involuntary severance pay and certain short-term deferrals, but the document must deal with these in precise language.

Even if you have revised your deferred compensation arrangements in 2008, we recommend a second review in light of the current posture of the Internal Revenue Service and its most recent Notice. Failure to comply with Code Section 409A means draconian results, namely, immediate inclusion in income and the payment of a 20% additional tax.