Employee Benefits Alert

OCTOBER 23, 2012

Section 409A Document Correction Relief: Take the Final Bite of the Apple before December 31st

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Background

Section 409A of the Internal Revenue Code (Section 409A) regulates the payment of non-qualified deferred compensation. If a plan or agreement is not otherwise exempt from Section 409A and does not comply with its provisions, the amounts payable under such plan or agreement are immediately includable in income and subject to an additional 20% penalty tax. Deferred compensation may also be subject to interest penalties if early taxation occurs and the required income tax is not paid on time. There may be adverse tax consequences under state law as well. For example, California also imposes a 20% penalty tax on non-compliant deferred compensation arrangements.

The Timing of Payments Conditioned Upon Execution of a Release May Not Comply with Section 409A

Many deferred compensation arrangements, such as change of control plans and employment agreements providing for severance, require that the employee first execute a release of claims or return company property before receiving any of the payments under the agreement or plan. [1] The Section 409A regulations do not allow individuals receiving deferred compensation payments to choose the year in which the payments begin. Based on this provision in the regulations, the IRS has taken the position that without restrictions around the timing of the execution of the release, the employee may execute or delay execution of the release in order to select the calendar year in which the payments will be made and, therefore, the arrangement may not comply with Section 409A.

Employers and Employees Have until December 31, 2012 to Correct Plans and Agreements That Run Afoul of the Strict Timing Requirements for Execution of Releases

In January 2010, the IRS issued Notice 2010-6, which provided an opportunity to correct certain documentary violations in order to reduce or avoid the adverse tax consequences under Section 409A, including plans and agreements that did not comply with Section 409A because the employee or service provider could control the timing of the payments conditioned upon an execution of a release. The relief provided under Notice 2010-6 was extended under IRS Notice 2010-80 with respect to plans and agreements in effect as of December 31, 2010.

Under Notice 2010-80, employers may amend plans and agreements that condition payments upon the execution of a release or other agreement to provide that the payments will be made at a certain time regardless of when the employee executes the release, as follows:

- If the plan or agreement already provides that the payment will be made within a certain time period following the payment event, such as termination of employment, the agreement could be amended to provide that the payment will be made on the last day of the specified period, or if the specified period begins in one calendar year and ends in another, the payment will be made in the later calendar year.

- If the plan or arrangement does not provide a specified period for payment, the amendment can provide either that the payment will be made on a fixed date or that the payment will be made during a specified period and if the period spans more than one calendar year, the payment will be made in the later calendar year.

Once the plan or agreement has been amended pursuant to the correction procedures in Notice 2010-80, the company must comply with certain information and reporting requirements regarding the correction. Specifically, the company is required to file an information statement regarding the correction with its federal income tax returns for the year in which the amendment was made.

Recommended Actions

Companies should review all of their deferred compensation arrangements to determine whether there are any actions that must be taken by the recipient of the payments prior to the commencement of such payments. If the plan or arrangement imposes such conditions, a company should take all necessary steps to ensure that the agreement or plan is amended to comply with Section 409A prior to December 31, 2012. Companies should also be sure to comply with the information and reporting requirements with respect to their federal income tax returns for the taxable years in which the corrections were made.

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Endnotes

[1] While this alert focuses on the timing of execution of releases prior to receiving payments under plans that are subject to Section 409A, the same analysis applies to payments conditioned upon the performance of various tasks such as the return of company property or the execution of non-competition, non-solicitation, or similar agreements.