

## Do Not Miss the December 31, 2012 Deadline for Section 409A Relief

10.12.2012

### PRACTICE AREAS

Employment and Labor

If you have common deferred compensation arrangements with your employees that require the employee to return a signed release of claims before payment will be received, that arrangement may be subject to significant tax penalties, unless the language relating to the timing of the payment is corrected before the end of the year.

As background, Internal Revenue Code § 409A (Section "409A") provides that deferred compensation is included in the employee's gross income for income tax purposes on the date it is deferred or the date it is no longer subject to a substantial risk of forfeiture (if a later date) unless the document that provides for deferred compensation complies with specific requirements relating to the timing of elections, distributions and funding. Penalties for failure to comply with Section 409A include taxes due as of the date included in gross income, interest, penalties, and an additional 20% tax. Some states have additional penalties.

Employers commonly offer deferred compensation plans, such as equity arrangements, severance plans, retention bonuses, and long-term incentive bonuses to their employees, all of which typically require the employee to take some action prior to the receipt of payment (such as the signing of a release or the return of property following termination of employment). For example, we have historically recommended drafting severance agreements so that the receipt of a signed release

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from the departing employee is a condition of payment (i.e., the Company will make the severance payment within seven (7) days of its receipt of a signed release ....).

We note that not all deferred compensation arrangements are subject to Section 409A (there are some exceptions) - but for those that are subject to Section 409A, the IRS' position is that this common practice of requiring the employee to take some affirmative action prior to payment may, in some instances, give the employee the ability to choose the year in which payment is made, by either quickly signing the release or delaying the signing of the release as desired. For example: assume the Company will make a severance payment within seven (7) days of its receipt of a signed release. If an employee resigns on December 1 in a specific tax year, the employee can sign and return the release immediately and be assured of recognizing the income in the current tax year - or, the employee could wait until December 31 to return the release, in which case, he or she will recognize the income and be taxed on the payment in the next tax year. According to the IRS, the ability to make this choice violates Section 409A.

Employers can correct this improper language without penalty - if the correction is completed prior to December 31, 2012. Pursuant to IRS Notice 2010-6, amended in part by IRS Notice 2010-80, the easiest approved correction for the discussed documentary failures is to provide for payment on a fixed date (such as on the 60th day following separation from service) so that delivery of the release does not affect payment timing. We believe this is the proper correction; however, we also believe that the employer can still require the receipt of a signed release as a condition of payment - the timing of receipt of the release simply cannot affect the timing of payment.

An appropriate revision might be "the Company will make the severance payment on the 60th day following separation from service 'if, and only if', the employee returns a signed release prior to the date of payment". In this example, the employee must still return the release - but he or she cannot change the date or other timing of the payment. If the employee signs and returns the release immediately, he or she still waits for the payment date. If the employee delays the return of the release beyond the 60 day period, the payment is forfeited.

We recognize that Section 409A is a complex regulation that oftentimes results in a circular analysis in determining what arrangements are subject to the regulation and whether any exceptions apply. For example, not all severance arrangements (even those with payment subject to the employee's actions) are subject to Section 409A. If you have any questions relating to any deferred compensation arrangements, or arrangements you think "might" be deferred compensation arrangements, you can contact any member of our Employment, Labor and Benefits Practice Group.