

LEGAL UPDATES AND NEWS

Year End Deadline for Employer Action: 409A Relief for Payments Contingent Upon Signing A Release of Claims

Payments under deferred compensation arrangements, including severance payments under employment agreements or change in control agreements, may be deemed to be “deferred compensation” subject to Internal Revenue Code Section 409A, unless a specific exemption applies. Violations of Section 409A generally result in a 20% penalty plus interest on payments made which are assessed on the person receiving such payments. Although a Section 409A violation has no monetary effect on employers, most employers take primary responsibility for drafting deferred compensation arrangements, employment and change in control agreements to ensure they comply with applicable law.

The IRS recently clarified that deferred compensation arrangements, employment agreements and change in control agreements that condition severance payments on the employee’s execution of a release of claims against the employer where the employee can determine the tax year in which the amount will be paid will violate Section 409A. For example, if a payment trigger event occurs near the end of a calendar year, the employee may decide not to sign the release until the following calendar year, thereby causing the employee to recognize income in year two instead of year one.

For deferred compensation arrangements that are subject to Section 409A, the IRS published guidance specifying methods to correct this issue. The appropriate correction method will depend on the release language in the deferred compensation arrangement. However, the two most common correction methods are: (i) to amend the arrangement so that severance will be paid on a fixed date after the employee’s date of termination, provided a release of claims is received before such fixed date (for example, the severance will be paid on the 60th day following the employee’s date of termination, provided the employee signs a release of claims before the 60th day) or (ii) to amend the arrangement so that the employee’s severance will be paid, or begin to be paid, within a designated period (not to exceed 90 days), provided however, that if the employee’s discretion to sign the release spans over two calendar years, then the employer will make the severance payment starting in the second calendar year, regardless of the year the employee signs the release. Although these are common correction methods, each arrangement is unique and should be reviewed with legal counsel.

If the payments that are conditioned upon signing the release are exempt from Section 409A (by reason of the short-term deferral exemption or otherwise), then the correction of the release language is unnecessary. However, best practices are that a minor amendment should be made to the release language to clarify that both the release and payment will be made by no later than the last day of the short term deferral period (which is 15th day of the third month following the end of the employee’s tax year or employer’s tax year, whichever is later, in which the right to the payment vests).

The IRS has given employers until December 31, 2012 to correct the release language in deferred compensation arrangements that are: (i) subject to Section 409A, and (ii) in effect on or before December 31, 2010. Therefore, before the end of this year, employers should contact their legal counsel as soon as possible to review the relevant documents for compliance, and determine whether their deferred compensation arrangements, including employment agreements and change in control agreements, need to be amended. Any amendment will likely need to be signed by both the employer and the employee, so please allow time for the necessary review and approvals.

The IRS published guidance also requires employers to attach a statement to their 2012 federal corporate income tax returns summarizing the correction, including disclosure of the affected employees' names and social security numbers. If corrected in 2012, affected employees are generally not required to attach the statement to their personal federal income tax returns.

If the employer adopts a clarifying amendment to the release language for which the underlying payment is exempt from Section 409A, then no filing with the IRS will be necessary for this type of amendment, regardless of whether the amendment is adopted before or after 2012.

If you fail to take action prior to December 31, 2012, or if a non-compliant arrangement was entered into on or after January 1, 2011, then the correction must be completed by amendment before payment is triggered under a non-compliant arrangement that is subject to Section 409A (for example, before the employee's termination triggers the right to severance). In such case, the employer and employee must both attach a statement to their federal income tax returns that sets forth the information required above. If payment is made under a non-compliant arrangement that has not been corrected before the triggering event occurs, then the opportunity to correct is lost and the employee is subject to penalties under Section 409A.

For publicly traded employers, it generally appears that a Form 8-K would not be necessary, since the amendment would be technical in nature and should not be considered a material amendment; however, the amendment should be included as an exhibit to the next Form 10-K or 10-Q filed with the Securities and Exchange Commission.

Financial institutions that are in "troubled condition" may be subject to regulatory restrictions that would prevent amendments to such arrangements. If your institution has been designated in troubled condition and your deferred compensation arrangements or employment or change in control agreements have release language, please contact legal counsel.

For more information regarding this Alert, please contact one of the following attorneys of our firm.

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