

Relief for Correcting Certain Internal Revenue Code Section 409A Failures Expires This Year

November 15, 2012

The Treasury Department and the IRS have provided favorable transition relief for correcting arrangements that impermissibly condition the payment of nonqualified deferred compensation on a service provider's completion of certain employment-related actions (such as the execution of a non-competition agreement, non-solicitation agreement or release of claims). This relief will expire on December 31, 2012. The issue primarily involves arrangements where payments are made upon execution of an agreement or when an agreement (such as a release) becomes effective and there is no specific payment date so that the timing of signing the agreement can impact the date amounts are paid.

Background

Section 409A of the Internal Revenue Code ("Section 409A") imposes detailed requirements on the time and form of payment of nonqualified deferred compensation. Failure to comply with Section 409A results in the immediate inclusion in an employee's [\[1\]](#) taxable income of the deferred compensation amounts, an additional 20% tax on the employee, and possible interest and penalties. However, the Treasury and IRS have provided relief that allows an employer to correct certain errors in plan documentation or operation without subjecting employees to some or all of these negative tax consequences. Described below is the relief that Treasury and the IRS have made available in situations where a deferred compensation arrangement impermissibly conditions the payment of amounts on a service provider's completion of certain employment-related actions.

Requiring Employees To Take Employment-related Action as a Condition for Receiving Payment

Some deferred compensation arrangements require an employee to perform an action prior to payment of deferred amounts that may impact the timing of payment. For example, employers commonly require an employee to execute a non-competition agreement, non-solicitation agreement or release of claims as a prerequisite for receiving severance or other payments upon termination of employment. If such payments are subject to Section 409A and the employee can affect the timing of the payment of such amounts based upon when he or she executes such agreement or release of claims, a Section 409A violation may exist (especially where the employee can affect the tax year in which the amounts are paid).

A violation does not exist in situations where, notwithstanding when an agreement is executed or becomes effective, payment is required to be made on a specified date since the timing of execution of the agreement would not impact the payment date.

Additionally, just because an employment agreement or other compensation-related arrangement conditions payment on the execution and delivery of a release it does not automatically mean that corrective action is needed. Some severance arrangements may not qualify as deferred compensation and require corrective action. For example, correction is not necessary where an arrangement involves unvested rights to payments that, if they become due, will be paid in full under the applicable documents within the "short term deferral" period provided by Section 409A (i.e., by March 15 of the following year) or because the amounts to be paid fall under a separation payment exception under Section 409A (i.e., the payments do not exceed two times the lesser of (i) the employee's annual rate of pay for the preceding year or (ii) the maximum compensation limit for qualified plans (\$250,000 for 2012), and will be paid under the applicable documents before the end of the second calendar year following the year of termination).

[\[2\]](#)

Transitional Relief for Arrangements in Effect as of December 31, 2010

Arrangements in effect as of December 31, 2010 may be corrected by removing the ability of the employee to delay or accelerate the timing of payment. Any payments made from April 1, 2011 through December 31, 2012 that could be paid during a period that spans two taxable years must be made in the second taxable year.[\[3\]](#) For amounts that remain deferred after December 31, 2012, the applicable document(s) must be amended no later than December 31, 2012 (and before the date of an event that would be a permissible payment event under Section 409A) as follows:

- If the arrangement provides for payment within a designated permissible period (such as 90 days) following the permissible payment event (such as separation from service), then it must be amended to provide for payment either (a) only on the last day of such designated period, or (b) in the second taxable year if the designated period spans two taxable years.
- If the arrangement does *not* provide for payment within such a designated permissible period, then it must be amended to provide for payment either (a) as of a fixed date that is either 60 or 90 days following the permissible payment event, or (b) during a specified period that is not longer than 90 days following the permissible payment event, provided that, if the period spans two taxable years, the payment must be made in the second taxable year.

Employers that take advantage of this relief are required to attach information regarding these corrections to their corporate tax returns, but the employer need not provide formal documentation concerning the corrections to affected employees. Employees subject to arrangements corrected in this manner need not attach a statement to their federal income tax returns concerning the correction, and will not be subject to income inclusion or additional taxes.

The Treasury Department and the IRS guidance also allows for correction for similar violations with respect to (i) arrangements in effect as of December 31, 2010 that are corrected after December 31, 2012 and (ii) arrangements effective after December 31, 2010 (whether corrected before or after December 31, 2012), but the more favorable relief discussed above will not be available.

In light of this expiring relief, employers should consider reviewing arrangements subject to Section 409A to determine if amendments to address the above-described issue need to be made prior to the end of 2012.

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[1] The terms "employee" and "employer" are used in this alert for simplicity. However, Section 409A generally applies to a wide variety of different "service providers" and "service recipients."

[2] As a result of these nuances, employers may want to have their arrangements reviewed by experienced counsel so that it can be determined whether corrective action is in fact necessary.

[3] If such payments are made in the first taxable year, they must be treated as operational failures and corrected accordingly. For more information on correcting such failures, please see our previous client alert at:

<http://www.proskauer.com/publications/client-alerts/irs-relief-and-voluntary-correction-program/>.

Related Professionals

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- **Steven D. Weinstein**
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