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Last Chance to Correct Payments Contingent on Service Provider Action to Comply with 409A

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December 31, 2012, is the deadline to correct a deficiency in deferred compensation arrangements that make payment contingent upon certain employee actions and are subject to Internal Revenue Code Section 409A. The affected arrangements could include: severance programs, employment agreements, separation agreements, equity or phantom equity programs, and nonqualified retirement plans.

These types of deferred compensation arrangements may violate Section 409A payment timing requirements if the employee can manipulate the time of payment based on the employee's execution and/or delivery of a release of claims; a noncompetition, nonsolicitation agreement or other agreement; or a failure to revoke.

In 2010, the Internal Revenue Service (IRS) issued 409A transitional relief that allows employers to correct arrangements that existed as of December 31, 2010, by either:

Amending the arrangement to provide for a fixed payment date that is not affected by the release, agreement or failure to revoke (i.e., the date 90 days following separation from service).

If a payment may occur in one of two tax years depending upon the timing of a release, agreement or failure to revoke, then correction may consist of amending the arrangement to provide that payment will be made during the later of the two tax years, regardless of the timing of the release, agreement or failure to revoke.

For example, if the portion of an employment agreement dealing with severance compensation provides, in part, the following:

> The sums received by employee under this Section 4(c) shall be considered liquidated damages in respect of claims based on any provisions of this agreement or any claims arising out of employee's employment with employer, and the commencement of the payment of such sums by employer shall not begin until employee executes and delivers a general release of all claims in form and substance satisfactory to employer.

Because the payment date of the amounts due to the employee under the agreement is contingent on the employee’s execution and delivery of a general release of all claims, the agreement is not in compliance with Code Section 409A. The agreement must be amended on or before December 31, 2012, to comply with Code Section 409A. The amendment must either:

Provide for a fixed payment date not affected by the release.

Add a provision that if payment under the amounts due to the employee may occur in one of two tax years based on when the employee executes and delivers the release, then payment will be made during the later of the two tax years.

What This Means to You

Employers sponsoring deferred compensation arrangements that provide for any payment date that could be contingent on the execution or delivery of a release, other agreement or failure to revoke should identify and correct any noncompliant provisions before December 31, 2012. Employers should be aware that correction may require the employee’s approval or approval of the Board of Directors or Compensation Committee to effectuate the required amendment and plan accordingly.

Contact Us

Please contact a member of the Employee Benefits & Executive Compensation practice group if you have questions or if we can assist with this or any other issue.

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