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COMPENSATION ALERT FEBRUARY 2011

Correcting Employment Agreements Under Section 409A

Section 409A of the Internal Revenue Code of 1986, as amended, imposes a comprehensive set of rules and requirements on plans and agreements that provide a "deferral of compensation." The consequences of failing to comply with Section 409A can be severe and include the accelerated recognition of income on deferred amounts and the imposition of an additional 20% income tax and interest. An area that employers often overlook but that poses significant risk is associated with the provisions in employment or severance agreements that condition the payment of severance on the employee signing a release of claims.

Severance Payments Under Section 409A

Many severance payments are not covered by Section 409A because they typically qualify for one of two exceptions.[1]

Short-term deferral exception. Severance payments are exempt from Section 409A under the short-term deferral exception if the employee is eligible for the payments only upon an involuntary termination (or termination for good reason within the meaning of the 409A regulations), and the payments will be made within two and one-half months after the end of the tax year in which the employee's employment terminates.

Separation pay plan exception. Severance payments are exempt from Section 409A under the separation pay plan exception if (i) the aggregate severance payments do not exceed the lesser of two times the employee's annual compensation in the year prior to termination, or a statutory limit (currently $490,000); (ii) the severance payments are paid prior to the end of the second year after termination; and (iii) the employee is eligible for the payments only upon an involuntary termination (or termination for good reason within the meaning of the 409A regulations).

Severance Payments Conditioned on Executing a Release

The IRS has indicated that, notwithstanding the exceptions for severance payments, an employment or severance agreement will run afoul of Section 409A if the payment of the severance obligation is conditioned on the execution of an effective release. The IRS explained that if the period during which an employee must execute a release straddles two tax years, the employee can dictate the year of payment, which is prohibited by Section 409A. For example, if an employee terminates employment at the end of 2011, he could delay signing the release until after January 1, 2012, to ensure payment of the severance in 2012 rather than 2011.

To eliminate the employee's discretion to determine the timing of the severance payment, the agreement should provide a fixed deadline to execute the release (e.g., the release must be executed and not revoked by the 60th (or 90th) day following termination) and should provide that the severance payment will be made on the last day of the fixed period (provided that the release has been executed and not revoked). The severance payment, however, can be paid after the release has been executed and not revoked, provided that the payment must be made in the second year if the period for executing the release begins in one tax year and extends into a second tax year.

Correction of Non-Compliant Agreements

In IRS Notice 2010-6, as modified by IRS Notice 2010-80, the IRS established a document correction program to correct documents that did not comply with Section 409A. Agreements entered into prior to December 31, 2010, that condition the payment of severance on the execution of an effective release that gives an employee the ability to delay or accelerate the timing of the severance payment can be corrected under this program.

Under IRS Notice 2010-80, the agreement can be corrected by amending the provision before the payment trigger occurs (e.g., the employee's separation from service) to provide that the severance payment will be made during a designated period of up to 90 days, but if the designated period straddles two tax years, the payment will always be made in the second tax year. If the payment trigger occurs before the agreement is corrected, provided that the notice requirement discussed below is satisfied, a violation of Section 409A will not occur if the payment is made by March 31, 2011. For payments made after March 31, 2011, the agreement can still be corrected under the program provided that (i) the provision has been amended prior to December 31, 2012, and (ii) where the potential payment period straddles two tax years, the payment is made in the second tax year.

In addition to amending the severance payment provision to comply with Section 409A, to obtain relief under the document correction program, the employer must attach a statement to its timely-filed original federal income tax return for the year in which the correction is made. The statement must identify each employee affected by the document failure and the plan or agreement in which the failure occurred. The statement must also (i) confirm that the document failure is eligible for correction under Notice 2010-6; (ii) identify the section of the notice under which the failure was corrected; (iii) confirm that all actions required for correction have been met; and (iv) specify the amount involved.

What to Do Now

This alert discusses one area in which your company's employment or severance agreements can run afoul of the complex requirements of Section 409A. Herrick can help you review your deferred compensation agreements, employment agreements and severance agreements to identify and correct document failures as soon as possible. Through reduced penalties and taxes, the IRS document correction program is designed to encourage early and voluntary correction of non-compliant documents.

In general, Herrick can help you evaluate whether your benefit plans and other employee arrangements are achieving their goals and whether they meet all legal requirements. As both the IRS and the US Department of Labor are actively auditing plans and plan sponsors, Herrick can help you avoid the plan or operational failures that, when discovered on audit, produce taxes, penalties and other serious consequences. For more information on Herrick's Employment Practice, including our employee benefits and executive compensation experience, please click here. This *Compensation Alert* is one in a series of compensation, ERISA and employee benefits-related alerts. To read past alerts, please click here. For more information on this alert or other compensation or ERISA matters, please contact:

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[1] *See* Treasury Regulation §1.409A-1.