

## December 31, 2012 Deadline to Correct Certain Section 409A Payment Timing Errors

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December 31, 2012, is the deadline for correcting certain errors in the written provisions of nonqualified deferred compensation arrangements that provide payments that are contingent on the recipient's execution of a release of claims, or a restrictive covenant agreement or similar document. These errors can occur in any type of deferred compensation arrangement, including severance, nonqualified retirement programs, employment agreements, change-in-control payments, and deferred equity awards. Employers should identify and revise noncompliant agreements by the deadline to avoid potentially significant penalties to the employee or other service provider under section 409A of the Internal Revenue Code of 1986, as amended ("section 409A"), including accelerated inclusion for federal income tax purposes, a 20 percent federal excise tax (and potentially an equivalent state tax), and a federal interest penalty, unless submitted through a correction program that requires notice to the recipient.

### Background

In Notice 2010-6, the Internal Revenue Service (the "IRS") stated that nonqualified deferred compensation arrangements for which the payment date is contingent on and determined by an employment-related action by the service provider – including execution of a release of claims or noncompetition or nonsolicitation agreement – violate section 409A if it is possible for the recipient to manipulate the tax year of payment by timing the return of a release or other agreement. For example, an agreement subject to section 409A that provides that an employee will receive severance payments commencing within a specified period after returning an executed release of claims violates section 409A because the employee could affect the time when payments would commence during that designated payment period by "timing" his return of the release. If that specified payment period were to straddle two tax years, the employee theoretically could exercise control over the tax year in which the payments would be included in his gross income.

## Notice 2010-80 Transition Relief

Notice 2010-80 provides transition relief for correcting this type of document failure, but the arrangement must be revised to comply with section 409A by **December 31, 2012**. There are two IRS-approved methods of correcting such payment timing failures. First, the arrangement can be amended to provide that payment will be made on a fixed date (e.g., on the last day of the designated period for returning the release, or, if none, 60 or 90 days after the section 409A compliant triggering event). Alternatively, the arrangement can be amended to provide that if the payment period could extend over two tax years, the payment will be made in the second tax year regardless of when the service provider returns the documentation. Both correction options are intended to eliminate any opportunity for the employee or other service provider to improperly affect the timing of payment.

To qualify for this transition relief, the nonconforming agreement must be amended by December 31, 2012 to comply with one of the approved methods, and payments under a nonconforming agreement between March 31, 2011 and December 31, 2012 must be administered consistently with the selected method, or corrected as operational errors under Notice 2008-113. Generally, both the employer and employee would be required to disclose information about the correction on their respective federal income tax returns. However, for corrections completed under the transition relief by December 31, 2012, the IRS waives the requirements that the employer provide an information statement to the employee or other service provider, and that the employee attach information about the correction to his or her federal income tax return; only the employer will be required to disclose information about the correction with its federal income tax return.

## Action Required

All nonqualified deferred compensation arrangements that require a release of claims, a noncompetition or nonsolicitation agreement, or other action by the service provider as a condition to payment, should be reviewed for compliance with section 409A payment timing concepts, and any necessary amendment should be signed by December 31, 2012. This document error may affect even those arrangements that already were reviewed or amended for section 409A compliance prior to 2010, because the IRS had not clarified its position on this issue at that time.



We would be pleased to assist clients in reviewing and revising their deferred compensation arrangements. If you would like assistance or further information on this subject, please contact one of the authors listed.

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