

October 2, 2012

Code Section 409A Correction Deadline Approaching: Deferred Compensation Payments Contingent on Signing Waivers, Releases and Other Agreements

Overview

It is common for nonqualified deferred compensation arrangements such as employment or severance agreements to condition payment of the deferred compensation on an employee signing a waiver of claims, release, non-compete or non-solicitation agreement, or similar document. The IRS takes the position that making the deferred compensation payment contingent upon an action that is controlled by the employee – *the signing of another agreement* – could allow the employee to control the tax year in which the payment will be made by accelerating or delaying the date on which the employee signs the agreement. This violates the Code Section 409A prohibition on an employee being able to designate the tax year in which deferred compensation will be paid.

Example: Under an employment agreement, Employee A will be paid deferred compensation upon separation from service provided that Employee A signs and submits a waiver and release of claims and does not revoke the waiver and release during a stated revocation period. Based on the timing of when Employee A's separation from service occurred, Employee A could sign the waiver and release in 2012 or wait and sign the waiver and release in 2013. As a result, Employee A can control the tax year in which he will receive the deferred compensation.

Other deferred compensation arrangements that are commonly contingent on an employee having to sign side agreements include change in control agreements, equity or incentive compensation programs, separation agreements and supplemental executive retirement plans.

Under IRS transitional relief, employers have until December 31, 2012, to correct any nonqualified deferred compensation plan that includes an impermissible contingent payment provision. Deferred compensation arrangements not subject to Code Section 409A or that qualify for an exemption under Code Section 409A (e.g., qualifies as a short term deferral or separation pay plan) do not need to be corrected.

What Must Employers Do?

Under IRS guidance, employers have several alternative methods for correcting a nonqualified deferred compensation plan that contains a payment event that is contingent upon the employee's signing another agreement.

If The Payment Event Has Not Yet Occurred

If a payment event (e.g., separation from service) has not yet occurred, the plan will not violate Code Section 409A if it is amended before December 31, 2012, to remove the employee's ability to delay or accelerate the timing of the payment through his or her own action or inaction. The following amendments are permitted:

- If the plan currently provides for payment during a stated period after the payment event (if the employee signs the required agreement and it becomes effective), the amendment must provide either (a) that the payment will occur on the last day of the payment period, or (b) if the payment period spans two calendar years, the payment will be made in the second calendar year, even if the employee signs the required documents in the first calendar year.
- If the plan does not currently provide for a payment period (if the employee signs the required agreement and it becomes effective), the amendment must provide either (a) that the payment will be made on a fixed date either 60 or 90 days after the payment event occurs (if the employee signs the required documents), or (b) that payment will be made during a specified period not longer than 90 days following the payment event (if the employee signs the required documents) and that if the specified period begins in one calendar year and ends in the next calendar year, the payment will be made in the second calendar year, even if the employee signs the required documents in the first calendar year. A nonqualified deferred compensation plan that was previously amended to correct a provision that allowed the employee to delay or accelerate the timing of a payment as a result of the employee's action can only be corrected by amending the plan to comply with (b) above.

Corrective amendments may not make any other change to the time or form of payment.

Special Transition Rule - The Payment Event Has Already Occurred

For plans in existence on December 31, 2010, if the payment event (e.g., separation from service) has already occurred, then the plan will not violate Code Section 409A as to amounts paid after March 31, 2011 if:

- Any payments that could be paid during a period that begins in one calendar year and ends in a later calendar year, are made during the later calendar year (or if paid in the first calendar year, a correction that includes reporting to the IRS is made); and
- To the extent any amounts remain deferred under the plan after December 31, 2012, the plan must be amended to comply with Code Section 409A no later than December 31, 2012.

Affected deferred compensation paid on or before March 31, 2011 will be treated as not in violation of Code Section 409A.

Contact an attorney from the Butzel Long Employee Benefits Practice Group to discuss the steps necessary to help ensure that your nonqualified deferred compensation plans do not contain payment events impermissible because the timing of payment is contingent on the employee signing and submitting another agreement. Failure to fully self-correct this problem before the December 31, 2012 cut-off date results in a violation of Code Section 409A and immediate inclusion of the deferred compensation in an affected employee's gross income plus interest and penalties.

If you have any employee benefit questions, please contact your regular Butzel Long attorney, a member of the Butzel Long Employee Benefits Practice Group, or the authors of this Client Alert.

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