



Employment Contracts and Nonqualified Deferred Compensation Plans May Require Amendment By Year-End

July 18, 2012

In order to maintain compliance with Section 409A of the Internal Revenue Code, employers should review and correct, as needed, by December 31, 2012, any nonqualified deferred compensation plans and employment contracts in existence since on or before Dec. 31, 2010, to avoid possible income tax and penalties.

Section 409A of the Internal Revenue Code applies to employment, severance, nonqualified deferred compensation, and other arrangements that provide for post-termination severance or other compensation unless the agreement qualifies under an exception, such as a payment within 2 1/2 months after the year in which entitlement to payment occurs. Nonqualified deferred compensation and employment agreements may not qualify for an exception and therefore must comply with Section 409A.

Under federal employment laws, employees are often provided a minimum period, often up to 45 days, following termination of employment to consider a release before signing it, and a minimum period (generally seven days) following execution of a release to revoke it.

Certain nonqualified deferred compensation plans and employment agreements have provisions that condition payment upon an individual's signing a release of claims against the employer. Release provisions with waiting periods that in effect allow a person to pick a payment in the current or following year do not comply with Section 409A. Agreements with this problem, if any benefit is vested, that have been in existence since on or before Dec. 31, 2010, must be amended before the end of 2012 to avoid section 409A tax problems for employees and employers. Plans and agreements entered into after Dec. 31, 2010, if any benefit is vested, are not eligible for this transition relief and can be corrected only through the IRS's Section 409A document correction program, if eligible.

Problem

A severance agreement subject to Section 409A provides for a lump-sum severance payment within 15 days following its execution and nonrevocation of a release. The employee has 45 days after the date of termination to consider the release before signing it and seven days to revoke the release after signing it. If



the executive's employment were to terminate on Dec. 1, the executive could obtain payment in the current year or delay his severance payment to the following year by waiting to sign the release until January.

Solution

Notices 2010-6 and 2010-80 indicate that the cure to this problem will depend on the terms of the release provision. In general:

- Agreements providing for severance payments to be made within a specified period following termination of employment that are conditioned on an employee signing and not revoking a release should be amended to either:
 - Provide for payment on the last day of the period; or
 - Provide that if the period spans two taxable years, the payment will automatically be made in the later of the two years, regardless of the year in which the release is signed.
- Agreements providing for severance payments to be made following an employee's execution and nonrevocation of a release and that do not have a specified payment period should be amended to either:
 - Provide for payment either 60 days or 90 days following the date of termination;
 - Provide for payment during a specified period not exceeding 90 days following the termination date, except that if the period spans two taxable years, the payment will automatically be made in the later of the two years, regardless of when the release is signed.

For covered agreements existing on or before Dec. 31, 2010, with noncompliant release provisions, employers have been able to rely on a transition period under which no document or operational failure will be deemed to occur if either:

- Payments were complete by March 31, 2011; or
- For payments made after March 31, 2011, where the release provision consideration period spans two tax years, the payments are made in the later of the two years (or, if in the earlier of the two years, are treated as an "operational failure" and corrected under Section 409A's operational correction program).

Correction Agreement Or Plan After Dec. 31, 2012

If a "bad" release provision is not fixed before the end of this year, the agreement can thereafter be fixed only under the IRS's document correction program, if eligible. Corrections under the document correction program are subject to additional requirements, including a filing with the IRS, and may protect employees from only a portion of the tax penalties that would otherwise apply.

What Employers Should Do Now

Employers should as quickly as possible act to ensure any plans or agreements with release provisions comply with or are exempt from Section 409A as follows:



1. Identify all plans and agreements in effect on or before Dec. 31, 2010, that provide for payments contingent upon a person executing a release of claims or other similar agreement.
2. Determine whether any such plan or agreement is subject to Section 409A.
3. Amend the plans or agreements with impermissible release provisions to comply with the release timing rules by Dec. 31, 2012, for any such arrangement that has been in existence since Dec. 31, 2010, or before.

If you have questions about compliance with Section 409A, please contact your Lathrop Gage attorney or a member of the Employee Benefits department listed on this alert.