# Executive Compensation Alert:

## Relief Period for Section 409A Release Timing Errors Expires on December 31, 2012 Action Needed

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FENWICK & WEST LLP

Non-qualified deferred compensation arrangements that are not exempt from Section 409A of the Internal Revenue Code of 1986, as amended (the "**Code**"), should be reviewed to ensure compliance with Section 409A's rules governing the timing of release of claims.

Under guidance from the Internal Revenue Service (the "**IRS**"), if a company has in place a nonqualified deferred compensation plan that is not exempt from Section 409A, and the plan conditions receipt of benefits on execution of a release of claims, the agreement may need to be amended by December 31, 2012 to ensure compliance with Section 409A.

### Background

Conditioning payment of deferred compensation upon execution of an agreement (such as a release of claims) by an employee may allow the employee to manipulate the timing of receipt of the deferred compensation. The most common example is an employee who is given a period of time to consider whether to execute a release of claims (generally 21 to 45 days). This period of time (commonly referred to as "release timing") could span two calendar years if the termination occurs in December, thereby pushing the amount required to be included in income to the next calendar year. It is this potential for manipulation that the IRS sought to avoid in Notices 2010-6 and 2010-80.

### Examples of Arrangements with Release Timing Issues

The following agreements are, or may be, subject to Section 409A and also may condition receipt of benefits upon execution of a release of claims;

—nonqualified deferred compensation plan (where the employee defers salary or the employer guarantees a rate of return on deferred amounts);

—employment agreements with severance provisions that contain a definition of constructive termination or a "good reason" definition; and

—severance agreements, separation agreements and change in control bonus plans. The type of severance agreements that may be subject to Section 409A are those that contain a good reason definition, provide for periodic payments of severance paid over time and agreements that provide for separation pay in excess of Section 409A's prescribed limits (lesser of two times the employee's annual salary or $500,000 (for 2012)).

**Making the Release Requirement 409A Compliant**

An agreement that provides for the payment of deferred compensation will satisfy Section 409A's release requirements if structured in the following two ways:

(1) payment is made on a fixed date (60 or 90 days) following the event that gives rise to the payment; or

(2) payment is made during a specified period of time (not to exceed 90 days following the event giving rise to the payment), and if the specified period can span two calendar years, payment needs to be made in the second calendar year.

**Examples**

- An employment agreement, not otherwise exempt from Section 409A, provides for the payment of six months' base salary upon termination of employment. Severance is conditioned on the employee returning a release of claims. This release requirement is not compliant with Section 409A because there is neither a fixed date for payment nor a specified period of time following termination of employment for the payment to be made. Accordingly, if the employee undergoes a termination of employment in December, she may wait until the following year to return the release, thereby deferring the severance (and its taxation) to the next calendar year. The agreement can be amended to be compliant with the release timing provisions of Section 409A by providing that payment will be made within 60 days of a termination of employment, provided the release is effective on such date, and provided further that if the 60 day period spans two calendar years, payment will be made in the second calendar year.

- A separation agreement, not otherwise exempt from Section 409A, provides that severance will be paid on the 61st day after termination of employment, provided the release of claims is effective on the 60th day. Here, the employee cannot manipulate the timing of the receipt of his severance as the severance will be paid on the 61st day following the termination of employment, provided the release is effective on such date. If the release is not effective by the 60th day, no severance is payable. This arrangement complies with Section 409A because payment is made on a fixed date.

### Relief for Non-Compliant Release Requirements

IRS Notices 2010-6 and 2010-80 provide transitional relief for release requirements that are not compliant with Section 409A, but the type of relief varies depending on when the agreement was entered into or amended, as set forth in the table below:

| Type of Document | Time Frame for Correction | General Procedure for Correction |
|---|---|---|
| Agreements entered into on or before December 31, 2010 | Must be amended no later than December 31, 2012 with respect to amounts payable in 2013 or thereafter. | Employer must file a statement of correction to its tax return, but the employee does not need to file a statement of correction. |
| Agreements entered into after December 31, 2010, or amended after December 31, 2012 | No deadline, but must be amended prior to the event giving rise to the payment (such as an employee's termination date). | Employer and employee must both file a statement of correction with its and his/her respective tax return. |

### What to do Next

- Review agreements to determine if Section 409A applies and whether a release is required;
- Determine when the agreement was entered into; and
- Amend the agreement to comply with Section 409A's release requirements.

**For more information, you may contact any attorney in the Executive Compensation and Employee Benefits Group at Fenwick & West LLP.**

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