

Important Section 409A Relief Expires at Year-End

WHAT IS THE ISSUE?

The IRS is taking the position that any agreement (employment, severance, deferred compensation plan, etc) that provides for a severance payment that is conditioned on the execution of a release of claims violates Section 409A of the Internal Revenue Code if certain provisions are not included in the agreement.

According to the IRS, if the payment of severance is conditioned on the execution of a release of claims and the employee has leeway on the timing of the execution of the release, then the employee may be able to control the year he or she receives payment by timing the execution of the release.

The IRS views this level of control as a violation of Section 409A and may cause the affected employee to be subject to current income inclusion, a 20 percent penalty tax and additional premium interest taxes.

In light of its aggressive approach to this issue, the IRS issued Notice 2010-6 and Notice 2010-80 to provide correction guidance and transition relief for noncompliant agreements.

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WHAT DOES THE TRANSITION RELIEF PERMIT?

The transition relief permits employers to amend any noncompliant agreement in order to comply with the requirements of Section 409A, but only if the plans are amended no later than December 31, 2012.

Corrections made pursuant to the transition relief are not subject to certain reporting requirements that are normally applicable under Section 409A.

For example, neither the employer nor the employee is required to make a tax filing with respect to the correction. However, the employer must attach an information statement regarding the plan correction to its federal income tax return.

The transition relief applies to both agreements that were in effect as of December 31, 2010 and agreements that were not in effect on December 31, 2010 if such agreements are substantially similar to other agreements of the employer that were in effect on December 31, 2010.

WHAT SHOULD EMPLOYERS DO NOW?

Employers should review all of their employment and separation agreements which condition any payment upon the execution of a release of claims (or a non-compete agreement or non-solicitation agreement). Employers should amend these plans before December 31, 2012, using one of the available documentation correction methods provided in Notice 2010-6 and Notice 2010-80.

The appropriate correction method will depend on whether or not the existing release provision specifies a period for payment or not.

Even if an employer does not amend a noncompliant agreement prior to December 31, 2012, the employer should amend the agreement prior to an employee's actual separation of service in order to avoid possible tax penalties to the employee.

If the agreement is corrected prior to the separation from service the affected employee will be required to attach a statement regarding the plan correction to his or her federal income tax return.