

Employee Benefits Alert

Section 409A Compliance: Transition Relief Permitting Correction of Certain Document Failures Will Expire December 31, 2010

July 7, 2010

Earlier this year, the Internal Revenue Service (IRS) issued Notice 2010-06, which permits taxpayers to correct certain inadvertent failures to comply with the documentary requirements of Section 409A of the Internal Revenue Code of 1986, as amended.

One item highlighted by Notice 2010-06 concerns situations where payment schedules are determined based on the timing of an employee's execution and delivery of a noncompetition agreement or a release of claims. The execution of these types of agreements by employees is fairly common practice in severance-eligible situations whereby an employee, per the terms of an employment agreement or severance agreement, must sign a release and/or agree to be bound by restrictive covenants in order to receive payments of severance. Many existing employment and severance agreements provide that severance payments will commence on the date that the employee executes and delivers a release or noncompetition agreement (and, in some cases, following the end of a legally required revocation period), a common practice thought by many to be compliant with Section 409A prior to Notice 2010-06.

In Notice 2010-06, the IRS has taken the position that an arrangement that provides for payments to be made or commence on the date the employee signs and returns a release or noncompetition agreement may permit the employee to designate the taxable year in which payments are made and, thus, could result in a violation of Section 409A. Notice 2010-06 affords certain relief for correcting a nonqualified deferred compensation arrangement by removing the ability of the employee to manipulate payment timing and providing that the payment be made on a certain date following a permissible payment event. For example, under the Notice, a plan provision that provides that severance payments will commence on the first payroll date after the employee executes and submits a release of claims does not comply with Section 409A. However, this provision can be corrected by amending the plan to provide that severance payments will commence on the 90th day following the employee's separation from service, provided that the employee has executed and submitted a release of claims, and the statutory period during which the employee is entitled to revoke the release has expired on or before that 90th day.

In addition to the release issue described above, as we indicated in our January 8, 2010 employee benefits alert, "[IRS Issues Guidance for Correcting Document Failures Under Section 409A](#)," other document failures may be corrected pursuant to Notice 2010-06 including, but not limited to, the following—

- terms providing for a payment "as soon as practicable" or substantially similar language following a permissible payment event (e.g., "payment as soon as practicable following separation from service" should be amended to read "payment no later than 90 days following separation from service")
- permissible payment event with no definition or an ambiguous definition (e.g., "payment upon an employee's termination of employment" should be amended to read "payment upon an employee's separation from service within the meaning of Section 409A and the regulations thereunder")
- impermissible definitions of "separation from service," "change in control" or "disability"



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- certain impermissible alternative payment schedules (e.g., “payment in a lump sum upon involuntary separation from service and payment in 10 annual installments upon voluntary separation from service” should be amended to read “payment in a lump sum upon separation from service”)
- failure to include a six-month delay of payments to specified employees of public companies following their separation from service.

In many cases, the relief provided under the Notice is limited, and certain penalties will continue to apply if the corrected plan provision affects the operation of the plan within one year following the date of the correction. However, transition relief is available that permits correction of certain document failures without incurring penalties under Section 409A so long as the document failure is corrected by December 31, 2010. Note, however, that to the extent that payments have been made (or not made) in a manner that is inconsistent with the amended provision, such payments will be treated as operational failures and will need to be corrected by December 31, 2010, under IRS Notice 2008-113.

In order to stay current with the most recent pronouncements issued by the IRS and in light of the pending expiration of the transition relief available under the Notice, we recommend that our clients undertake a wholesale review of their nonqualified deferred compensation arrangements now. Taxpayers should be mindful that the IRS has commenced Section 409A audits and that taxpayers will not be eligible to take advantage of the relief available under Notice 2010-6 once an audit has commenced. Although the relief available under Notice 2010-6 may not be the only means of correction, it provides a degree of certainty and an opportunity for penalty relief in many instances that plan sponsors should not ignore.

CONTACT INFORMATION

If you have any questions regarding this alert or other executive compensation or employee benefits issues, please contact —

Bruce E. Simonetti
bsimonetti@akingump.com
212.872.8023
New York

Jessica Cherry
jcherry@akingump.com
212.872.7437
New York

Austin S. Lilling
alilling@akingump.com
212.872.1007
New York

Nyron J. Persaud
npersaud@akingump.com
212.872.8123
New York

Rolf Zaiss
rzaiss@akingump.com
212.872.1050
New York

Robin M. Schachter
rschachter@akingump.com
310.728.3363
Los Angeles

Michael Gerald
mgerald@akingump.com
310.728.3246
Los Angeles