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Any deferred compensation arrangement that requires an employee to complete some action as a condition to receiving payment (*e.g.*, execute a release of claims or a non-solicitation or non-competition agreement, return company property) should be reviewed and, if necessary, amended for compliance with Section 409A of the Internal Revenue Code to avoid potential adverse Section 409A tax consequences.¹ An amendment to such arrangement may be necessary even if it was previously amended for compliance with the final Section 409A regulations.² More favorable correction relief is available for arrangements that were entered into before 2011 if such arrangements are amended no later than December 31, 2012.

Background

The IRS has stated that linking the timing of payment of deferred compensation with the timing of an employee's action in providing an effective release of claims, non-competition or similar agreement could allow for an impermissible manipulation of the timing of such payment in violation of the Section 409A requirements.³ The types of arrangements that may be subject to Section 409A and may include provisions requiring a "release timing"⁴ Section 409A compliance amendment are:

- change in control bonus plans and agreements, including "carve-out" plans;
- equity agreements with severance benefit features (*e.g.*, vesting acceleration upon termination without cause); and
- employment and separation pay arrangements (plans and individual agreements providing severance benefits, including those payable upon or after a change in control)⁵

The types of severance benefit arrangements that would most likely be subject to Section 409A (either in whole or in part) are those that may pay severance benefits:

- due an employee's resignation other than for reasons limited to the "409A good reason safe harbor" definition;
- exceeding the "involuntary separation pay" exemption limit (lower of two times annual pay or the statutory limit (\$500,000 for 2012)); or
- in periodic installments with benefits also payable in the event of termination due to death or disability, so that benefits could be paid outside of the "short-term deferral" exemption period.

Section 409A compliant release timing provisions

A deferred compensation payment will comply with the Section 409A release timing requirements if it provides that, regardless of the date the release of claims is returned and becomes effective, payments will be made or commence as follows:

- on a fixed date either 60 or 90 days following the employment-related event that gave rise to the payment (*e.g.*, termination of employment), or
- during a specified period no longer than 90 days following the employment-related payment event, with payment made or commencing in the later taxable year if the specified period could span two taxable years.

Examples

Example 1: An executive employment agreement that is not exempt from Section 409A provides for a lump sum severance payment of 12 months' base salary. The severance payment is subject to the executive's delivery of an effective release of claims, with payment to be made on the first payroll date that occurs following delivery of an effective release. There is no specific deadline for return and effectiveness of the release. The agreement does not comply with the Section 409A release timing rules and should be amended to comply.

Example 2: Same facts as in Example 1, except that the agreement provides that the effective release must be provided within 60 days following the date of termination. Because under this agreement the executive could possibly manipulate the timing of the severance payment into another taxable year (*e.g.*, if the executive were to terminate service on December 1st of a taxable year and have 60 days within which to sign and return an effective release), the agreement does not comply with the Section 409A release timing rules and should be amended to comply.

Example 3: Same facts as in Example 1, except that the agreement provides that the effective release of claims must be provided within 60 days following the date of termination, and regardless of when the release becomes effective, the severance benefits will be paid on the 60th day following termination. The agreement does not need to be corrected because the executive cannot manipulate the timing of the severance payment by controlling the timing of provision of an effective release.

Transition relief for arrangements entered into by December 31, 2010⁶

IRS Notice 2010-80 includes special transition relief for deferred compensation arrangements in existence on or before December 30, 2010 that do not comply with the Section 409A release timing rules. Such arrangements may be amended for compliance under the transition relief no later than December 31, 2012 with respect to amounts payable after such date. In order to be eligible for this transition relief, the employer is required to file a statement of correction with its corporate tax return. However, the employee is not required to file a statement of correction with the employee's individual income tax return. No Section 409A taxes will apply in connection with such correction.

General relief for arrangements entered into after December 31, 2010 or amended after December 31, 2012

IRS Notices 2010-6 and 2010-80 also permit correction of arrangements that were not in effect as of December 31, 2010 (or were in effect by that date but are amended after December 31, 2012) and contain Section 409A release timing errors. Such correction may be completed either before or after December 31, 2012. However, for such correction to be effective, the employer is required to file a statement of correction with its corporate tax return AND the employee must also file a statement of correction with the employee's individual income tax return. Further, in order to avoid Section 409A taxes that would otherwise apply, such corrective amendment must be completed prior to the event giving rise to the payment (*e.g.*, termination of employment). Additionally, all arrangements between the company and any other employees that contain the same or similar Section 409A release timing errors must also be corrected.

Recommended next steps

In order to allow sufficient time to correct such errors before the transition relief expires, employers should take the following steps:

- Review and revise documents.
- Obtain any necessary consents from employees to document amendments.
- If necessary, have Board of Directors or Compensation Committee take action to adopt any necessary amendments.

Cooley's Compensation & Benefits Group is prepared to help you to identify arrangements that are subject to Section 409A, bring them into documentary compliance with its requirements, and make use of available Section 409A correction procedures. If you would like our assistance, please contact one of the attorneys listed above.

CIRCULAR 230 DISCLOSURE

The following disclosure is provided in accordance with the Internal Revenue Service's Circular 230 (21 CFR Part 10). Any tax advice contained in this Alert is intended to be preliminary, for discussion purposes only, and

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NOTES

1 Adverse tax consequences under Section 409A may include premature taxation, an additional 20% federal income tax (and possibly an additional state tax equivalent, as is the case in California), and an interest-charge tax.

2 On January 19, 2010, the Internal Revenue Service (IRS) issued Notice 2010-6, which prescribes the correction methods for an arrangement that requires an employee's execution of a release of claims or completion of any other employment-related action as a condition to receiving benefits where the timing of the employee's action could affect the timing of the payment. This particular issue is not specifically addressed in the final Section 409A regulations, so that some deferred compensation arrangements that were previously revised to comply with the final Section 409A regulations may contain such provisions.

3 It is quite common that employees are required to provide a release of claims as a condition of payment of severance benefits. Federal age discrimination laws require that employees who are age 40 or older must be provided with a minimum period following their receipt of the required release of claims to consider whether or not to sign the release and a minimum period after delivery during which the employee may revoke the release. Employees under age 40 are required to be provided with a "reasonable period" to consider whether or not to sign such a release. It is a common practice in severance arrangements to provide that benefit payments will not commence until such time as the release is effective and may not be revoked.

4 References in this Alert to "release timing" are intended to include the timing of completion of any employment-related action as a condition to receiving benefits, including the timing of entering into a non-solicitation, non-competition or similar agreement and the timing of return of company property.

5 Any arrangement that is exempt from Section 409A would not require a release timing Section 409A compliance amendment. For example, a severance benefit arrangement that pays a lump sum severance benefit within 60 days following an involuntary termination and does not pay such benefit due to death, disability, or the employee's resignation is exempt from Section 409A under the "short-term deferral" exemption and the "involuntary separation pay exemption" up to its maximum limit.

6 Pursuant to IRS Notice 2010-80, any amounts paid under such arrangements on or before March 31, 2011 are treated as not having failed to comply with Section 409A. Any amounts paid under such arrangements after March 31, 2011 but on or before December 31, 2012 are treated as not having failed to comply with Section 409A if either (1) the designated payment period is within one taxable year, or (2) the designated payment period spans two taxable years and payment is made in the second taxable year. Additionally, if payments are erroneously made in the first taxable year and the payment should have been made in the second taxable year, the early payment error is correctable under the Section 409A operational error correction procedures in IRS Notice 2008-113.

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Key Contacts

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| Tom Reicher San Francisco | treicher@cooley.com +1 415 693 2381 |
| David Walsh Reston | dwalsh@cooley.com +1 703 456 8021 |
| Thomas Welk San Diego | twelk@cooley.com +1 858 550 6016 |

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