



Transition Relief under Code Section 409A Will Expire on December 31, 2012 for Certain Deferred Compensation Arrangement Corrections

November 28, 2012

*This Alert is intended as a reminder that the limited transition relief available to correct certain deferred compensation arrangements that impermissibly link the timing of payments to an employee's performance of an action (such as the signing of a release of claims or a restrictive covenant agreement) is scheduled to expire on **December 31, 2012**. In the absence of corrective action, employees with impermissible arrangements could be subject to a 20% penalty tax plus interest under Section 409A of the Internal Revenue Code ("Section 409A"). Affected arrangements may include employment agreements, severance plans or deferred compensation plans that condition an employee's right to receive severance or other deferred compensation payments upon the employee's execution of a release of claims.*

The rules related to employee releases under Section 409A are very fact specific and, as such, many arrangements that condition an employee's right to receive payments upon the employee's execution of a release will be exempt from Section 409A or may already comply with Section 409A without the need for further action. Additionally, while certain transition relief rules will expire at year-end, many of the same corrective methods currently available with respect to noncompliant arrangements will remain available in 2013 and beyond (subject to limitations).

BACKGROUND

In general, Section 409A limits the ability of employers and employees to change the payment date (particularly with respect to the year of payment) for deferred compensation arrangements that are subject to Section 409A. In some cases, employee severance arrangements may be considered "deferred compensation" subject to Section 409A. If an employment agreement entitles an employee to receive a severance payment that is considered "deferred compensation" under Section 409A, and the agreement conditions the payment to be made only on or after the employee's execution of a release agreement, the arrangement may violate Section 409A if the employee can effectively control the calendar year during which payments will be made (or begin to be made) by choosing when to deliver the executed release to the employer.

CORRECTING NONCOMPLIANT RELEASE ARRANGEMENTS

In 2010, the IRS published a general documentary correction program under Section 409A for noncompliant arrangements, and that program was subsequently revised to provide additional means for correcting noncompliant employee release arrangements.¹ Under these rules, the general method for correcting noncompliant release arrangements under the IRS' Section 409A documentary correction program is to: (1) impose a contractual deadline for the employee's delivery of an executed release to the employer before the payment on which the delivery of the release is conditioned will be made and (2) require that the payment to be made if the release is delivered be paid on a fixed date or within a fixed calendar year, irrespective of when the release is delivered. For example, a corrected arrangement may provide for payment of severance upon the 60th day following an employee's termination of employment, provided that the employee has signed and not revoked a release prior to that date. As an alternative example, a corrected arrangement may provide for payment of severance within a 60 day period following the employee's termination of employment assuming that a release has been signed and not revoked within that period, provided that if the 60 day window period for payment will straddle two calendar years, then the payment must be made (if at all) in the second calendar year. Both of these corrections ensure that the departing employee cannot control the timing of the severance payment.

The transition relief scheduled to expire on December 31, 2012 will allow for any of the correction methods described above to be made to arrangements that were in effect as of December 31, 2010 without requiring the affected employee(s) to provide notice of the correction to the IRS (although the employer must provide notice of correction to the IRS with its tax return). Corrections to noncompliant release arrangements made under the IRS' correction program after 2012 will generally require IRS notification by both the affected employee(s) and the employer.

Other methods for correcting noncompliant employee release arrangements may also be available, both before and after December 31, 2012, which in some instances may not require notification to the IRS. However, those methods are beyond the scope of this Alert, being dependent on whether the facts and circumstances of the arrangements allow for one of the other methods to be used.

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¹ The general IRS documentary correction program under Section 409A can be found in IRS Notice 2010-6, which was partially amended by IRS Notice 2010-80, which is the basis for the transition relief described in this Alert. For general information regarding the IRS' documentary correction program, please see our client memo from February 1, 2010 describing IRS Notice 2010-6. This memo can be found at <http://www.simpsonthacher.com/content/Publications/pub943.pdf>.

If you have questions or need help in addressing these issues, please feel free to contact your Simpson Thacher relationship partner or any of the following members of the Executive Compensation and Employee Benefits Group:

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