# Termination Payments Conditioned on a Release of Claims: Don't Run Afoul of 409A

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By now, most employers have incorporated Internal Revenue Code Section 409A ("409A") into their tax compliance checklists. Deferred compensation - in all of its forms - is subject to 409A, unless a specific exception applies. One aspect of 409A compliance that continues to require attention involves payments conditioned on an employee's release of claims against the employer. The application of 409A in this context derives from the employee's ability to affect the year of payment by choosing when to execute a release of claims. The employee's potential control over timing is treated as a 409A violation by the Internal Revenue Service.

This alert describes a specific category of 409A failure and associated correction methods. It is beneficial, generally, to correct 409A errors as soon as they are discovered. In addition, because 409A liability is assessed on a tax-year basis, relief may be greater where errors are addressed by the end of a calendar year in which they are detected.

On a positive note, the release issue will not apply to the extent an agreement or plan qualifies for an exception from 409A, such as the short-term deferral rule or *certain* severance payments. The availability of a 409A exception should be evaluated closely.

*Typical Drafting Errors*. One of the two most common release-related drafting errors under 409A is to provide for payment to be made upon a separation from service, following an employee's execution and tender to the company of a release of claims. This type of provision does not state a deadline by which the release must be signed or by which the payment must be made. Another common drafting error is to provide for payment to be made within a fixed period of time following separation from service (e.g., 90 days), provided a release has been executed and has become irrevocable. The latter approach is closer to being compliant, in that a post-separation from service period of no more than 90 days is used. The possibility that the 90-day period could span two calendar years, however, could allow the employee to determine whether a payment is made in the earlier versus the later year. In particular, the employee could delay signing the release until January of the second year in order to ensure a one-year deferral of taxation on the payment. This is a 409A violation.

*IRS Guidance - Substance of Correction*. IRS Notice 2010-6 and Notice 2010-80 prescribe correction methods for a number of 409A errors. Problems relating to releases that must be signed in order to receive benefits on termination of employment are covered in these Notices. Looking first at the substance of the documentary corrections, the compliance method must eliminate the ability of the employee to affect the timing of payment by choosing when to complete and submit the release. Two types of solutions are offered by the IRS Notices.

One, where no post-termination payment date or period has been included in the agreement or plan, the document can be amended to provide that payment will be made on the 60th or 90th day following separation from service, provided the release has been signed and become irrevocable prior to the payment date. Alternatively, the document can be amended to allow for payment within a period of up to 90 days following termination, if the release has been signed and become irrevocable, *as long as* the document also states that an amount payable during a period spanning two calendar years will be made in the second calendar year.

Two, where a permissible post-employment payment period is included, but the ability to affect the year of payment has not been foreclosed, the document can be amended to provide either (i) for payment on the last day of the period; or (ii) for payment in the second calendar year if the payment period spans two calendar years.

*Immediate Steps for 2011-2012 Payment Period*. One item requiring immediate attention is actual payment under non-409A compliant agreements, where payment will be made during a period that spans 2011 and 2012. Such payments should be made in 2012. This operational step is an important aspect of corrective action on the release issue.

Amounts that are paid inadvertently during 2011 may be treated as an operational failure eligible for correction under Internal Revenue Service Notice 2008-113. One method of correction under Notice 2008-113 involves repayment to the employer of the 2011 distribution. In general, accomplishing this repayment *during 2011* will result in fewer employer and employee consequences under the correction method. Relief under 2008-113 also involves federal income tax return disclosure and correction of substantially similar document failures in other plans or agreements. The Notice should be reviewed carefully to ensure relief.

*IRS Notices - Transition Relief*. In addition to the steps for 2011 noted above, employers should evaluate other aspects of transition relief available during 2011 and 2012 for agreements and plans containing problematic release language.

*Six-Month Delay for Specified Employees*. Finally, employers should keep in mind that special rules relating to releases do not eliminate the need for compliance with the required six-month delay for deferred compensation paid to certain employees of public companies made upon a separation from service. The two sets of requirements must be coordinated in applicable documents, although exceptions from the six-month delay are sometimes available.

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*For more information about this topic, please contact the author or any member of the Williams Mullen Employee Benefits & Executive CompensationTeam.*

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