

RELEASE ME:

4TH QUARTER COMPLICATION FOR 409A PLANS

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BACKGROUND ABOUT 409A AND THIS ARTICLE

- ▶ IRC 409A is a small piece of the Internal Revenue Code, added in 2004, which now embraces many of the pay practices of American business. It was enacted to regulate “deferred compensation,” but hundreds of pages of regulation and notices have expanded its scope to cover a variety of severance agreements, option and appreciation rights, bonus arrangements, and performance plans that typically pay people in the future for services in a prior year.
- ▶ This article describes a relatively new 409A rule that applies to all covered plans and contracts which require employees and independent contractors (“service providers”) to sign releases or other employment-related commitments as a condition of payment.
- ▶ The new rule, described in this article, is as important as it is obscure. Unless IRS retreats, and there is no indication it will do that, many service providers will be subject to 409A penalties, which include a 20% excise tax, current taxation of all deferred vested amounts, and a penalty interest rate dating back to the first year the deferred amounts became vested.
- ▶ The new 409A rule requires plans to revise payment procedures now and a plan amendment codifying those procedures no later than December 31, 2012.

EXECUTIVE SUMMARY ABOUT A NEW 409A RULE.

- ▶ The new 409A rule applies after March 31, 2011. Failure to adopt its procedures immediately can result in very serious tax penalties. Fortunately for most 409A arrangements, the new rule does not have practical effect until the last quarter of 2011.
- ▶ The rule applies to all 409A plans and contracts which require signed releases or other employment-related commitments before making payments.
- ▶ The purpose of the rule is to take away a last-minute ability of service providers to select the year they receive 409A benefits. If a “payment window” between a payment event and the plan’s deadline for payment overlaps the end of a calendar year, payments generally

may not start until the year in which the payment window ends, regardless of the year in which the release or commitment is signed.

- ▶ An example is a plan which requires that payments start within a payment window of 90 days following a separation from service, and conditions payment on a service provider executing a release. If the 90-day payment window overlaps December 31, 2011, the payments cannot be made in 2011, and should instead be made in 2012, even if the release was signed and effective in 2011. This will be the rule going forward for future years.
- ▶ Although the new rule was effective on April 1, 2011, a practical concern does not arise for most 409A plans until the last quarter of 2011. That is because the permitted payment window is generally 90 days or less under 409A plans, meaning that it will not overlap two calendar years if a payment event occurred in the first three quarters of 2011. (There can be no violation of the new rule if a payment window does not overlap two calendar years.)
- ▶ Complicating things, some 409A plans permit payments to be made in the year of the payment event or the following 2 ½ months, an extended payment window. All new payment obligations since March 31, 2011 for which releases or signed commitments were required should be examined closely to see if the payment window extended into 2012.
- ▶ If someone goofs, and a payment that should have been pushed to 2012 is mistakenly paid in 2011, penalties will apply unless the payment can be reversed under complicated IRS correction rules. If directors or officers are involved, or if the correction does not occur in the year of the mistaken payment, a scaled down penalty and special tax filings may be necessary to avoid full 409A penalties.
- ▶ Important:
 - The plan's approach to the new IRS rule must be in place now as an administrative procedure.
 - An amendment must be signed no later than December 31, 2012 to codify the administrative procedure retroactively.
 - For the year of the amendment, the employer must file a notification with its tax return disclosing that the amendment was adopted in reliance on the IRS correction procedure.
- ▶ Notices 2010-6 and 2010-80 have the details of this new rule and the tax return filing requirements. Notice 2008-113 has correction procedures for those who err.
- ▶ What follows is more information about overly-complicated IRC 409A, and this newest rule. Do not be your own lawyer on this one, and please do not just rely on this article.

HUH? WHAT'S 409A?

So what's this all about? A quick primer is in order. IRC 409A is the deferred compensation statute which regulates many executive pay practices. It applies to voluntary arrangements which allow "service providers" (generally employees, but sometimes independent contractors) to select, in advance, the year in which they receive income.

But that's not all. By regulation, 409A also applies to many high-value severance arrangements, change in control agreements, post-retirement SERPs that are not IRS-qualified, and excess benefit plans for pensions that exceed certain limits. 409A even applies to options and stock appreciation rights which are discounted or payable in multi-year installments, or issued with respect to preferred stock, or which have payment features extending over more than one tax year. Even restricted stock purchased with non-recourse notes may be covered under 409A.

It's a rat's nest of plans and agreements that many would not have considered "deferred compensation", but they are all embraced within 600 pages of regulation and preamble explaining 409A, and more than 100 pages of follow-up procedures.

If an employer hasn't already analyzed every one of its pay practices, plans, employment agreements, stock and option contracts, and severance promises for 409A applicability, it is behind the curve and should do this immediately. But let's assume you have done your homework, and know which plans are 409A and which ones are not.

Today's assignment:

How many of your 409A plans require releases or other employment-related commitments which a service provider is required to sign before getting paid his or her money from a 409A plan?

This type of 409A plan is the subject of this article. It's a new subset that few businesses thought to identify, at least until 2010 when IRS released information about how to make 409A document "corrections," Notices 2010-6 and 2010-80.

THE NEW 409A RULES APPLY TO PAYMENTS WHICH ARE CONDITIONED ON THE EXECUTION OF A RELEASE OR OTHER EMPLOYMENT-RELATED COMMITMENT.

All of this derives from the key 409A rule that the timing of deferred payments should be selected in advance, generally prior to the first year when services are performed, to earn the deferred payments. Payments cannot then be accelerated or postponed unless a regulatory exception applies. Plans are allowed a window to make payment (usually up to 90 days) after a designated date or permitted event in 409A, such as separation from service, death, change in control, or disability. Service providers cannot be in "direct or indirect" control of the timing decision when a payment window overlaps two tax years.

IRS finalized the timing rule in its regulations in 2007, but did not specifically mention a fact pattern that was quite common. What if service providers were given the opportunity to select

the payment year by timing the date of their signatures on releases or other employment-related commitments? In Notice 2010-6, IRS officially stated that this typical arrangement – where a release or other employment-related agreement was required to be signed before payment – could lead to illegal manipulation of the payment dates. It then followed up with a second clarifying notice, Notice 2010-80, to make it a bit easier to “correct” this newly announced problem.

EXAMPLE: CEO Sally resigns in November, 2011 and is entitled to a deferred bonus under her contract, payable in 60 monthly installments. The contract requires that she release all claims. If she does, the first payment will start as soon as administratively possible after a seven-day rescission period expires, and in no event later than 90 days after her resignation and separation from service.

IRS CONCERN: Sally gets the forms to sign in November. If she executes right away, the payments could start in 2011. If she holds off a bit, she can juggle the first payment into the following tax year.

IRS FIX: Sally’s employer should adopt a procedure for 2011 and future years that payments will start in 2012, the year in which the 90-day period ends, regardless of the year in which the release is executed.

Further FIX: No later than December 31, 2012, her employer should amend the contract, codifying this procedure. For the year in which it signs the amendment, the employer must also attach a note to its corporate return in a format set out in the 2010 Notices. In a case like this, Sally will probably have to agree, but she obviously will prefer the amendment to paying the 409A penalties, which are assessed to service providers, not their employers. Sally will not have to attach a filing to her tax return, although that was the original IRS position.

If someone goofs: ...by paying Sally in 2011, correction may be possible, but there is a huge advantage to doing the “fix” in the same year as the mistaken payment. The IRS refers everyone to its Byzantine “correction” procedures in Notice 2008-113 for operational violations of 409A. Depending on the facts, these procedures may require payment of a sanction, a schedule to tax returns, and possibly amended returns. Other solutions are possible, but are not discussed within the Notices or this article, and require sophisticated guidance.

60 DAYS, 90 DAYS, OR WHAT?

The key step is to look at the timing rules presently in a 409A plan. Typically, they will require that payment be made within a window of 90 days (or less) following a payment event, such as separation from service.

If the plan's payment window overlaps December 31, the new procedures kick in. Although the consideration period for a typical release under the age discrimination laws is generally only 21 days (or 45 days if there has been a reduction in force), the 2010 Notices under 409A looks to the more expansive payment periods within the plan, provided they comply with 409A.

So let's assume the plan says to pay within 90 days after a separation from service, and the 90 days end on January 30 of the following year. Here is what the amendment (required by December 31, 2012) and the administrative procedure (required now) should say:

- ▶ Payment will not be made until January 30, even if the release is signed in 2011, or
- ▶ Payment will be made in calendar year 2012, even if the release is signed in 2011.¹

If the plan has no designated window, create one, for up to 90 days, and pay in the second year before that window closes.

And, if the plan has a 90-day payment window, and the payment event occurs in September, 2011, guess what? The payment should simply be made in 2011, because the payment window ends in 2011.

QUESTIONS AND NON-BINDING ANSWERS OF THE IRS

The IRS, unfortunately, does not issue private letter rulings or determination letters for 409A plans. However, the lawyers in government who wrote these rules are quite helpful when called. What follows are non-binding answers to questions I raised recently.

▶ **Can release provisions be removed?**

Yes. The IRS is concerned about service provider discretion. A removal of requirements that a release or commitment be signed as a condition of payment eliminates that discretion. However, it does deprive an employer of the protection which can only be provided through a currently executed release. So think hard before removing release provisions, because some departing service providers may have a beef, may be litigious, and may use that 409A money to pay lawyers. However, if you can live with that, removing the release provision blunts the complexity of the new 409A rule.

▶ **Does the rule apply if an employer has a right to require a release, but does not?**

No. The new rule only will apply if a service-provider is asked to sign a release. This is very helpful. Many deferred compensation plans provide for releases, but rarely require that service providers actually sign them – when good natured and loyal persons retire, for example.

¹ Although not stated, it makes sense that this payment must also occur before the date the window closes, i.e. sometime from January 1 to January 30, 2012 in this example.

A decision not to require a release is a decision of the employer, not the service-provider. Employer discretion is allowed under the 409A regulations to pay in one year or another when a payment window overlaps two calendar years, provided that: (1) the payment window is not longer than 90 days, and (2) the service provider is not, “directly or indirectly,” part of the decision-making process.

I like this practical answer. It eliminates the new rule requirement to shift a lot of money into a following year which a service provider planned to receive in a current year. It also allows plans to retain provisions which require execution of releases in the employer’s discretion, which is helpful in the case of contested departures.

► **Does the new rule apply to typical sign-offs required by TPAs and trustees of rabbi trusts?**

Unclear. The service provider technically can control the timing of payments by delaying signature on routine plan processing forms (possibly due to tax planning, but more likely due to vacation or simple procrastination).

The new rule refers to “employment related” releases and commitments, which we generally think of as the sort of agreement an employer obtains with respect to age discrimination and other employment-related claims. It will be interesting to see how TPAs and institutional trustees of rabbi trusts address this. These institutions, and sponsoring employers, often will not permit payments from 409A plans unless the employee gives updated tax information and confirms that the payment will discharge any further claims with respect to the plan.

Clearly, the service provider has an element of control. But is IRS really requiring that every deferred compensation arrangement requiring such sign off be under this new procedure? Is every such plan with a benign information / sign off provision required to defer the last quarter of payments until the final year? Our hunch is that the new rule will be limited to plans which require general releases, or new non-compete or non-solicitation-type agreements, which are clearly “employment related.”

However, conservative persons will take a different tack. Unless IRS clarifies or, better yet, repeals this new rule, plans which require signatures before payments should adopt the IRS model procedure, which shifts payments to the year in which a payment window concludes regardless of the year in which the employee signs the administrative forms.

► **Can payment windows be shortened?**

Yes. If there is a 90-day payment window, and if an employer believes it can administer a 30- or 45-day window, shortening it is a practical way to limit the effect of the new rule. This is OK, and is another way to diminish the effect of the new rule requirement. A shorter window lessens the possibility of overlap between two calendar years, and overlap of windows is what triggers the new rule.

This would not violate the 409A rule that payment events generally cannot be accelerated. A shortening of a payment window does not accelerate a payment event, but simply shortens the time in which the employer has discretion to make the payment.

CONCLUSION

Review all plans and contracts for 409A applicability. Determine if they require a service provider to sign a release or other “employment-related” commitment before payment. For 409A plans which require such signatures, get to work immediately if you expect any new payment events in this quarter. Your procedure under the new 409A rule should be in place now.

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