Is the Release of Claims Language in Your Agreement Compliant with Internal Revenue Code Section 409A?

Take Time to Check Now, Before December 31, 2012

November 20, 2012

In IRS Notice 2010-80, the IRS modified its correction programs described in Notice 2008-113 (operation failures under Code Section 409A) and Notice 2010-6 (documentary failures under Code Section 409A) to provide limited transitional relief to correct agreements that contain non-compliant language relating to payments dependent upon an employee completing certain employment-related actions (e.g. execution and submission of a non-competition agreement, non-solicitation agreement, or a release of claims). This transitional relief ends on December 31, 2012, so it is important to review existing agreements to make sure that language conditioning payment on completing certain employment-related actions—in particular, executing a release of claims—complies with, or is exempted from, the updated Code Section 409A guidance from the IRS.

Prior to the issuance of IRS Notice 2010-6, many practitioners believed that Section 409A permitted designating a specified period (e.g. 90 days) to complete the required employment-related action (e.g. execution of a release of claims, non-competition agreement, etc.) and pay the deferred compensation, typically severance payments. The final regulations under Code Section 409A appeared to support language requiring the execution of a release, etc. prior to receiving payment so long as the period did not exceed 90 days from the date of the payment event (e.g. termination of employment) and the employee taxpayer did not have a right to designate the tax year in which the payment would be received ("90-day rule").

In IRS Notice 2010-6, the IRS provided the following language in one of its examples:

"...[E]mployment agreement provides that the amount is payable within 90 days of [Employee's] separation from service, but not until [Employee] executes and submits a release of claims and any period during which [Employee] may revoke the release pursuant to applicable law has expired before the end of the 90-day period. If [Employee] fails to execute the release the amount is forfeited."

In IRS Notice 2010-6, the IRS clarified that the language in the example above would violate the "no discretion" requirement under the 90-day rule. The IRS reasoned that if the period that an individual could use to execute the release, etc. potentially spanned two tax years, the individual has the ability to either accelerate the payment in the current tax year by quickly executing the release, etc. or, alternatively, delay the payment into the subsequent tax year by delaying the execution of the release, noncompetition agreement, etc. Instead of permitting the parties to provide for a specified period to complete the employment-related actions, IRS Notice 2010-6 requires that a payment contingent on such employment-related action must be paid on a specified date (e.g. 90th day following termination of employment, etc.). The appropriate correction to provide for a specified date under Notice 2010-6 depends on whether the existing agreement contains a specified period or not.

Responding to feedback that the correction methods in Notice 2010-6 were too inflexible, the IRS, in Notice 2010-80, provided additional correction methods that permit agreements to use a specified period (e.g. within 90 days of termination of employment) but must include a proviso that, in a situation where the period could span two tax years, payment will always be made in the subsequent tax year.

Notice 2010-80 also provides certain transitional relief from the penalties and reporting requirements under Code Section 409A if the non-compliant language in existing agreements is corrected by December 31, 2012. Even if this transitional relief is utilized prior to December 31, 2012, there are still employer reporting requirements, although these reporting requirements are more limited than they would be without the transition relief. Additionally, if an agreement includes language that does not comply with the requirements under the IRS Notices and the payment is made after March 31, 2011 (if all payments under an agreement are completed prior to March 31, 2011, such agreement is exempt from the new release, etc. timing requirements under the IRS Notices) but before December 31, 2012, documentary failures will be exempted so long as any
payments that could have been paid during a period that begins in one tax year and ends in the subsequent tax year were made in the subsequent tax year. If the payments were made in the earlier tax year, it would be treated as a Code Section 409A operational failure and would need to be corrected under IRS Notice 2008-113.

As summarized above, there are several different fixes that the IRS Notices provide for, and different agreements may require different approaches. If you believe you might have employment agreements, severance agreements, change in control agreements, etc. that contain language regarding payments contingent on employment-related actions (e.g., execution of release of claims) that might be non-compliant with guidance provided in the IRS Notices, please contact Margaret Hunter at 313-568-6788, Gabriel Marinaro at 313-568-6874, James Obermanns at 248-203-0758, Mark Weisbard at 312-627-2161, or your regular Dykema contact.

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