

LEGAL UPDATE

May 2015 By: *Edward J. Rayner and Matthew O. Young*

RELEASES AND SECTION 409A – A TRAP FOR THE UNWARY

Many companies require departing employees to execute a general release of claims as a pre-condition to receiving severance. In order to satisfy certain legal requirements, these releases often incorporate a consideration period (typically 21 days or 45 days) and a revocation period (typically 7 days). Usually releases or separation agreements will provide that the employee will receive the severance or commence receiving the severance on the 8th day after the employee executes the release (because of a 7 day revocation period). In this situation, by choosing to waive some or all of the consideration period an employee may be able to control the tax year in which a severance payment is made. For example, an employee is terminated on December 15th and can execute the release anytime through January 6th of the subsequent tax year. If he executes the release prior to December 23rd, then if his release provides for payment on the 8th day after execution he would receive the severance payment in the tax year in which he was terminated, but if he executes the release after December 23rd then he would receive the severance in the following tax year. The Internal Revenue Service (the “IRS”) views arrangements of this type as violating Section 409A of the Internal Revenue Code (“[Section 409A](#)”).

SECTION 409A

Section 409A is a provision of the tax law imposing significant penalties on employees¹ who participate in a “nonqualified deferred compensation plan” that fail to comply with its requirements.

The regulations issued under Section 409A define

¹ Section 409A covers not just employees, but generally anyone providing services, so it would also typically apply to consultants, independent contractors and others. For the sake of simplicity, in this legal update we only use the term “employee”, but by using that term also mean to include consultants, independent contractors and others providing services.

“nonqualified deferred compensation plans” far more broadly than would be expected. As defined “nonqualified deferred compensation plan” can include severance arrangements, bonus plans, membership dues reimbursements, business expense reimbursements, tax gross-ups and many other arrangements that would not commonly be considered to be a “nonqualified deferred compensation plan.”

The consequences of participating in a “nonqualified deferred compensation plan” that does not satisfy Section 409A can be extremely severe. The employee would be taxed immediately upon vesting of the “nonqualified deferred compensation plan”, even if he has not yet received the money and will not receive the money for a number of years. In addition, the employee is assessed an additional 20% penalty tax plus interest and any other similar nonqualified deferred compensation plan the employee participated in is also deemed to fail the requirements of Section 409A (whether or not it does) and also incurs the 20% penalty tax, immediate taxation and interest. Some states (such as California) impose their own additional penalties on a “nonqualified deferred compensation plan” failing to satisfy the requirements of Section 409A or a state law version of Section 409A.

THE TRAP

In the example described above, the IRS has taken the position that the ability of the employee to control the year of taxation by choosing the date on which he will sign and submit the release causes the severance arrangement to fail to satisfy Section 409A, which would result in the severance payments being subject to the 20% tax, immediate taxation and interest charges, as well as, causing any other similar “nonqualified deferred compensation plan” the employee participated in to also be deemed to fail Section 409A.

The IRS has discussed this issue publicly at conferences and seminars. It also has published IRS Notices 2010-6 and 2010-80, which provide guidance on how to fix releases which do not comply with Section 409A, including this issue.

APPROACHES TO CONSIDER

Practitioners have adopted two common approaches to address this issue when drafting releases:

- The first approach is simply to provide in the release that the company will pay (or begin paying) the severance a set period of time following the termination date (typically 30 or 60 days), provided that the release has become final and non-revocable by the employee by such date. By providing a fixed date for payment, the release satisfies the rules under Section 409A because the employee can no longer control the year of payment by choosing on what date to execute and return the release.
- The second approach is for the release to provide that the company will pay (or begin paying) severance following the date the release has become final and non-revocable, but that in the event the period the employee has to review and revoke the release spans two calendar years, the company will pay (or begin paying) the severance as soon as practicable, but in no event earlier than the first day of the second calendar year. This approach permits the Company to pay severance earlier than would arise with the set payment date, but still satisfies Section 409A because it removes the employee's ability to determine the year in which he or she receives her severance.

OTHER 409A SEVERANCE CONCERNS

It should be noted that a severance arrangement can fail to satisfy Section 409A for reasons other than the release problem discussed above. It is vital that any severance or other arrangement which could conceivably constitute a "nonqualified deferred compensation plan" be reviewed by qualified tax counsel.

If you need to have an arrangement that may constitute a "nonqualified deferred compensation plan" reviewed by qualified tax counsel, please do not hesitate to contact either Edward J. Rayner (erayner@pryorcashman.com or 212-326-0110) or Matthew O. Young (myoung@pryorcashman.com or 212-326-0179).

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Edward Rayner chairs Pryor Cashman's Executive Compensation, ERISA & Employee Benefits Group. His practice encompasses all aspects of executive compensation, employment and severance arrangements, pension plan investments and employee benefits.

Ed has extensive experience negotiating, designing and implementing employment agreements and severance agreements for CEOs, boards of directors and senior executives of public and private corporations, both domestic and foreign. He has represented a large number of clients in leveraged and management buyouts, including many of the most prominent buyout firms, as well as management teams and individual senior executives.

Ed is well versed in the issues arising from using stock in privately held companies in connection with compensation arrangements. In addition, he regularly represents bankers, asset managers, hedge fund managers and other financial professionals in connection with employment, severance, partnership and compensation arrangements.



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Matthew Young is a member of Pryor Cashman's Executive Compensation, ERISA & Employee Benefits, Labor & Employment, Corporate and Tax Groups. Matt advises on transactional matters with a focus on employee benefits and compensation issues in the context of acquisitions, dispositions, securities offerings and financing arrangements. He represents a variety of executives and companies in the entertainment, fashion, health care, financial services and other industries.

A significant part of Matt's practice involves the negotiation, review and preparation of employment, consulting and severance arrangements. He advises clients on the structure, implementation and administration of qualified and nonqualified employee pension, welfare and compensation plans, programs and arrangements. Matt also provides clients with general ERISA advice, including fiduciary obligations, and assists plan sponsors with compliance issues such as plan corrections under Employee Plans Compliance Resolution System (EPCRS) and Internal Revenue Service (IRS) plan determination letter requests.

Applying years of experience in ERISA, compensation and benefits matters, Matt navigates the myriad requirements of ERISA, the Internal Revenue Code (including Section 409A), the Consolidated Omnibus Budget Reconciliation Act (COBRA) and the Family and Medical Leave Act (FMLA).