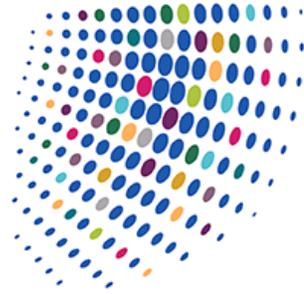


Alerts & Publications

Section 409A Transition Relief Expires December 31, 2012

September 12, 2012



Internal Revenue Code Section 409A — which governs the tax treatment of deferred compensation — imposes detailed requirements on a broad range of compensation arrangements. The penalties for failure to comply can be harsh. Employers may be surprised to find that Section 409A imposes requirements on severance and other compensation arrangements that require an employee to execute a release of claims as a condition to receiving payment. These arrangements may need to be amended by December 31, 2012 in order to comply with Section 409A.

The IRS view is that conditioning compensation upon execution of a release may run afoul of Section 409A if the employee is able to control the year in which the payment is made (and thus subject to tax) by how quickly (or how slowly) the employee signs and returns the release. Employers may be required to amend these arrangements so that, once the employee's date of termination is known, the year of payment will be fixed and cannot be manipulated by the employee's timing in delivering the release.

(For simplicity, we refer throughout this Client Alert to payments that are conditioned on the employee's providing a release, but the same analysis would apply to payments conditioned on an employee's providing a non-competition agreement or other restrictive covenant arrangement. Similarly, this Client Alert principally focuses on severance arrangements, but corrective action may also be necessary for other compensation arrangements (such as bonuses), the payment of which is conditioned on the employee's providing a release or entering into a restrictive covenant arrangement.)

Background

Section 409A imposes requirements on a broad range of nonqualified deferred compensation plans and arrangements, including some severance arrangements. IRS regulations issued in 2007 required employers to amend the documents governing these arrangements by December 31, 2008 to comply with the payment requirements under Section 409A (or, alternatively, to structure the arrangement to be exempt from Section 409A). However, the IRS issued additional guidance in 2010 taking the position that severance and other arrangements that are subject to Section 409A may not be in compliance if an employee's right to receive the payment is conditioned on the employee's providing a release to the employer and the arrangement provides too much leeway as to the timing of the payment.

Not all severance pay plans and arrangements are subject to Section 409A. However, our experience suggests that executive severance pay arrangements are frequently subject to Section 409A. Whether a particular severance pay arrangement is subject to Section 409A depends on the amount and timing of the payments and how the payment triggers are defined.

Failure to comply with Section 409A may result in severe tax penalties for the employee, including accelerated inclusion of the payment in income and a 20 percent penalty tax under federal law. Interest penalties may also apply, and for employees in California, an additional 20 percent penalty tax is imposed under state law. Thus, it is important for employers to review their arrangements that may be subject to Section 409A and make any necessary amendments by December 31, 2012 as required under the IRS guidance.

Corrective Measures

In general, an arrangement that is subject to Section 409A and requires that the employee deliver a release to receive the payment may be corrected under the IRS guidance if the arrangement was in effect as of December 31, 2010 (including, for these purposes, a plan in effect on December 31, 2010 in which a particular employee commences participation after that date in accordance with the plan terms in effect on that date).

If an arrangement is required to be amended, the amendment would specify the year in which the severance payment will be made, regardless of when the employee provides the release. If the arrangement provides a specified period for the payment (for example, within 60 days after the termination of employment), the amendment could provide for the payment to be made on the last day of the specified period. Alternatively, the amendment could provide that if the specified period spans two calendar years, the payment will be made in the second of the two years.

If the arrangement does not provide a specified period for the payment, the amendment could either provide that the payment will be made on a fixed date (for example, the 60th day after termination) or that the payment will be made during a specified period (and, if the period spans two calendar years, that the payment will be made in the second of the two years).

Other Considerations

In many cases, amending an arrangement as described above will require the consent of the affected employee and approval by the employer's board of directors or a board committee. Employers should allow time for the arrangements that may be eligible for correction under the IRS guidance to be reviewed, any required amendments to be drafted, and any required approvals and consents to be obtained in advance of the December 31, 2012 deadline.

An employer that amends an arrangement in reliance on the IRS guidance described above is also required to attach a short information statement regarding the correction to its federal income tax return for the year in which the amendment was made. Unlike other Section 409A corrective procedures, the employer in this case generally would not be required to provide an information statement to the employee and the employee would not be required to attach a statement regarding the correction to his or her tax return.

IRS Circular 230 Disclosure

To ensure compliance with requirements imposed by the IRS, we inform you that any tax advice



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