Dangers of Release of Claims Provision in Deferred Compensation Plans

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It is usual practice for attorneys drafting deferred compensation agreements to require an employee to sign a release of claims agreement before they may receive their deferred compensation. These releases protect the employer from the employee using the money to fund a lawsuit against the employer and generally settle all matters as between the parties going forward. While a release of claims makes perfect sense, they have been identified by the IRS as a potential way for employees to control their payout and allow deferral of payment beyond the dates in the agreement, or to accelerate payment by signing off on the agreement.

Section 409A may apply to a variety of agreements including employment agreements, severance agreements, and many long-term incentive plans including nonqualified stock options, restricted stock units, stock appreciation rights, and phantom stock plans. It is common for an employer to include either a release of claims, non-compete agreement or non-solicit agreement as part of the consideration of earning such compensation. If the arrangement includes a release of claims it is important to be wary of the potential violation of Section 409A and the penalties that would result.

WHAT IS SECTION 409A?

Congress enacted Section 409A of the Internal Revenue Code in 2004 shortly after the Enron scandal in an effort to regulate executive pay practices.

There are essentially three steps to analyzing any deferred compensation plan under Section 409A.

Step One: Does Section 409A apply?

In order for Section 409A to apply, the arrangement must be considered "deferred compensation" as defined under Section 409A. Section 409A broadly defines deferred compensation as any nonqualified plan or arrangement which provides a service provider (typically an employee) a legally binding right to compensation in one taxable year, but which the service provider does not receive until a subsequent year. In other words, once the employee has earned the compensation it must be paid to the employee in the same year (with limited exceptions) or it will be subject to Section 409A. It should be noted that while an amount may be subject to a substantial risk of forfeiture, this does not preclude the application of Section 409A.

Section 409A has a limited set of exceptions. The biggest of these exemptions is the "short term deferral rule." This rule states that if the compensation is paid within 2 ½ months after the later of the employer's or service provider's taxable year end in which the amount vested then the nonqualified plan is exempt from the requirements of Section 409A. Typically this means if the arrangement requires payment by March 15th of the year following the year of vesting then the arrangement is exempt from the requirements of Section 409A.

Step Two: Does the plan violate Section 409A?

If the arrangement is a deferred compensation plan under the first step and does not meet any of the exemptions, then the next step is to determine whether the payments meet the timing and manner requirements of Section 409A. Section 409A provides for six permissible payment events: (1) separation from service; (2) death; (3) disability; (4) change of control; (5) an unforeseen emergency; or (6) a date or fixed schedule determined prior to the deferral. The plan will violate Section 409A if it allows for payment at a time other than the occurrence of one of the permissible events.

Step Three: What are the penalties?

A nonqualified plan which violates Section 409A imposes an excise tax on the *employee* equal to 20% of the payment. Additionally, the payment will be taxed at the time the payment vests, instead of receipt. As such, if the payment vested in a year prior to the year of violation, then the payment will also be subject to a premium interest rate tax equal to the underpayment rate plus 1%. It is vital to note that these payments are assessed on the service provider (employee). As you can imagine, these penalties can add up rather quickly and can be a heavy burden for the employee to absorb.

THE RELEASE OF CLAIMS PROBLEM

As previously mentioned, the penalties for a Section 409A violation can be quite severe. It is important to be cognizant of potential issues and able to spot them in your client's documents. Many attorneys may advise their clients as standard protocol to include a release of claims in employment agreements, severance agreements and other deferred compensation arrangements which may be subject to Section 409A. Those who are not experienced in deferred compensation may not be aware of the serious implications of including a release of claims.

In 2010, the IRS announced that a deferred compensation arrangement which requires the employee to sign a release of claims (or non-compete or non-solicitation agreement) prior to a separation of service or change in control, may violate Section 409A. The Service's rationale is that the period of time given to an employee to sign the release allows some control over when the payments will be made, which could result in the employee choosing the year he or she will receive the compensation and ultimately determining the year the employee is taxed on such income.

PRACTICE TIPS

If you are drafting any sort of deferred compensation plan, the odds are you have someone specialized in the area assuring compliance with Section 409A. However, if you are reviewing the document as part of salary negotiations, due diligence on a deal or otherwise, there are a few things you will want to verify.

In addition to the problem areas mentioned, you should confirm whether the agreement or

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plan conditions the payment on the execution of a release of claims, non-compete agreement, or non-solicitation agreement. If such a condition exists, the next step is to determine if the employee has the ability to delay or accelerate the timing of payment as a result of executing such document. If so, this may cause a violation of Section 409A.

HOW DO I FIX IT?

Pursuant to Notice 2010-6, the IRS allowed employers until December 31, 2012 to amend their plans to remove the employee's ability to delay or accelerate the payment timing. If the plan includes a provision designating the time of payment within a certain period after a permissible payment event, then the plan must be amended to state that payment may only be made on the last day of the designated period. If the plan does not include a designated period for payment following the permissible payment event, then the plan should be amended to only allow for payment at a fixed date of either 60 or 90 days following the permissible event. Going forward, any new deferred compensation plans or arrangements which may include a release of claims requirement should be drafted to include these fixed-date payments.

Although the relief period expired on December 31, 2012, some speculate that the IRS will extend this timeframe. As of press time, the IRS has not extended the relief period. If you think a client may have an issue with a release of claims provision in a deferred compensation arrangement, you should seek review from a deferred compensation specialist.

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