Severance Arrangements Under Internal Revenue Code Section 409A

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Late last month, the Internal Revenue Service ("IRS") provided some relief to employers attempting to comply with the new rules under section 409A of the Internal Revenue Code (the "Code") applicable to nonqualified deferred compensation arrangements. Under Notice 2007-86, employers now have until December 31, 2008, to amend documents to comply with Code section 409A. If arrangements subject to Code section 409A are not documented, employers have until December 31, 2008, to put those arrangements in writing.

Although the relief provided under Notice 2007-86 is welcome, the relief is limited primarily to documentation. Operationally, employers must currently comply with Code section 409A. Therefore, news of this Code section 409A relief should not lull employers into a false sense of security. It is critical that employers continue to identify plans subject to Code section 409A and take steps to bring those plans into compliance. Despite the recent IRS notice, we are advising clients to continue updating documents for two reasons. First, updating documents will help demonstrate operational compliance with Code section 409A. Second, updating a document now will not prevent an employer from updating the document again in the future if the IRS provides attractive compliance alternatives.

Employers must be aware that Code section 409A applies to many arrangements not traditionally considered "deferred compensation." This article reviews Code section 409A issues as they arise in severance arrangements.

Background. Code section 409A generally limits (1) the situations in which an employer may distribute deferred compensation, (2) the circumstances under which the payment of deferred compensation may be accelerated, **and** (3) the time and manner in which an employee may elect (a) to defer compensation, or (b) the time and/or form of payment. If a nonqualified deferred compensation arrangement fails to satisfy Code section 409A's requirements, the covered employee will be subject to income tax, a 20% penalty tax, and possible interest charges on amounts subject to Code section 409A.

The scope of Code section 409A is broad. Essentially, any arrangement that defers payment of compensation can be subject to Code section 409A. As a result, except for certain exceptions discussed below, severance pay arrangements will be subject to Code section 409A's requirements.

Identifying Severance Pay Arrangements. The first step an employer must take to bring severance pay arrangements into compliance with Code section 409A is to identify its severance pay plans. Severance arrangements can take a variety of forms. The following are a few examples of arrangements that may raise issues under Code section 409A:

- Salary continuation provisions in an employment contract that apply if, before the end of the contract's term, the employer terminates the employee's employment without cause, the executive terminates employment for "good reason" or following a change in control, or the employee's employment terminates under other specified circumstances (*e.g.*, disability, death, etc.);
- Severance policies or programs that cover all employees or particular groups of employees (*e.g.,* executives, managers, hourly, etc.);
- Severance pay negotiated in conjunction with an employee's termination of employment; and,
- Severance pay offered in conjunction with a change in control and/or pursuant to a window program.

Determine a Compliance Strategy. Once the employer identifies its severance pay arrangements, the employer must determine the compliance strategy it will follow for each arrangement. In general, the employer can structure the arrangement either to comply with Code section 409A as a deferred compensation plan or to fall outside the scope of Code section 409A under the short-term deferral and/or separation pay exceptions, described below.

For a variety of reasons, it is generally preferable to structure a severance arrangement so it falls outside the scope of Code section 409A to the extent possible. First, an employer has much greater flexibility in administering a program that is outside the scope of Code section 409A. For example, Code section 409A generally prohibits an employer from accelerating deferred compensation payments. In some contexts, however, it might be in the employer's best interest to provide a lump sum payment to the employee instead of severance payments over a stated period. If the arrangement is outside the scope of Code section 409A, modifying the arrangement to accelerate payments is permitted. Second, with respect to specified key employees of publicly traded corporations, Code section 409A prohibits payment of deferred compensation due upon termination of employment before the date that is six months after the employee's termination date. Severance payments that fall outside the scope of Code section 409A are not subject to this six-month delay rule. Third, the timing of payments under a plan subject to Code section 409A generally cannot be subject to the discretion of the employer or the employee. In many severance arrangements, however, severance payments will not commence until the employee executes and returns a release of claims against the employer. Effectively, this gives the employee control over payment commencement that could violate Code section 409A. Finally, if an arrangement is outside the scope of Code section 409A, the risk of an inadvertent violation of Code section 409A in operation is greatly diminished.

Exceptions. In many cases, an employer can structure a severance pay arrangement so it falls outside the scope of Code section 409A.

A. Short-Term Deferrals. Code section 409A does not apply to certain payments that are subject to a substantial risk of forfeiture ("SRF") if the payments are completed within a short time after the employee's right to those payments is no longer subject to an SRF. In general, an employee's right to payments is subject to an SRF if the payments are conditioned upon the employee's future performance of substantial services. For example, an arrangement could fall within the short-term deferral exception if payments are conditioned upon the employee's completion of three years of employment and the amount due will be paid in a lump sum immediately upon his/her completion of that service.

In the severance context, it is important to note that an arrangement could fall within the short-term deferral exception if payments are conditioned upon the involuntary termination of the employee's employment without cause (assuming such a termination is not otherwise imminent). In revising a severance pay arrangement, however, the short-term deferral exception is not always available. In general, if payments under a severance arrangement are not subject to an SRF currently, an employer cannot add a risk of forfeiture to bring the arrangement within this exception.

B. Separation Pay Plans. Code section 409A does not apply to separation pay to the extent the separation pay falls within one of the following exceptions.

1. Separation Pay Upon Involuntary Separation or Under a Window Program. Code section 409A does not apply to payments following an employee's involuntary separation from service or pursuant to a window program provided the following requirements are satisfied:

(a) Total payments to the employee do not exceed the lesser of (i) $450,000; or, (ii) two times the employee's annualized compensation based upon his/her rate of pay for the calendar year preceding the year in which his/her separation from service occurs; and,

(b) The arrangement provides that all payments will be completed by the end of the second calendar year following the calendar year in which the employee's separation from service occurs.

The IRS will adjust the $450,000 limit periodically to reflect increases in the cost of living. An "involuntary separation from service" generally refers to the employer's termination of the employee's employment without the employee's consent (express or implied) while the employee is willing and able to work. An involuntary separation from service can include a voluntary separation for "good reason," provided certain requirements (including documentation requirements) are satisfied. A "window program" generally refers to a program established in conjunction with an impending separation from service, for employees who separate within a fixed period (not to exceed 12 months).

2. Collectively Bargained Separation Pay Plans. Code section 409A does not apply to payments made pursuant to a collectively bargained separation pay plan provided the plan provides separation pay only upon an involuntary separation from service or pursuant to a window program. This exception only applies to the extent the separation pay arrangement is contained in a collective bargaining agreement and has been the subject of arm's length, good faith negotiation.

3. Medical Reimbursements During the COBRA Period. Code section 409A does not apply to an employer's reimbursement of certain medical expenses incurred and paid by a former employee during the period that COBRA coverage would apply to the former employee if he/she elected COBRA coverage and paid the applicable premium. This exception applies to both voluntary and involuntary separations from service.

4. Reimbursement of Business, Moving, and/or Outplacement Expenses. Code section 409A does not apply to an employer's reimbursement of business expenses the former employee incurs if the former employee could otherwise deduct those expenses. Code section 409A does not apply to the employer's reimbursement of reasonable outplacement or moving expenses incurred by a former employee. This exception applies only to expenses incurred before the end of the second calendar year following the employee's separation from service that are reimbursed no later than the end of the third calendar year following the employee's separation from service. This exception applies to both voluntary and involuntary separations from service.

Special Considerations. The following are some situations that we have encountered that require special consideration under Code section 409A.

Tax-Exempt Employers. Nonqualified deferred compensation arrangements of tax-exempt employers are taxed under certain rules under Code section 457. These special tax rules do not apply, however, to bona fide severance pay plans. Previously, the IRS did not clearly define the term "bona fide severance pay plan" for this purpose. In July, however, the IRS announced that it anticipated issuing guidance that would limit the scope of the "bona fide severance pay plan" exception to Code section 457 to those arrangements that fall within a separation pay exception to Code section 409A, discussed above.We anticipate that the IRS will finalize this guidance. Because Code section 457 can effectively accelerate the taxation of payments due under the deferred compensation arrangements of tax-exempt employers, the severance pay arrangements of these employers must be reviewed closely to avoid unanticipated tax consequences.

ERISA Requirements. Separation pay arrangements that provide an employee with severance pay that extends more than 24 months following his/her employment may be subject to special requirements under ERISA.

Separation from Service. The separation pay exceptions of Code section 409A apply only to arrangements that condition payments upon an employee's separation from service. Generally, an employee will "separate from service" when he/she terminates employment. Special rules may apply, however, if the employee goes part-time or the employer is a member of a controlled group of corporations or a group of businesses under common control. The Code section 409A regulations permit an employer to make certain elections with respect to the definition of separation from service under these special rules that the employer must document in writing and that the employer should consider in updating severance pay arrangements.

Continued Coverage under Self-Funded Health Plan. Self-funded health plans are subject to nondiscrimination rules that prevent discrimination in favor of highly paid workers. If these rules are violated, the highly-paid worker could be taxed on health benefits he/she receives under the plan. These nondiscrimination rules can present significant issues if an employer wants to extend coverage under its health plan to one or more former executives under terms that are more generous than the terms available to other former employees. Employers should be aware that neither these nondiscrimination rules nor Code section 409A applies to insured health benefits.

Leave of Absence. Some employers place certain employees on "leave of absence" in conjunction with the employee's termination of employment. During the leave, the employee is treated as an employee even though he/she is not performing any service and the employee will not return to employment after the end of the leave. The term "separation from service" is defined under the Code section 409A regulations based upon the amount of service an employee is performing and not based solely upon the employer's characterization of the employee's status. Therefore, these terminal leave arrangements are very problematic under Code section 409A. Please be aware that these terminal leave arrangements can also present other difficult issues under employee benefit plans.
