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Surprises in Severance Packages: The New Deferred Compensation Rules Limit Flexible Arrangements

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It is often frustrating for corporate employees and shareholders to watch executives leave a company with a hefty severance package. Over time, Congress has attempted to regulate these arrangements by enacting certain rules, such as the limits on deductions for severance payments under the "golden parachute" rules. Congress's latest concern is the series of corporate scandals, such as Enron, where top executives received large severance payments immediately before a company's financial collapse. Congress's response was sweeping—an entirely new set of rules governing deferred compensation (including severance pay) under Section 409A of the Internal Revenue Code. But the new rules are not limited to top executives. Every severance plan and employment contract—whether a formal severance pay plan or informal practice, or an employment agreement with specified rights upon termination—needs to be reviewed for compliance with the new rules, which limit the timing and form of payments and acceleration of payments. This is because of the significant tax penalties which apply for non-compliance, including inclusion of income earlier than anticipated, and payment of interest and a 20 percent excise tax. This column

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discusses the new deferred compensation rules with respect to severance pay plans and their consequences, and suggests steps that can be taken to lessen the likelihood that your typical employment contract will subject your employees to additional tax.

The New Deferred Compensation Rules

In late 2004, Congress passed the American Jobs Creation Act, which deals with the timing and taxation of deferred compensation. Since severance plans can postpone compensation, they are potentially subject to the new rules. These rules are implemented under a new section of the Internal Revenue Code of 1986 (the Code), Section 409A. Very generally, Section 409A provides that elections to defer compensation earned in a taxable year must be made in the preceding year, and the time and form of the distribution must be specified at that time. Changes may be made to elections, but generally must be elected a year before payment begins and defer the election for five additional years.

Severance pay plans are referred to as "separation pay arrangements" under the new regulations, to avoid confusion with "severance pay" referred to in Code Section 457(f). It should be noted that the new rules apply to certain independent contractors and directors as well as employees, but this article will use the terms "employee" and "employer" to refer generally to service providers and service recipients, respectively, including independent contractors or other individuals.

Section 409A was generally effective beginning in 2005, but there were a number of grandfather and transition rules that minimized the need to make immediate changes. In late 2004, the Internal Revenue Service issued Notice 2005-1, which provided preliminary guidance in accordance with the terms of the statute. Proposed regulations were issued on October 4, 2005. The IRS has indicated that it intends to finalize the proposed regulations during the middle of 2006. The proposed effective date for the new regulations will be January 1, 2007, but employers must follow the statute "in good faith compliance" in the interim time period.

Under the proposed regulations, amounts deferred before January 1, 2005, are not subject to Section 409A. Amounts are considered deferred before January 1, 2005, if a employee had a legally binding right to the amount paid, and the right to the amount was earned and vested as of December 31, 2004.

Generally, deferred compensation plans must comply with Section 409A now. Although plan documents can be amended on or before December 31, 2006, to reflect compliance with Section 409A, an employee cannot change elections in the year 2006 with respect to payments that would otherwise be received in 2006, or cause payments to be made in 2006 which would not otherwise become due until later. The IRS declined to renew transitional relief provided by Notice 2005-1 for 2006 deferral elections, because it believed that sufficient information has been provided to employees making an initial decision regarding elections for a deferred compensation plan. In addition, the transitional periods contained in Notice 2005-1, which allowed employees to terminate participation in a plan covered by Section 409A or to cancel previous deferral elections in 2005 with related distributions, were not extended past December 31, 2005.

Why Is Severance Pay Considered Nonqualified Deferred Compensation?

A nonqualified deferred compensation plan is "any plan that provides for the deferral of compensation," with certain exceptions for qualified retirement plans, tax-deferred annuities, simplified employee pensions, SIMPLEs and Section 501(c)(18) trusts.[1] A plan provides for the deferral of compensation if, under the terms of the plan and the relevant facts and circumstances, the employee has a legally binding right during a taxable year to compensation that has not been actually or constructively received and included in gross income, and that, pursuant to the terms of the plan, is payable to (or on behalf of) the employee in a later year.

The proposed regulations include exceptions for certain welfare benefit plans, including bona fide vacation leave, sick leave, compensatory time, disability pay, and death benefit plans.

Certain short-term deferrals—payments that are made within 2½ months after the year in which an employee has a binding right to payment—are excepted from Section 409A. Under the regulations, a promise made to an employee (either in an employment contract or in a severance plan) that severance or other payments will be made when he terminates employment generally creates a binding right earned when the promise is made, even though the employee must terminate employment to receive payment. Using this analysis, severance pay could be a payment deferred for a significant period of time, and therefore, as discussed below, not automatically excludable under the short-term deferral exception.

Despite requests from commentators, the IRS declined to grant a blanket exclusion from Section 409A for separation pay. The IRS noted that Section 409A lists several types of welfare plans which Congress elected to exempt entirely from coverage under Section 409A, such as bona fide vacation pay and sick leave, but that severance pay arrangements were not included in this list.

Notice 2005-1 did contain an exclusion from Section 409A for payments made during calendar year 2005 to non-key employees pursuant to severance plans classified as "welfare plans," under the Department of Labor regulations. In its proposed regulations, the IRS decided not to continue this exclusion after 2005. The IRS stated that the Department of Labor regulations reflected different concerns than those which Section 409A was designed to address. Thus, as discussed below, the IRS believes that payments made due to termination of employment (which the IRS calls a "separation of service"), unless involuntary, constitute sufficient employee control to justify their being covered under Section 409A.

Restrictions and Limitations Imposed by Section 409A

If a deferred compensation arrangement is subject to Section 409A, several restrictions apply to elections to defer compensation under the arrangement. Generally, the Section 409A rules require that an employee must make a deferral election in the taxable year before the year in which he performs services. The regulations contain an exception for initial deferral elections, under which an employee may make a deferral election within the first 30 days of participation in a covered plan. Deferral elections include an election both as to the time and form of the payment.

With certain exceptions, once a deferral election is made, the ability of the parties to change a compensation arrangement to delay payment, or to change the form of payment, is limited and will generally require receipt of deferred compensation to be delayed for several years. Generally, (1) such election may not take effect until at least 12 months after the date on which the election is made; (2) in the case of an election related to a payment not made on account of disability, death, or the occurrence of an unforeseeable emergency, the plan requires that the payment with respect to which such election is made be deferred for a period of not less than 5 years from the date such payment would otherwise have been paid; and (3) any election related to a payment to be made at a specified time or pursuant to a fixed schedule may not be made less than 12 months prior to the date the payment is scheduled to be paid.[2]

Section 409A also limits an employee's ability to accelerate payment of deferred compensation, except as provided for in regulations (*e.g.*, to comply with a domestic relations order or certain conflict of interest rules, to pay employment taxes, and certain de minimis payments). Payments must be made on a fixed date or schedule, and cannot be accelerated in the absence of certain events, such as death, disability, unforeseeable emergency, or a separation from service. Where the time of payment is based upon the occurrence of a specified event, a plan must designate an objectively determinable date or year following the event upon which the payment is to be made. For example, a plan may state that deferred compensation may be paid in a lump sum on January 1, 2015, or, if earlier, 30 days after death.

Because it may not always be administratively feasible to make a payment upon the exact date stated in a plan, payments will be treated as made upon the designated date if they are made by the later of the first date it is administratively feasible to do so, or after the designated date, or the end of the calendar year containing the designated date (or the end of the calendar year if only a year is designated). Certain exceptions also apply where a payment would result in material harm to the employer, such as a violation of securities law or contract provisions. Although a payment delay may be permitted where a genuine dispute arises with respect to an employee's rights to such pay, the IRS noted that the employee must act in good faith (*e.g.*, one cannot manufacture a bogus dispute to delay payment) and make reasonable, good faith efforts to pay an amount, in order to meet the requirements of Section 409A.

Since separation from service is a permissible "payment event," a plan can permit payment of deferred compensation upon separation from service, or within a specified time thereafter. For example, a simple plan stating that $50,000 will be paid as a lump sum upon separation from service (with no other elections) would meet the rules of Section 409A.

The determination of when a separation from service occurs has an obvious bearing on separation pay arrangements. The proposed regulations state that a separation from service occurs if an employee dies, retires, or otherwise has a termination of employment with the employer. A separation does not occur in instances of military leave, sick leave, or other bona fide leaves of absence, if the period of the leave does not exceed six months, or if longer, if the employee's right to reemployment upon return from leave is protected under statute or by contract. If such a right does not exist, the employment relationship is deemed to terminate on the first date immediately following such six-month period. The IRS intends to employ a facts and circumstances test for determining whether a termination has occurred.

The regulations include an anti-abuse rule, which looks at whether an employee continues to provide services after a purported separation, and if so, whether the employer and the employee intend for the employee to provide more than insignificant services.[3] Generally, the separation will be ignored if the former employee provides services at an annual rate that is 50 percent or more of the services rendered, on average, during the final three full calendar years of employment, and the annual remuneration for such services is 50 percent or more of the average annual remuneration earned during the immediately preceding three full calendar years of employment.

Special Rules for Severance Payments to Specified Employees

If a "specified employee" in a corporation whose stock is publicly traded on an established securities market has a separation from service, payment of deferred compensation must be delayed at least six months following the separation.[4] This rule was enacted specifically to address ad hoc arrangements which allowed executives to take immediate severance pay before a company bankruptcy. A specified employee is defined using the concepts of a "key employee" under the top heavy rules. Generally, he or she will be (i) an officer with compensation greater than $140,000 (for 2006; then indexed); (ii) a five percent owner of the employer; or (iii) a one percent owner of the employer who earns more than $150,000 (indexed). Generally no more than the lesser of 50 employees or 10 percent of the controlled group employees will be considered officers for this purpose.

Specific Exclusions and Rules for Deferral of Separation Pay

A "separation pay arrangement" is any arrangement that provides separation pay, or where an arrangement provides amounts both for separation pay and non-separation pay, the

portion of the arrangement that provides separation pay. Separation pay includes any amount of compensation which is conditioned on either a voluntary, or involuntary, separation from service. In determining what constitutes separation pay, it is irrelevant whether compensation is conditioned upon the execution of a release of claims, noncompetition or nondisclosure provisions, or other similar conditions.[5]

The regulations exclude separation pay made in connection with an involuntary termination or a window program, which falls below certain monetary limits, separation pay arrangements entered into pursuant to a collective bargaining agreement, and arrangements which meet the short-term deferral rules. The exceptions, discussed below, minimize the burdens of compliance applicable to many customary separation pay arrangements.

"Small" Involuntary Payments, Window Payments, and Other Exceptions

First and foremost, the proposed regulations exempt from Section 409A separation payments made in connection with an *involuntary* termination or a window program, if the entire amount of payments does not exceed two times the employee's annual compensation or, if less, two times the limit on annual compensation that may be taken into account for qualified plan purposes under Section 401(a)(17) (*i.e.*, $220,000 for calendar year 2006).[6] For example, if a separation pay plan provides that an employee will receive 10 weeks of his base salary of $100,000 upon a termination by the employer, payable immediately upon termination, under the employee's monthly pay schedule, the separation pay would not be covered under Section 409A. In its proposed regulations, the IRS noted that this exception is generally consistent with the Labor Department's safe harbor that distinguishes severance plans from pension plans (although there is no compensation cap on the Labor Department safe harbor). While this exemption should help many short-term separation payments made to non-highly compensated employees avoid coverage under Section 409A, it may not cover all arrangements.

Section 409A also does not apply to separation pay plans that meet the short-term deferral exception described above. If separation payments are made within 2½ months after the year in which an *involuntary* termination occurs, the short-term deferral exception (discussed below) may apply to exempt the payments from being subject to Section 409A. This is because the IRS takes the position that the employee has no binding right to any payment that is made only an *involuntary* termination, so cannot control its timing. By contrast, an employee can choose when to take a voluntary termination, or quit, so that employee is generally deemed to have a right to severance pay when the promise is made.

In addition, although many separation pay arrangements cannot meet the election rules imposed by Section 409A, because they are negotiated on an ad hoc basis, separation pay that is triggered by an *involuntary* termination or a window program, and that is the subject of *bona fide*, arm's length negotiations, will not be subject to Section 409A if the negotiations take place before the date when the employee has a legally binding right to payment. The dollar limitations regarding the amount of an arrangement, as discussed above, do not appear to apply in this case.

Other than in the context of window programs, discussed in more detail below, separation pay arrangements reached in the context of a *voluntary* termination will generally be subject to Section 409A. The IRS noted comments to the effect that, for payments available upon a voluntary termination of services, employers often reserve the right to eliminate the arrangement at any time, and employees generally do not have a legally binding right to the payment until payment actually occurs, or such other time as the employer's discretion to eliminate the right to the payments lapses. However, these circumstances did not appear to convince the IRS to exempt such arrangements because they were not binding. Rather, the IRS will look to whether an employer's negative discretion lacks substantive significance, or

the person granted the discretion is controlled by, or related to, the employee to whom the payment will be made.

While *involuntary* termination payments are often covered under the short-term deferral rules, termination pay which may only be made "for good reason" will not be treated as subject to a substantial risk of forfeiture. Good reason arrangements often arise in the context of a change in control, allowing corporate employees to receive separation pay if their company is subject to a takeover, their job changes significantly, or other circumstances require (or strongly "encourage") such employees to leave. The IRS was concerned about the line-drawing necessary to classify certain good reason arrangements as involuntary terminations, while classifying others as voluntary, but did request comments on this issue. This will be an important issue, as many plans cover both involuntary and "for cause" terminations. A related issue may arise with respect to severance pay which is triggered by a resignation following a "constructive discharge" occurring under state law. Absent further guidance, it makes sense for employers to assume such arrangements are subject to Section 409A, unless they meet another exception, and to remember that the substance of these arrangements will likely be subject to IRS scrutiny.

The proposed regulations acknowledge that separation pay arrangements often arise in the context of a "window program." A "window program" is defined as a program established by an employer to provide for separation pay in connection with a separation from service, for a limited period of time, of no more than one year, to employees who separate from service during that period. For example, an employer may establish an early retirement window program, under which employees who have reached a certain age and a certain number of years of service are offered incentives to voluntarily retire, within a specified time period. The IRS regulations note that a program will not be considered a window program if the employer routinely provides similar separation pay in similar situations for substantially consecutive, limited periods of time. In applying this facts and circumstances based test, the IRS will look to factors such as whether a window program is offered because of a specific business event or condition (such as the economic decline of the business), the degree to which separation pay relates to such event or condition, and whether the event or condition is temporary or discrete, rather than a permanent aspect of the employer's business.[7]

Although participation in a window program would typically involve a *voluntary* separation from service, the proposed regulations treat separations due to participation in a window arrangement similarly to involuntary separations from service. The proposed regulations also contain exemptions for separation pay arrangements reached in connection with a bona fide collective bargaining agreement.

Reimbursement Arrangements

Finally, the regulations address arrangements where an employer reimburses expenses incurred after a termination, even though some might technically constitute deferrals. Although the IRS believed that a blanket exclusion for such reimbursements was "not tenable," certain types of reimbursements, which represent the amount of expenses incurred, are excluded from Section 409A. The IRS recognized that reimbursement arrangements following termination are common, but that it would not be possible for many of these arrangements to strictly comply with the deferred compensation rules. The types of reimbursement arrangements excluded include reimbursements that are otherwise excludible from gross income, reimbursements for expenses that the employee can deduct under Code Section 162 or Section 167 as business expenses incurred in connection with the performance of services (ignoring any applicable limitation based on adjusted gross income), outplacement expenses, moving expenses, medical expenses, and any other types of "de minimis" payments that do not exceed $5,000 in the aggregate during any given taxable year.[8]

The reimbursement exception includes the provision of in-kind benefits, or direct payments made by the employer to the person providing the goods or services to the

terminated employee, if the provision of such in-kind benefits or direct payments would be treated as reimbursement arrangements if the employee had paid for such in-kind benefits or such goods or services and received reimbursement from the employer. For example, outplacement services offered by an organization that normally provides outplacement services for a fee would be considered a reimbursement under the Section 409A rules. Moving expenses paid directly to a moving company on behalf of a terminated employee would also be included, if the other requirements of the rules are met. Reimbursements must be limited to amounts that a former employee has actually incurred as an expense. Otherwise qualified reimbursements must be paid before the end of the second calendar year following the calendar year in which a termination occurs.

There are certain common reimbursement arrangements that are not covered. For example, if a company continues medical payments but such payments are includible in income (because the non-discrimination rules are not met) there is no exclusion, because such arrangements are taxable. A similar issue arises with respect to medical benefits for domestic partners. The ability of an executive to continue membership in country clubs or golf clubs, or to use an office or executive jet for a period of time after termination, or to take advantage of an indemnity agreement, are taxable benefits not covered by the reimbursement exception. These arrangements may have to be changed, since the exact amount and timing of payments cannot be deferred in advance.

The Short-Term Deferral Exception and its Application to Severance Pay

Notably, the proposed regulations provide an exception for "short-term deferrals," if, absent an election to defer payment to a later time period, at all times a plan requires payment of compensation, and the amount is actually or constructively received by an employee by the later of (i) the date that is 2½ months from the end of the employee's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture; or (ii) the date that is 2½ months from the end of the employer's year in which the amount is no longer subject to a substantial risk of forfeiture. As discussed above, compensation is not subject to a substantial risk of forfeiture as of the date that an employee first has a legally binding right to such compensation. So, for example, if an employer provides an annual ten percent bonus to its employees who meet certain minimum targets measured every December 31, and pays the bonus to each employee on January 31 of the following year, the employer's bonus program would not be subject to Section 409A if he or she had no right to the payment until December 31 of the prior year. An arrangement need not provide in writing that payments will be made by the required deadline, but the short-term deferral rules will only apply if amounts are in fact paid out by such deadline. Failure to make payments in accordance with the short-term deferral requirements will result in an automatic violation of Section 409A. The rules contain an exception for unforeseeable administrative or employer solvency issues.

Some severance plans may fall under the short-term deferral exception. As discussed above, if one does not have a binding right to payment unless an *involuntary* termination occurs, a payment made 2½ months from the end of the year in which that involuntary termination occurs could be a short-term deferral. But a severance plan that provides payments for "good reason" or upon voluntary separation is deemed to create a binding right to payment before the termination, so the short-term deferral exception would not apply.

Moreover, application of the short-term deferral rules can depend on the existence of a "substantial risk of forfeiture." Under other areas of the Code, inclusion of deferred compensation arrangements has often been delayed based on the premise that compensation promised to an employee is subject to a substantial risk, such as a requirement that the employee remain employed for a minimum period of time, or meet other performance

conditions.[9] But the proposed regulations limit the ability to create an artificial risk of forfeiture or to amend an arrangement to extend a substantial risk of forfeiture. Under Section 409A, where the parties to an arrangement attempt to periodically extend, or roll, a substantial risk of forfeiture, the IRS will look to whether such parties ever intended that the right be subject to any true substantial risk. If, for example, a risk of forfeiture is continually extended in a manner in which the employer can be reasonably assured that a forfeiture condition will not occur, the "risk" will be considered illusory and will be ignored by the IRS for purposes of Section 409A. (The IRS has stated informally it believes that these "rolling" risks of forfeiture do not work to defer compensation.)

Other Provisions

The IRS was concerned that the exceptions created for certain separation pay arrangements would allow a nonqualified deferred compensation arrangement to be recharacterized as separation pay, in order to avoid application of Section 409A. Therefore, the exceptions do not apply in cases where separation pay is offered or provided in lieu of amounts which would otherwise be subject to Section 409A.[10] For example, if an employee is offered separation pay in exchange for waiving his right to payment of incentive pay which would otherwise by subject to Section 409A, the separation pay will be treated as a payment of the original amount of deferred compensation.

Grandfather Rules

IRS guidance contains certain grandfathering provisions for plans that were in effect prior to January 1, 2005. If an employee's rights to deferred compensation were earned and vested as of December 31, 2004, and the employee had a legally binding right to such compensation, Section 409A does not apply to such compensation. The grandfathering rules apply to separation pay arrangements, which are treated as separate plans for purposes of calculating grandfathered amounts. In other words, separation pay plans are not aggregated with an employer's other plans (such as 401(k) plans and stock compensation programs), for purposes of applying the grandfathering rules. The IRS decided to treat separation pay arrangements as separate plans, because of concerns that these arrangements are very different from other types of nonqualified deferred compensation, and aggregating them with other plans sponsored by an employer would increase compliance burdens and concerns. Therefore, if an employer inadvertently violates Section 409A in administering a separation pay plan, the violation will not be attributed to other plans for purposes of correction and taxation issues.[11]

The grandfathering rules *do not* apply to arrangements that were materially modified after October 3, 2004. Therefore, such plans must fully comply with the requirements of Section 409A, even with respect to amounts deferred prior to January 1, 2005. Generally, changes to a plan which are intended to bring the plan into compliance with the new requirements are not considered material modifications. However, enhancements and additions to a plan made after October 3, 2004, which increase benefits or rights available, or enhance the features of such plan, are deemed material modifications which will bring the plan outside of the grandfathering protections. In addition, adding features permitted under Section 409A which were *not* permitted by the terms of a plan prior to this date, such as an allowance for payments made upon a constructive termination under state law, would also be considered a material modification.

Checklist

Below is a checklist of questions and compliance concerns presented by Section 409A, including Notice 2005-1 and the proposed regulations. The checklist provides a general

summary of the Section 409A requirements applicable to separation pay plans, but should not be used as a substitute for seeking advice from a qualified legal professional regarding these issues.

- Review employment agreements and other benefit plans to see if any of them provide for severance payments or reimbursements upon termination of employment.
- Determine whether any such arrangements are exempt from Section 409A (*e.g.*, short-term deferrals and payments for involuntary termination or in connection with a window program, which meet all of the requirements of the rules) and make sure that they remain exempt on a going forward basis.
- Review any post-employment reimbursements covered by an otherwise exempt arrangement to ensure that they meet the requirements under the rules.
- Review grandfathered benefits for potential "material modifications" which would destroy grandfathered status.
- Amend plan documents (or adopt a plan document with the terms required by Section 409A), and other employee communications regarding all separation pay arrangements subject to the rules.
- Implement a process for requiring deferral elections and subsequent elections to be made for severance pay that is deferred compensation.
- Implement a process for delaying payment under a separation from service of a specified employee

Conclusion

Employers who sponsor separation pay plans must be aware of the new rules imposed by passage of Section 409A, and related guidance issued by the IRS. Although there are several exceptions built into the new IRS regulations, which cover many common separation pay arrangements, employers should be particularly careful with respect to large separation pay packages offered to key employees and other executives, because these packages may be deemed to involve deferred compensation subject to the numerous requirements of Section 409A. In addition, "plan documents," which in some cases may be the separation pay contract itself, may need to be amended to incorporate the terms required by Section 409A. As the deadline for the amendments approaches, employers should also seek legal guidance on reaching good faith compliance with the terms of the statute, as enunciated in Notice 2005-1 and the IRS's proposed regulations.

Notes

1. 26 C.F.R. § 1.409A-1(a).

2. A "payment" is each separately identified amount to which a service provider is entitled to payment on a determinable date. The ability to elect installment payments is considered a single payment for purposes of these rules, unless a plan specifies that a series of installment payments is to be treated as a series of separate payments. 26 C.F.R. § 1.409A-2(b)(2)(i).

3. An employer and a service provider will be deemed to have intended for the employee to provide more than insignificant services if services are provided at an annual rate equal to at least 20 percent of the services rendered

and the annual remuneration for such services is equal to at least 20 percent of the average remuneration earned during the immediately preceding three full calendar years of employment (or a lesser period, if the service provider has not been employed for three full years).

4. 26 C.F.R. § 1.409A-3(g)(2). The term "specified employee" is defined in accordance with Code Section 416(i).

5. 26 C.F.R. § 1.409A-1(m).

6. 26 C.F.R. § 1.409A-1(b)(9)(iii).

7. 26 C.F.R. § 1.409A-1(b)(9)(v).

8. 26 C.F.R. § 1.409A-1(b)(9)(iv).

9. *See* Code Section 83; 26 C.F.R. § 1.83-3.

10. 26 C.F.R. § 1.409A-1(b)(9)(i) and (m).

11. 26 C.F.R. § 1.409A-1(c)(2).

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