GUIDE FOR HUMAN RESOURCE PROFESSIONALS REGARDING THE APPLICATION OF SECTION 409A TO SEPARATION PAY ARRANGEMENTS

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1. **Background**. As part of the American Jobs Creation Act of 2004, new Section 409A of the Internal Revenue Code (the "Code") was enacted to regulate nonqualified deferred compensation plans. Section 409A makes **5** major changes to the operation of nonqualified deferred compensation plans as follows:

   a. Expands the scope of what constitutes a nonqualified deferred compensation plan to encompass a wide variety of executive compensation arrangements, including severance pay plans, employment agreements with severance benefits, and equity based compensation.

   b. Specifies when elections to defer compensation under such plans must be made.

   c. Specifies the **time** when amounts from a nonqualified deferred compensation plan can be distributed, and when elections regarding the **form** of distributions can be made and modified.

   d. Prohibits plans from permitting the acceleration of distributions from nonqualified deferred compensation plans.

   e. Provides significant penalties on plan **participants** if Section 409A is violated, including immediate income taxes, the imposition of a **20%** excise tax, underpayment of tax interest penalties and a Form W-2 reporting.

   Section 409A contains a list of welfare benefit plans that are specifically excluded from coverage under Section 409A, including bona fide vacation leave, sick leave, compensatory time, disability pay and death benefit plans. Noticeably absent from this list was an exception for severance plans which most practitioners hoped would exist. However, the IRS and Treasury believed that if severance plans were excluded from Section 409A, they would be used as a form of deferred compensation.

   It should be noted that many employers have never acknowledged the existence of severance plans, even though a severance policy exists in an Employee Handbook and all employees have received the same severance benefits for many years. In this context, P&E generally recommends that employers identify all severance policies as ERISA severance plans, and include such severance plans in the Form 5500 filing for all other welfare benefit programs.

The purpose of this Summary is not to address all issues regarding nonqualified deferred compensation plans. Each employer should identify all plans that are or can be a form of nonqualified deferred compensation and apply the rules to each specific plan. The goal of this Summary is to alert Human Resource Professionals regarding the application of Section 409A to severance agreements, severance plans, and employment agreements that provide for the payment of severance benefits.

2. **Separation Pay Arrangements**. In general, all "separation pay arrangements" will be treated as a form of deferred compensation under Section 409A, unless a specific regulatory exemption applies. It should be noted that an arrangement may cover a single individual. The Preamble to the Proposed Regulations explained that the Treasury and the IRS used the term "separation pay" rather than "severance pay" specifically to avoid confusion with other provisions of the Code that used the term severance pay. Therefore, any separation pay arrangement, regardless of what it is called or the type of agreement in which it is contained, must be analyzed under the general framework of the Section 409A rules. For example, if the plan provides for payment upon an involuntary termination, and the right to payment does not "vest" until a termination of employment occurs, there would not be a deferral of compensation as long as all payments are made within **2½** months after the end of the calendar year in which the termination occurs. If, however, the separation payments are to be made over a longer period, the arrangement must comply with Section 409A, unless it fits within one of the exclusions described below.

The Proposed Regulations **exempt** the following arrangements from the definition of deferred compensation under Section 409A:

a. For purposes of only the 2005 calendar year, payments to "non-key" employees pursuant to severance plans that are classified as welfare plans under the Department of Labor ("DOL") Regulations. The DOL Regulations provide that a severance plan is any program that provides a benefit to employees for a period of less than **24** months. If the benefits go for a longer period, they are considered to be a retirement benefit under ERISA. For purposes of this provision, a key employee is an officer earning more than **$140,000** in 2006 and **$145,000** in 2007 (with a limit of no more than **50** employees, or if less, the greater of **3** or **10%** of all employees); a **5%** owner; or a **1%** owner having annual compensation of more than **$150,000**.

b. Arrangements providing for severance pay upon an individual's actual involuntary separation from service or pursuant to a window program if the arrangement provides that:

   i. The separation pay (**not including** certain expense reimbursements, in kind benefits, direct service recipient payments, and de minimus payments discussed below) does not exceed **2** times the **lesser of**:

      A. The sum of the employee's annual (Section 415) compensation for services for an employer (or an individual's net earnings from self-

employment for services as an independent contractor), for the calendar year preceding the calendar year in which the separation from service occurs; or

B. The maximum that may be taken into account under qualified retirement plans under Section 401(a)(17), which is **$220,000** for the 2006 calendar year and **$225,000** in 2007; and

ii. The separation pay is paid **no later** than December 31 of the **second calendar year**, following the calendar year in which the separation from service occurs. Under this rule, an individual who terminates employment in January, 2007 could actually receive payments until the end of 2009. However, since the maximum severance benefit is **$450,000**, this rule will not be available for many senior executive terminations. Nevertheless, it is important to note that payments under this program may avoid the **6** month delay in payment.

c. Arrangements for employees covered under collective bargaining agreements ("CBAs") that provide for severance pay upon an involuntary separation from service or pursuant to a window plan. In order to meet this requirement, the agreement must be contained in the CBA; the severance payments be the subject of arms length negotiations; the CBA must be a bona fide agreement between employer representatives and employers; and the CBA must be the result of good faith bargaining.

d. Arrangements that entitle an employee to certain reimbursements that are otherwise **excludable** from gross income (such as COBRA benefits), reasonable outplacement expenses, or reasonable moving expenses actually incurred and directly related to the termination of service. Once again, such reimbursements must be incurred and paid by December 31 of the **second calendar year** following the calendar year in which the separation from service occurs.

e. Arrangements that entitle an employee to in kind benefits or payment by an employer directly to the person providing goods and services to the employee. For example, the provision of free cable services to terminated employees of a cable company will not result in the deferral of compensation.

f. Arrangements that entitle an employee to reimbursement or other payments or benefits that do not exceed **$5,000** in the aggregate. Thus, **de minimus benefits** are exempted from the scope of Section 409A.

g. Arrangements that provide for payment upon an involuntary separation and that are structured to meet the requirements of the short-term deferral exemption generally available under Section 409A (i.e., the **2½** month rule). Under this provision, any severance benefits paid to an employee by the **later of** the **15th** day of the third month following the employers' first taxable year in which the

involuntary separation occurs or the **15th** day of the third month following the end of the employee's first taxable year in which the separation occurs, is **not subject** to Section 409A. For calendar year employers, this means that all severance benefits must be paid by the March 15 following the calendar year in which the termination occurs. In most instances, employers will seek to rely upon this exemption **due to its simplicity**. More importantly, under the short-term deferral rules, if the benefits are not paid within the **2½** month period, such as March 15 above, but are paid by the December 31 in which the **2½** month rule should be satisfied, no penalties will be imposed under Section 409A. In order to obtain this relief, specific reference must be made to the **"payment date"** to satisfy the short-term deferral rule. Accordingly, detailed written agreements will help avoid penalties under Section 409A.

h. Although not exempt from Section 409A, for separation pay that is subject to bona fide arms length negotiation at the time of any involuntary termination, the election as to the **time** and **form** of payment may be made on or before the date an employee obtains a "legally binding" right to payment. This rule permits an employer to negotiate the payment of benefits for a period longer than and an amount greater than those provided above, if specific **payment dates** exist. Thus, any employment agreements providing for severance benefits or severance benefits must be drafted to include **"fixed" payment dates**.

3. **<u>Separation from Service</u>**. Benefits under all nonqualified deferred compensation programs, including severance agreements, may generally **<u>not</u>** be paid after a Separation from Service. The term "Separation from Service" means an individual is no longer employed by an employer on account of a termination of employment, retirement, Disability or death. Consistent with Proposed Treasury Regulation Section 1.409A-1(h), no Separation from Service will occur if an employee continues to perform services as a consultant or an employee in excess of any amount of time permitted under such guidance.

a. **<u>Leave of Absence</u>**. For purposes of Section 409A, the employment relationship is treated as continuing in effect while an employee is on military leave, sick leave, or other bona fide leave of absence, as long as the period of leave does not exceed **6** months, or if longer, as long as the employee's right to reemployment with the employer is provided either by statute or contract. Otherwise, after a **6** month leave of absence, the employment relationship is deemed terminated.

b. **<u>Part-Time Status</u>**. Whether or not a termination of employment occurs is determined based upon all facts and circumstances. However, in the event that services provided by an employee are **<u>insignificant</u>**, a Separation from Service shall be deemed to have occurred. For purposes of Section 409A, if an employee is providing services to an employer at a rate that is at least equal to **20%** of the services rendered, on average, during the immediately preceding **3** full calendar years of employment (or such lesser period), and the annual compensation for such services is at least **20%** of the average annual compensation earned during

the final **3** full calendar years of employment (or such lesser period), no termination will be deemed to have occurred since such services are **not insignificant**.

c. **<u>Consulting Services</u>**. Where an employee continues to provide services in a capacity other than as an employee, a Separation from Service shall not be deemed to have occurred if the former employee is providing services at an annual level that is **50%** or more of the services rendered, on average, during the immediately preceding **3** full calendar years of employment (or such lesser period) and the annual remuneration for such services is **50%** or more of the annual remuneration earned during the final **3** full calendar years of employment (or such lesser period).

In many situations, executive employees wish to remain employed on a part-time or consulting basis following a traditional retirement, and employer appreciate the continuity such arrangements provide. However, these new rules require careful consideration to determine if anticipated severance or supplemental retirement benefits may be paid.

4. **<u>Publicly Traded Company Key Employee Issues</u>**. Throughout the Proposed Regulations, reference is made to a service provider and a service recipient. For purposes of simplicity, we have generally reviewed all issues in the context of an employer and an employee. However, for purposes of Section 409A, the term "service recipient" means the entity for whom services are performed and with respect to whom the legally binding right to compensation arises, and all entities which would be considered part of a **"single employer controlled group"** under Section 414 of the Code.

Section 409A further provides that **"key employees"** of a corporation whose stock is publicly traded on an established securities market (in the U.S. and elsewhere) **may not <u>receive</u> a distribution** of severance or other deferred compensation benefits until **6** months after the date of any separation from service, except in the event of death. As noted above, a key employee is defined by reference to Section 416(i) of the Code and generally includes the top **50** officers earning more than **$140,000** in 2006 and **$145,000** in 2007 for large corporations.

In further considering key employee status, the key employee rule in the Proposed Regulations requires an employer to designate the **12**-month period that will be used for determining whether employees meet the criteria for being key employees. Employees who meet the criteria within the specified period are actually treated as key employees for a **12**-month period beginning **4** months later. For example, if key employee status is determined as of September 30, 2005, it would apply as of January 1, 2006.

Under the Proposed Regulations, a designation for 2005 and 2006 of the **12**-month measurement period "may" be made anytime up until December 31, 2006 and that designation may apply for any separation from service on or after January 1, 2005. The

default rule, if the employer makes no designation, is that the **12**-month period ends on each December 31.

Whether an employer is using the default rule or actually electing to use the **"calendar year"**, the first step is to identify the employees who will be treated as key employees for January 1, 2005 to March 31, 2005. To do this, an employer has to look back to calendar year 2003, and the employees who are key employees at any time during 2003 are the key employees subject to the **6**-month delay rule for those first **3** months. The next step is to identify the employees who are key employees during 2004. They are subject to the **6**-month delay for the period from April 1, 2005 to March 31, 2006. The employees who are key employees during 2005 are subject to the **6** month delay for the period from April 1, 2006 to March 1, 2007.

This **6** month delay rule should be addressed in all severance and employment agreements. Furthermore, since publicly traded status is determined on a controlled group basis, all subsidiaries of U.S. and foreign public companies must be made aware of this limitation.

5. **Good Cause Terminations**. Many employment agreements provide that an employee may voluntarily terminate employment if certain events occur within **6** months following a change in control, including assignment to duties inconsistent with the status as an officer or reduction in base salary. The legislative history to Section 409A and the Preamble to the Proposed Regulations specifically raise questions concerning such provisions.

   a. **Legislative History of Section 409A**: The legislative history provides that the Secretary of the Treasury is authorized to prescribe Regulations to define certain terms, including a substantial risk of forfeiture and when a substantial risk of forfeiture should be disregarded. The legislative history provides as follows:

      "It is intended that substantial risk of forfeitures may not be used to manipulate the timing of income inclusion. It is intended that substantial risk of forfeitures should be disregarded in cases in which they are illusory or are used in a manner inconsistent with the purpose of the provision. For example, if an executive is effectively able to control the acceleration of the lapse of a substantial risk of forfeiture, such risk of forfeiture should be disregarded and income inclusion should not be postponed on account of such restriction."

      The above language was intended to address the issue of whether a substantial risk of forfeiture exists, postponing income when an executive has the ability to elect to receive a severance benefit following a change in control. It would appear that upon the change in control, the mere ability to receive payment, even contingent upon adverse employment actions such a reduction in compensation or authority, could result in taxation.

b. **<u>Preamble to the Proposed Regulations</u>**: The Preamble to the Proposed Regulations further identify that commentators requested that payments upon a termination of service for **"good reason"** be treated as a right that is subject to a substantial risk of forfeiture. The IRS and Treasury acknowledge that such provisions are typical in change of control events. However, the Proposed Regulations provide as follows:

"The Treasury Department and the IRS are not confident that amounts payable upon a voluntarily separation from service, and amounts payable only upon a termination of services for good reason, always may be adequately distinguished. Furthermore, even if the types of good reasons sufficient to constitute a substantial risk of forfeiture could be elucidated, the application of such a rule would involve intense factual determinations, leaving taxpayers uncertain in their planning and creating a significant potential for abuse. Accordingly, the Regulations do not treat the right to a payment upon a separation from service for good reason categorically as a right subject to a substantial risk of forfeiture. However, the Treasury Department and the IRS request comments as to what further guidance may be useful with respect to arrangements containing these types of provisions."

c. **<u>Practical Implications</u>**. The practical implications of the above rules are as follows:

i. The IRS is being pushed very hard to come up with some exceptions where a termination for good reason will be deemed to be a substantial risk of forfeiture. However, the ultimate outcome of this debate is uncertain.

ii. Upon a change in control, an employee could potentially be deemed to be in constructive receipt of income under the old "constructive receipt" rule, outside of the scope of Section 409A. However, terminating employment to receive a payment would generally not result in taxation under the old constructive receipt rule.

iii. For public companies, an employee who terminates employment under a good reason provision will **not be able** to receive payment for a **6** month period of time. This is the primary area of debate between practitioners and the IRS.

iv. For nonpublicly traded companies, the continuance of a good reason termination should not present significant difficulties, since there is no taxation under the old constructive receipt rule and payments may be made within the **6** month period of time following the triple trigger (<u>i.e.</u>, change in control, diminution of duties, and election to receive benefits).

Due to the uncertainty regarding the use of a "good cause" provision, this issue must be monitored and many employment agreements may require revision by **December 31, 2007**, unless this deadline is extended.

6. **Grandfathered Rule**. To the extent that a **"legally binding"** right to benefits existed as of **December 31, 2004**, and the benefits were earned and **"vested"** as of that date, such benefits are "grandfathered" under Section 409A. It is important to note that a "legally binding right" and "vesting" are different events, since an employee can have a legally binding right, subject to a need for continued employment to vest and be paid a benefit. For example, an employee may obtain a legally binding right to a bonus as of December 31, 2006. However, the bonus is subject to a substantial risk of forfeiture if a voluntary termination of employment prior to December 31, 2007 would result in a forfeiture of the bonus.

   For purposes of employment agreements, **no vesting** of any severance benefits should exist until there is a termination of employment or potentially a change in control. Accordingly, employment agreements will **not be** grandfathered for purposes of Section 409A and will be subject to the **6** month delay in payment for public companies, the good reason debate, and the need to have fixed payment dates as addressed elsewhere.

7. **Section 409A Reporting and Penalties**. The following reporting requirements and penalties exist:

   a. An employer is required to report the amounts subject to Section 409A on IRS Form W-2 (whether or not a violation occurs). Form W-2 reporting was required for deferrals beginning in 2005. However, in accordance with IRS Notice 2005-94, the IRS suspended W-2 reporting for Section 409A for 2005 due to the issuance of the Proposed Regulations and the inability of payroll companies to implement the rules for 2005. IRS Notice 2006-100 provided new guidance with regard to the withholding rules for 2006.

   b. Form W-2 reporting should be coordinated with the FICA tax reporting requirements, even with a Section 409A compliant SERP (i.e., FICA taxes exist upon vesting under Section 3121(v) of the Code).

   c. Payments that do **not comply** with Section 409A will be subject to a **20%** excise tax and the underpayment of tax interest penalties when an employee files his or her individual tax return.

   d. Employees will also be subject to regular income tax on any amounts "improperly" deferred in the year of deferral. It should be noted that under the Proposed Regulations the IRS reserved the right to issue guidance with regard to the calculation of the income inclusions.

8. **Miscellaneous Issues**. Additional issues for consideration regarding severance pay arrangements and employment agreements are as follows:

a. All deferred compensation programs of the same **"type"** must be **"aggregated"** when applying Section 409A to any individuals. In addition to account balance plans, non-account balance plans, and equity based compensation arrangements, the Proposed Regulations create a new category for "separation pay arrangements and window plans". With this new category, all amounts deferred with respect to an employee under all separation pay arrangements of an employer due to an involuntary termination or participation in the window plan are aggregated together, and will not be aggregated with the other types of programs.

b. All employment agreements containing severance benefits must be reviewed.

c. For employees subject to the **6** month delay rule, it is P&E's recommendations that employers consider **paying interest** on delayed payments.

d. The definition of a **"change in control"** should be considered in all severance and employment agreements and may require revision to conform with Section 409A.

e. All documents subject to Section 409A must currently be reviewed and revised **December 31, 2007**.

f. This Summary does not address the treatment of foreign plans or receipt of benefits by resident and non-resident aliens in the U.S. The Proposed Regulations provide significant relief for broad-based foreign plans, totalization agreements (to address U.S. and foreign social security type benefits) and equalization agreements (to address payments to make employees whole for different tax rates). P&E anticipates addressing this issue in a separate summary.

9. **Conclusion**. We hope this Summary is helpful to clients and contacts of Palmieri & Eisenberg. If we may be of assistance in reviewing any employment or severance agreements, or any other deferred compensation programs, or with regard to any other employee benefit or employment matters, please do not hesitate to contact us.

This Summary was prepared by the Law Firm of Palmieri & Eisenberg, located in Princeton, New Jersey, for clients and associates of the Firm. This Summary is being provided to help educate clients and employers regarding these new rules. P&E is **not** providing any legal advice to any employers to whom this Summary is provided, as a courtesy. Employers are strongly encouraged to work with their own legal counsel in reviewing these important issues.

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