Severance Pay under the Final Section 409A Regulations

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Overview

The IRS recently issued final regulations under Section 409A of the Internal Revenue Code (the Code) related to nonqualified deferred compensation. While the final regulations generally retain the approach taken by the IRS in the proposed Section 409A regulations, the final rules include greater flexibility with respect to severance pay arrangements. In particular, and as explained in more detail below, the final regulations:

- expand the available exceptions to Section 409A for severance pay, including an expansion of the definition of involuntary termination to include certain "good reason" terminations; and
- permit those exceptions to be combined so that multiple components of severance pay can be excluded.

This alert summarizes the rules set forth in the final regulations with respect to severance arrangements and provides our recommendations for bringing your arrangements into compliance with the new rules.

Background

The American Jobs Creation Act of 2004 (the Act) added Section 409A to the Code, which provides that all amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in income, unless strict timing and documentary requirements are satisfied. Among the Section 409A requirements is a six-month delay for payments made to specified employees of publicly traded companies (explained below) upon termination of employment. A violation of Section 409A results in the assessment of a 20% tax and interest on the employee or service provider, in addition to regular income and employment taxes.

The final regulations are scheduled to become effective on January 1, 2008, by which date all severance arrangements must be in documentary compliance with the final regulations. Until that date, all severance arrangements must be operated in good faith compliance with the final regulations, the proposed regulations or other guidance issued under Section 409A.

Exceptions to Section 409A for Certain Severance Pay

The final regulations include the following exceptions to Section 409A for various components of severance arrangements. As stated above, these exceptions may generally be used in combination.

Involuntary termination or participation in a window program. Severance will be excluded from Section 409A if payable solely upon an involuntary termination or pursuant to a window program, provided that the severance amount:

- cannot exceed two times the lesser of (a) the individual's annual compensation for the preceding calendar year, and (b) the tax-qualified plan compensation limit (2 x $225,000, or $450,000, for 2007), and;
- must be paid no later than December 31 of the second calendar year following the year of termination.

Significantly, the "two times exception" may apply for amounts up to the cap even where the total severance payments exceed that cap. As a result, if the total payments to an involuntarily terminated employee under a severance pay arrangement may exceed the above cap, the arrangement can be structured so that the amount up to the cap qualifies for the "two times exception"—and is therefore exempt from Section 409A—and so that the excess amount complies with Section 409A, including, if applicable, the six-month delay for specified employees.

An arrangement that provides for severance pay other than on an involuntary termination (for example an arrangement that provides for severance pay upon a voluntary resignation) is not eligible for this exception, even if the actual trigger to the payment is in fact an involuntary termination. However, as explained below, the final regulations expand the definition of "involuntary termination" so that more arrangements will now qualify for the involuntary termination exception.

Certain good reason terminations considered involuntary. The final regulations expand the scope of involuntary terminations that will qualify for the above "two-times exception" to include certain "good reason" terminations. Whether a good reason condition will be respected as involuntary generally will depend upon the particular facts and circumstances; however, to be considered involuntary, a good reason condition must:

- not be established for the purpose of avoiding Section 409A; and
- require employer actions that result in a material negative change in the employment relationship (such as a material negative change in responsibilities, working conditions or compensation).

Additional factors include the extent to which the good reason termination payments are in the same amount and are made at the same time and in the same form as payments available upon an employer-initiated involuntary termination, and whether the employee is required to give the employer notice of the existence of the violation of the good reason condition and a reasonable opportunity to cure the violation.

To provide taxpayers with more certainty as to whether a good reason termination will be respected

as involuntary, the final regulations include a safe harbor. An arrangement including a good reason condition meeting the following requirements will be deemed to provide for payments solely upon an involuntary termination:

- the good reason includes (i) a material diminution in the employee's base pay, authority, duties, responsibilities or budget, or the authority, duties and responsibilities of the employee's supervisor, (ii) a material relocation, and/or (iii) a material breach of the employment agreement or service agreement;
- the termination from service occurs within a limited period not exceeding two years following the initial existence of a violation of one of the above events;
- the amount, time and form of payment upon the termination is substantially identical to the amount, time and form of payment payable due to an employer-initiated involuntary termination; and
- there are notice and cure periods satisfying the regulations.

Involuntary termination payments made within short-term deferral period. Severance arrangements that provide for lump-sum payments shortly following an involuntary termination may also be exempt from Section 409A. In particular, under the short-term deferral exception to Section 409A, compensation paid within two-and-a-half months after the end of the year in which it vests will be exempt from the provision. Because payments that can be made solely upon an involuntary termination—including good reason terminations qualifying as involuntary—"vest" when the termination occurs, those payments will be exempt from Section 409A provided that they are paid within the short-term deferral period. As a result, arrangements that satisfy this exception can provide for unlimited amounts of severance pay. Moreover, if this exception is available, the required six-month delay for specified employees of public companies will not apply.

Expense reimbursement arrangements and in-kind benefits. The final regulations clarify that a right to a nontaxable benefit is not subject to Section 409A (for example, an arrangement to provide health coverage excluded from income). Moreover, the final regulations provide that the following taxable reimbursements are exempt from Section 409A:

- outplacement and moving expenses (including loss incurred due to sale of a primary residence) and expenses the employee could otherwise deduct as a business expense (provided that the expense is incurred by the end of the second year after termination and the reimbursement is made by the end of the third year);
- medical expenses or the provision of medical benefits (within the maximum applicable COBRA period); and
- in-kind benefits and service payments on behalf of the employee (provided that the expense is incurred by or the benefits are provided by the end of the second year after termination and the payment is made by the end of the third year).

Other exceptions. The final regulations also include exemptions from Section 409A for the following other types of severance pay arrangements:

- certain bona fide collectively bargained agreements that provide for severance pay only

upon an involuntary severance from service or pursuant to a window program;

- certain foreign arrangements where amounts are required to be provided under applicable foreign law; and
- payments that in the aggregate do not exceed the applicable dollar amount under Section 402(g) (elective deferrals under a qualified plan); for 2007, this amount is $15,500.

Six-Month Delay for Specified Employees

A specified employee subject to the six-month delay rule is a person who is a "key employee" under the top-heavy qualified plan rules (i.e., a 5% owner, a 1% owner with compensation greater than $150,000 or a corporate officer with compensation greater than $145,000, for 2007) at any time during the 12-month period ending on a specified employee identification date (the default is December 31). If a person is a key employee as of the specified employee **identification** date, the person is treated as a key employee for the entire 12-month period beginning on the specified employee **effective** date (the default is the first day of the fourth month following the specified employee identification date). For example, if the specified employee identification date is December 31, then the specified employee effective date is April 1, and the employee will be a specified employee until the following April 1.

The final regulations provide flexibility to employers to determine the group of specified employees, provided that the methodology is applied consistently. In particular, the final regulations provide an alternative method for determining the specified employees each year: either delay severance payments for six months for all employees or designate a sub-group of up to 200 identified employees as specified employees (so long as this sub-group includes all those employees who would be specified employees under the normal rule). Moreover, the final regulations include a process for determining specified employees following a merger, spin-off or public offering.

Our Recommendations

As stated above, all severance arrangements must be brought into documentary compliance with Section 409A by January 1, 2008. It is, therefore, time for employers to undertake a thorough review, and likely revision, of all of their employment contracts and other severance pay arrangements to ensure the compliance deadline is met. While the final regulations provide significantly more flexibility to employers to structure arrangements that are exempt from Section 409A, ensuring the availability of those exemptions will require careful drafting.

For more information on this or other tax matters, please see our prior tax publications, or contact:

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