Applying Section 409A to Severance Benefits

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This Note explains the application of Internal Revenue Code section 409A relating to nonqualified deferred compensation plans to various types of severance benefits.

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Section 409A of the Internal Revenue Code and its related regulations (Section 409A) provide comprehensive rules governing the taxation of nonqualified deferred compensation. Very generally, "deferred compensation" is broadly defined as any form of compensation which is payable in the year after the year in which the legal right to payment arises. Severance payments are considered a form of deferred compensation subject to Section 409A unless an exception or exemption applies. Failure to comply with Section 409A results in full taxation of all deferred compensation of the same type, plus a 20% penalty tax, plus interest if compensation was deferred in a year before the year of the violation.

This Note describes different types of severance benefits and explains when and how they are subject to the rules of Section 409A.

For more information, see *Practice Note, Section 409A: Deferred Compensation Tax Rules (www.practicallaw.com/6-501-2009)*.

SEVERANCE BENEFITS SUBJECT TO SECTION 409A

The general rule is that severance benefits are a form of deferred compensation subject to Section 409A unless an exception or exemption applies. The fact that severance is subject to Section 409A does not in itself result in any tax penalties. However, severance benefits that are subject to Section 409A must satisfy the requirements of Section 409A, including the following:

- No payments that are triggered by a termination of employment or a separation from service can be made to a "specified employee" (see *Practice Note, Specified Employees Under IRC Section 409A (www.practicallaw.com/7-501-1330)*) of a publicly-traded company until six months after termination.
- Payments must be triggered by one of the payment events permitted by Section 409A:
  - on a specified date or fixed schedule;
  - death;
  - separation of service (see Separation From Service);
  - disability;
  - change of control; or
  - unforeseen emergency.
- Elections of the form of payment must be made before the year in which compensation is earned.
- Employer and employee discretion about the time and form of payment is no longer allowed.
- Certain terms such as "separation from service" and "change of control" must match the definitions outlined in Section 409A.

Section 409A applies to independent contractors (including directors) as well as employees (see *Practice Note, Section 409A: Deferred Compensation Tax Rules: Basic Section 409A Requirements (www.practicallaw.com/6-501-2009)*).

Separation from Service

Generally, the most common Section 409A payment event giving rise to severance benefits is a "separation from service". However, the Section 409A definition may or may not be different from the company's practice on termination of employment.

Under Section 409A, a separation from service occurs when the employer and employee anticipate one of the following at the time of the termination of employment:

- The employee will not perform any further services after a certain date.
- The level of services that the employee will perform after a certain date (whether as an employee or an independent contractor) is no more than 20% of the average level of services the employee performed in the previous 36 months.

In general, a separation from service requires an 80% reduction in the average level of services, but agreements may provide a threshold of as low as 50%.

If an employee has been terminated but continues to perform services as a consultant or in another capacity for the employer or any affiliate, the employee may not have a separation from service if the level of services is above the threshold level. However, a change in status from director to employee or vice versa can qualify as a separation from service.

An employee who ceases to perform services but is kept on the payroll for other purposes (for example, continuation of medical coverage) has separated from service (see *Practice Note, Section 409A: Deferred Compensation Tax Rules: Separation from Service (www.practicallaw.com/6-501-2009)*).

Tax Reporting of Severance Pay

Severance pay must generally be reported on Form W-2 (or Form 1099-MISC for an independent contractor) in the year of termination rather than the year of payment if it is subject to Section 409A. While this does not mean that it is taxable in the year of termination, it must be reported. However, the IRS has waived this reporting requirement until it finalizes the regulations on reporting compensation subject to Section 409A.

SEVERANCE BENEFITS EXEMPT FROM SECTION 409A

Certain types of severance benefits are exempt from Section 409A because they do not involve the deferral of compensation. Other types of severance benefits may be exempt under special rules. Severance benefits can be exempt from the Section 409A rules under the following circumstances.

No Legally Binding Right to Compensation

If the employee has no legally binding right to receive compensation in a future year, there is no deferred compensation in the first place. This is the case with severance benefits that the company can eliminate at any time before the termination. Most broad-based severance plans are designed in this manner and are exempt from Section 409A if the severance pay is paid in a lump sum shortly after termination. If severance pay is paid in installments that could be paid in years after the year of termination, the severance pay may be subject to Section 409A unless it meets one of the other exceptions.

For the same reason, severance benefits that are negotiated at the time of termination, to which the employee had no previous legal right, are also not subject to Section 409A. However, if the severance benefits are in lieu of other rights that were subject to Section 409A, the severance benefits are then subject to Section 409A as well (see *Practice Note, Section 409A: Deferred Compensation Tax Rules: Substitution Constitutes a Deferral of Compensation (www.practicallaw.com/6-501-2009)*).

Disputes About Entitlement

If there is a bona fide dispute concerning the employee's entitlement to a form of compensation that is otherwise subject to Section 409A, a lump sum payment in settlement of the dispute does not violate the rule against accelerating payment of deferred compensation provided that the amount paid does not exceed 75% of the employee's claim. For example, assume an executive has an employment agreement providing that he be paid two years of base salary in installments if terminated without cause and that the total amount of payments to which the executive is entitled is $1 million. If the company and the executive have a bona fide dispute about whether he was terminated for cause and they agree to settle the dispute by a lump sum payment of $500,000, the payment in a lump sum does not violate Section 409A even though an accelerated payment of deferred compensation is generally prohibited.

Payments Satisfying the Short-term Deferral Rule

Payments made within a short time frame after the close of a year are not deferred compensation. This is called the short-term deferral rule. If the employer uses a calendar year, compensation that is paid no later than March 15 after the year in which the employee's right to compensation is no longer subject to a substantial risk of forfeiture is exempt under the short-term deferral rule (see *Practice Note, Section 409A: Deferred Compensation Tax Rules: Substantial Risk of Forfeiture (www.practicallaw.com/6-501-2009)*). If the employer uses a fiscal year, the compensation must be paid by the later of March 15 or 2½ months after the end of the employer's fiscal year. Applying the short-term deferral rule to severance payments means that severance must be paid no later than March 15 of the year following the year in which the right to the severance is no longer subject to a substantial risk of forfeiture (see *Substantial Risk of Forfeiture*).

If payment of the severance is conditioned on the employees' execution of a release of claims, as is commonly the case, this can cause the severance payments to fail to qualify under the short-term deferral rule even if the severance is actually paid by March 15 of the following year, unless the severance agreement specifies a deadline by which the release must be signed or the severance is forfeited. IRS Notice 2010-6 specifies the circumstances under which a release provision does not cause a severance agreement to violate Section 409A and permits severance agreements that do not comply with the requirements to be amended by December 31, 2010 (see *Effect of a Release of Claims or Noncompetition Provision*).

The short-term deferral rule applies to lump sum severance pay that is paid not later than March 15 of the following year. If the severance pay is paid in installments, the short-term deferral rule can apply to the installments paid by March 15 if the agreement provides that each installment is a separate payment for Section 409A purposes.

The short-term deferral rule cannot be used for payments that are a substitute for other types of deferred compensation even if the payments are made by March 15.

Note that if a contract provides that the employee has walkaway rights to resign without good reason and receive severance benefits after a specified occurrence (usually a change of control), the short-term deferral rule does not apply after the vesting event occurs if the payment could occur after March 15 of the following year.

For example, an executive's contract provides that he is entitled to severance pay if he resigns within one year following a change of control. Because his resignation may occur after March 15 of the year following the change of control, the short-term deferral rule no longer applies to his severance pay once the change of control occurs and the severance pay is subject to Section 409A even if payment is actually made by March 15.

Substantial Risk of Forfeiture

Applying the short-term deferral rule depends in part on whether the right to the severance benefits is subject to a substantial risk of forfeiture before the date of termination. As a general rule, if the severance benefits are payable only on an involuntary termination, they are subject to a substantial risk of forfeiture. However, if the severance benefits are also payable on certain voluntary resignations, such as good reason resignations, the benefits may not be considered forfeitable. The good reason rules (see *Termination for Good Reason*) are used as a guideline for determining if the right to severance benefits is forfeitable.

Effect of a Release of Claims or Noncompetition Provision

A waiver or release of claims or a restrictive covenant in a severance agreement do not subject an employee's separation pay to a substantial risk of forfeiture. Where the employee has control over the performance of a condition (such as whether to sign a noncompetition agreement or to release claims), a substantial risk of forfeiture does not exist. The separation pay is subject to Section 409A and must meet the Section 409A payment timing requirements. To solve this problem, the agreement should provide for payments at a fixed time or on a fixed schedule, subject to the employee signing and not rescinding a release of claims or noncompetition agreement.

Severance Pay Exception

Severance pay that is payable only on involuntary termination (or voluntary termination under a window program lasting not more than 12 months, (see *Definition of Window Program*) is exempt from Section 409A if it meets the following conditions:

- It is paid by the end of the second year following the year of termination.
- It does not exceed the lesser of two times the:
  - employee's base salary at the end of the year before the year of termination; or
  - limit on compensation under a qualified retirement plan (currently $245,000 in 2010).

To qualify for this exception, the severance pay must be payable only on involuntary termination of employment (or voluntarily under a window program). If the agreement permits payment on voluntary termination of employment (other than under a window program), it doesn't qualify for the exemption even if the employee's actual termination is involuntary.

Definition of Window Program

A window program is a program established by an employer that is made available for a limited period of time (no longer than 12 months) to employees who separate from service during that period under specified circumstances. A program is not considered a window program if the employer establishes a pattern of repeatedly providing for similar separation pay in similar situations for substantially consecutive, limited periods of time. This determination is based on certain facts and circumstances, including:

- Whether the severance pay is on account of a specific business event or condition.
- The degree to which the separation pay relates to the event or condition.
- Whether the event or condition is temporary or discrete or is a permanent aspect of the employer's business.

Termination for Good Reason

Many companies allow employees to resign if a good reason event occurs but still receive severance benefits as if the employees were terminated involuntarily. Under Section 409A, a resignation for "good reason" qualifies as involuntary termination only if the definition of good reason specified in the agreement meets either the Section 409A general definition or the safe harbor.

The general definition is a "material negative change" in the employment relationship, and also takes into account factors such as the notice the employee must give and whether the severance is the same as for an involuntary termination.

The good reason safe harbor requires that the separation from service must occur during a predetermined limited period of time of up to two years after one of the following conditions arise (the good reason conditions must arise without the consent of the employee):

- A material diminution in:
  - base compensation;
  - authority, duties or responsibilities;
  - authority, duties or responsibilities of the supervisor to whom the employee reports, including a requirement that the employee report to a corporate officer or employee instead of reporting directly to the board of directors; or
  - the budget over which the employee has authority.
- A material change in the geographic location where the employee must work.
- Any other action or inaction by the employer constituting a material breach of the employment arrangement or agreement.

In addition, two conditions must be met for the good reason safe harbor to be satisfied:

- The amount, time and form of the payment for good reason termination must be substantially identical to payment made on an actual involuntary separation from service.
- The employee must give notice of the existence of one of the good reason conditions within 90 days of the condition first occurring and the employer must have 30 days to cure the condition.

The severance agreement should be drafted carefully. A too liberal good reason clause is considered a voluntary termination, even if the employee is terminated involuntarily

Collectively Bargained Severance Arrangements

If set out in a collective bargaining agreement and applied to employees covered under that agreement, severance pay is not subject to Section 409A.

EMPLOYEE BENEFITS AND PERKS

In addition to cash severance payments, there are several special rules that apply to different benefits and perks that may be payable following termination.

Continued Medical Coverage and Medical Reimbursements

Continued medical coverage is not subject to Section 409A if it is not taxable to the employee.

Medical coverage that is taxable to the terminated employee, for example, coverage that is provided by a self-insured health plan that does not meet IRS non-discrimination rules, is not subject to Section 409A during the COBRA continuation health coverage period (for example, 18 months). However, if medical coverage lasts longer than 18 months, the coverage must comply with Section 409A (see *Reimbursements Subject to Section 409A*).

Many employers take the position that continued medical coverage is never taxable. However, when an employer with a self-insured medical plan provides more generous post-termination medical coverage for highly compensated employees than it provides for the rank and file employees, the coverage may be taxable. This is an unsettled area and even if an employer believes that its medical coverage is not taxable, it may wish to ensure that it satisfies the Section 409A requirements to avoid the potential for a penalty tax.

In-kind Benefits

Reimbursement for moving expenses, outplacement services and any other expenses that the employee could deduct if he paid for them himself are exempt from Section 409A if the expenses are reasonable and are incurred by the end of the second year after termination. Reimbursements must be made no later than the end of the third year after termination.

Continued Life and Disability Insurance Coverage

Continued life and disability coverage are exempt as welfare benefits even if otherwise taxable.

Miscellaneous Severance Amounts

A catch-all provision in Section 409A allows a limited amount of otherwise taxable perks, such as continued car allowance and club dues, to be exempt from Section 409A. The dollar amount is tied to the 401(k) maximum contribution limit, which is $16,500 (for 2010). Anything that exceeds this amount is subject to Section 409A, unless it satisfies another exemption.

REIMBURSEMENTS SUBJECT TO SECTION 409A

To satisfy Section 409A payment timing rules, reimbursements subject to Section 409A must comply with the following requirements:

- Expenses eligible for reimbursement must be clearly and objectively defined.
- Reimbursement must be available for expenses incurred during a defined time period such as five years. The employee's lifetime is also a permitted time period.
- There must be a specified annual maximum amount of payments with no carryover between years. However, reimbursement of medical expenses can have a lifetime rather than annual maximum.
- Reimbursements must be paid by the end of the year after the year in which the expense is incurred.
- The reimbursement right cannot be liquidated or substituted for other rights.

PAYMENT OF DEFERRED AND EQUITY COMPENSATION

If the agreement also provides for an acceleration of the vesting or payment of the employee's deferred or equity compensation, the requirements of Section 409A must be followed.

Stock Options and Stock Appreciation Rights

The vesting or exercisability of options and stock appreciation rights (SARs) may generally be either accelerated or extended to not later than the original expiration date or ten years from the grant date. Extension or acceleration of an option or SAR that was not originally subject to Section 409A does not make it subject to Section 409A.

Other Types of Equity Compensation

Vesting of restricted stock may be accelerated without subjecting the restricted stock to Section 409A.

If other types of compensation, such as restricted stock units, long-term incentive plans with a performance period of more than a year and supplemental employee retirement plans, are already subject to Section 409A, vesting can be accelerated but changes in the time or form of payment cannot be made.

Incentive Compensation

If the employee has the right to receive incentive compensation on termination regardless of whether incentive targets are met, the employee may be required to make any election to defer his incentive compensation before the beginning of the performance period, rather than six months before the end of the performance period (see *Practice Note, Section 409A: Deferred Compensation Tax Rules: Timing of Deferral Elections (www.practicallaw.com/6-501-2009)*).

CHANGE OF CONTROL PROVISIONS

The Section 409A regulations contain a definition of change of control which in many cases is different from the definition used in a company's other compensation plans.

A change of control definition that does not comply with Section 409A can result in accelerated vesting of deferred compensation, but it cannot result in accelerated payment of amounts already subject to Section 409A. Instead, payment on a change of control or on termination following a change of control is permitted only if the change of control qualifies under Section 409A (see *Definition of Change of Control*).

For example, an executive's agreement provides for 18 months severance payable in installments on termination of employment before a change of control or 36 months severance payable in a lump sum on termination of employment after a change of control. If the change of control does not satisfy the Section 409A definition, then half of the severance (representing the first 18 months) must be paid in installments. However, a portion of the first 18 months may be exempt from Section 409A under either the short-term deferral or severance plan exemptions (see *Box, Example: Interaction of Short-term Deferral Rule with Exception for Involuntary Severance Pay*).

Definition of Change of Control

The following constitute a change of control under Section 409A:

- Purchase of 50% of the company's stock measured by value or voting power.

EXAMPLE: INTERACTION OF SHORT-TERM DEFERRAL RULE WITH EXCEPTION FOR INVOLUNTARY SEVERANCE PAY

Assume an executive, who is a specified employee of a public company, has an employment agreement that provides that if he is involuntarily terminated or resigns for "good reason" (defined in a manner that satisfies Section 409A), is entitled to 1½ times his base salary plus target bonus, paid over 18 months. He is terminated on December 31, 2009, when his base salary is $600,000 and his target bonus is 100%. He is entitled to $1.8 million in severance, payable in eighteen monthly installments of $100,000 apiece. His base salary on December 31, 2008, was $550,000. The company uses the calendar year for its fiscal year. The agreement requires the executive to sign a release to receive the severance but it specifies the time by which the release must be signed in a manner that satisfies Section 409A.

If the agreement provides that each installment is treated as a separate payment for Section 409A purposes, then the first three installments, payable on January 1, February 1, and March 1, 2010, totaling $300,000, are exempt and can be paid even though six months have not passed since the termination.

For the remaining $1.5 million, the lesser of two times his base salary in the year before termination ($550,000) or the compensation limit in 2009 ($245,000) is $490,000, so the first $490,000 is exempt as paid under a severance plan. Therefore, the payments due on April 1, May 1, June 1 and July 1, and 90% of the August 1, 2010 payment, are also exempt from Section 409A. Although the remaining $1.01 million is subject to Section 409A, by the time it becomes payable, the six months will have expired, so no further delay is required. However, it is still subject to Section 409A and no change in the payment schedule can be made.

Now assume that the same executive's agreement provides that if his employment is terminated without cause or for good reason following a change of control, he is entitled to three years base salary and bonus ($3.6 million), payable in a lump sum on termination, and defines a change of control as sale of 25% of the company's stock. A change of control occurs on December 1, 2009, and he is terminated on December 31, 2009, as described above.

Because the change of control did not satisfy the Section 409A definition, it cannot result in an acceleration of payment. Accordingly, $1.01 million of his severance (the portion that would have been paid even if a change of control had not occurred and was subject to Section 409A) must be paid in installments as described above and the remaining $2.59 million can (and must) be paid in a lump sum.

- Purchase within one year of stock having 30% of the voting power. A higher percentage can be set but the agreement cannot distinguish between different blocks of stock.
- Change in a majority of board membership over a one-year period.
- Transfer of at least 40% of gross value of assets (a higher percentage can be set in the agreement) to an unrelated party. Approval of a merger or liquidation per se is not qualified, but the asset transfer rule can pick up most of these transactions.

The company that undergoes the change of control must be the employee's employer, its parent or another company that has guaranteed payment of the deferred compensation for a valid non-tax reason (*Practice Note, Section 409A: Deferred Compensation Tax Rules: Definition of Change in Control (www.practicallaw.com/6-501-2009)*).

STACKING OF EXEMPTIONS/EXCEPTIONS

The exemptions for various types of severance pay may be applied in combination, or stacked. For example, the severance pay exception can be used in conjunction with the short-term deferral rule, as shown in the example below.