NAVIGATING **SEVERANCE ARRANGEMENTS** IN THE SECTION 409A SEA CHANGE

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Section 409A of the Internal Revenue Code (the "Code"), and the subsequently issued proposed regulations, 70 Fed. Reg. 57930 (Oct. 4, 2005), establish an entirely new regime to address the operation of nonqualified plans that provide for the deferral of compensation. Previous Points in this NEWSQUARTERLY have discussed various aspects of the changes wrought by the enactment of section 409A. *See, e.g.,* David Pratt, *The Not-So-Brave New World of Deferred Compensation*, Sec. Tax'n NEWSQUARTERLY, Fall 2005 at 8. This Point will address the implication of section 409A for severance arrangements.

Under the new regime, typical severance arrangements are treated as plans that provide for the deferral of compensation, even though few would have considered such arrangements to be deferred compensation prior to the enactment of section 409A. Thus, both severance compensation under broad based severance plans and individual severance arrangements must be tested to determine compliance with section 409A. A failure to do so may expose participants in such arrangements to the 20% tax and interest provisions of section 409A.

EXCEPTIONS TO THE APPLICATION OF SECTION 409A

Severance arrangements, as well as deferred compensation generally earned and vested prior to January 1, 2005 are grandfathered and not subject to section 409A, provided that such arrangements are not materially modified after October 3, 2004. In order to be earned and vested, the compensation must not be subject "to either a substantial risk of forfeiture (as defined in [Treas. Reg.] §1.83-3(c)) or a requirement to perform further services." Notice 2005-1, Q&A #16. Unfortunately, as virtually all severance arrangements require continued service by the employee until actual termination, few, if any, severance arrangements with current employees would be considered earned and vested prior to the date on which an employment relationship terminates. Therefore, virtually any existing severance arrangement with a current employee will not fit into this exception. Of course, payments made under severance arrangements which were earned and vested prior to January 1, 2005 (where, for example, an employee terminated employment prior to this date) will continue to remain subject only to prior law and will avoid taxation under section 409A.

For currently existing severance arrangements, one of two broad based exceptions from the application of section 409A may be available. First, any severance arrangement that is payable upon an involuntary separation from service (or which is part of a window program) and that is collectively bargained under an arms-length negotiation will not be considered to provide a deferral of compensation. Prop. Reg. §1.409A-1(b)(9)(ii). Second, an exception from deferral of compensation also exists for employees who are not parties to a collectively bargained agreement. To qualify for this exception, payments upon the involuntary separation from service (or under a window program) under these types of arrangements must not exceed the lesser of: (a) two times the employee's annual compensation in the calendar year prior to the year of the separation from service or (b) two times the maximum limit on annual compensation under qualified plans under section 401(a)(17) for such year (this limit is $210,000 in 2005 and $220,000 in 2006). Prop. Reg. §1.409A-1(b)(9)(iii)(A). Additionally, to use this exemption from section 409A, all payments must be fully made by the end of the second calendar year after the year in which the separation from service occurs. Prop. Reg. §1.409A-1(b)(9)(iii)(B). These exceptions allow many involuntary separation arrangements for rank and file employees, and even for some executives, to remain unaffected by section 409A.

Under yet another exception, the short-term deferral exception, severance pay will not be considered deferred compensation if at all times all severance payments will be made within 2½ months after the end of the later of the employer's or employee's fiscal year in which the severance payments were no longer subject to a substantial risk of forfeiture. Prop. Reg. §1.409A-1(b)(4). Thus, severance payments under an involuntary separation arrangement made in a lump sum or over a short period (up to 14½ months depending on the date the employee terminates) would not be subject to section 409A.

ISSUES WITH GOOD REASON

Unfortunately, language in the Preamble to the section 409A proposed regulations raises significant concerns about the application of the short-term deferral exception. The Preamble leaves open the question whether the inclusion of a provision for constructive termination or for termination for "good reason" would result in the severance arrangement no longer being subject to a substantial risk of forfeiture. According to the Preamble, "the Treasury Department and the IRS are not confident that amounts payable upon a voluntary separation from service, and amounts payable only upon a termination of services for good reason, always may be adequately distinguished…. 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." 70 Fed. Reg. 57941. Many employment contracts include a good reason termination provision on the theory that an employer should not be able to force the employee to resign by materially altering aspects of an employment arrangement to avoid paying the con-

tractually agreed severance. Under the Service's current interpretation, the inclusion of such constructive termination provision to protect the employee may lead any such severance arrangement not only to be classified as free from a substantial risk of forfeiture, but also to fail to qualify as an involuntary separation agreement.

The position taken in the Preamble has two consequences. First, commencing with the date that the arrangement is executed, the payments will not be considered to be subject to a substantial risk of forfeiture. Thus, the short-term deferral rule will not be applicable and the deferred amounts must then comply with section 409A. For severance arrangements, the most troublesome issue in complying with section 409A arises with respect to specified employees of public companies (as defined in section 416(i) without regard to paragraph (5)). Section 409A provides that payments made to a specified employee of a publicly traded corporation upon a separation from service must be delayed for at least six months following that separation. I.R.C. § 409A(a)(2)(B)(i). If the short-term deferral exception applied, payments to a specified employee could be made immediately in lump sum (or in installments that would otherwise comply with the short-term deferral exception); however, if the specified employee's severance arrangement includes a good reason termination provision, then, under the Service's current interpretation, the employee may not be able to receive payments during the six-month waiting period. This remains the case even if the employee does not exercise the good reason provision and is actually terminated without cause by the employer (provided that the employee would receive the same or greater payments upon a good reason termination as the employee would receive upon a termination without cause).

Second, the arrangement might no longer be considered solely an involuntary separation arrangement. Because section 409A imposes a tax at the plan level, a violation of section 409A in a single plan in a category of deferred compensation will cause all plans in the same category to become subject to the penalty and interest provisions of section 409A. There are four categories of plans for deferred compensation: account balance plans, non-account balance plans (such as defined benefit retirement plans), involuntary separation plans and all other plans (including equity awards governed by section 409A). Prop. Reg. §1.409A-1(c)(2). Thus, if a severance contract with a good reason provision is simultaneously an involuntary separation arrangement and also an "other" plan, and if such contract were to fail to comply with section 409A, then all severance arrangements as well as all plans in the other category could be immediately subject to the penalty and interest provisions of section 409A.

Finally, the Service's position regarding good reason provisions is inconsistent even within section 409A. The preamble notes that payments upon a purely voluntary separation from service may not always be adequately distinguished from true constructive terminations; therefore the inclusion of a good reason provision may be tantamount to the absence of a substantial risk of forfeiture. However, when addressing grandfathered arrangements, the inclusion of the same good reason provision does not make the benefits under an arrangement earned and vested. Given this double standard, planners must carefully consider the Service's position on good reason provisions.

COMPLYING WITH SECTION 409A

Complying with section 409A generally means ensuring that payments deferred under the severance arrangement follow the election and distribution rules under the Code. The initial election to defer compensation must generally be made on or before the end of the fiscal year immediately preceding the first fiscal year in which the services relating to the compensation are first performed. I.R.C. § 409A(a)(4). Under separation agreements negotiated around the time of the employee's termination, it seemed that no valid election could be timely made, as the compensation payable would arguably have related to services performed either in the current year or even in prior years. Fortunately, the Service has in the proposed regulations provided that the initial election for involuntary separation arrangements (as stated above, this would apparently not currently include arrangements where a good reason termination was applicable) may be made up to the time the employee has a binding right to the payment, provided that such severance compensation is the subject of an arm's length negotiation. Prop. Reg. §1.409A-2(a)(9).

Although section 409A requires that distributions generally be made under a fixed schedule, severance plans raise special issues. Although payments under a compliant plan may generally be spread over any fixed period of time agreed to by the parties, certain items of severance must be restricted to a limited payment period to comply with section 409A. For example, reimbursement arrangements generally do not comply with the distribution rules under section 409A. However, some reimbursement arrangements, such as moving expenses or reimbursements of medical coverage under a discriminatory health plan, will be exempt from section 409A provided that reimbursements for taxable amounts expire by the end of the second taxable year following the year of the termination of service. Prop. Reg. §1.409A-1(b)(9)(iv). These types of reimbursement arrangements are exempt regardless of whether the termination was involuntary or voluntary, i.e., under a severance arrangement providing for good reason. Also, as discussed above, distributions of deferred compensation under a section 409A compliant plan to a specified employee on account of a termination of severance must not commence until

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CLE CALENDAR

All programs listed below are subject to rescheduling or cancellation. For the latest information, please refer to the corresponding contact information.

DATE	PROGRAM	INFORMATION
May 17	**SALT & Tax Shelters - Policy, Practices & Problems** Washington, DC, Georgetown University Law Center CLE	ABA Tax Section **www.law.georgetown.edu/cle** 202-662-9890
May 31	**"Last Wednesday" Teleconference: New Bankruptcy Act - Tax and Nontax Issues Relating to the Closely Held Business and Its Owners**	ABA Tax Section **www.abanet.org/tax** 202-662-8670
June 8-9	**Charitable Giving Techniques**, Boston, MA	ALI-ABA **www.ali-aba.org** 800-253-6397
June 22	**Tax CLE on the Road: Tax Aspects of Real Estate Transactions** Atlanta, GA	ABA Tax Section; Atlanta Bar Tax Section; Georgia Bar Tax Section **www.abanet.org/tax** 202-662-8670
June 28	**"Last Wednesday" Teleconference: Fiduciary Income Tax (Topic TBA)**	ABA Tax Section **www.abanet.org/tax** 202-662-8670
July 19-21	**Estate Planning for the Family Business Owner** Chicago, IL	ALI-ABA **www.ali-aba.org** 800-253-6397
August 3-8	**ABA Annual Meeting** Honolulu, HI	ABA Meetings & Travel **www.abanet.org/annual/2006** 800-285-2221
October 5-6	**Consolidated Tax Return Regulations** Washington, D.C.	ALI-ABA **www.ali-aba.org** 800-253-6397

SECTION MEETING CALENDAR
www.abanet.org/tax/meetings

2006	**JOINT FALL CLE MEETING**, **October 19-21**, Hyatt Regency, Denver, CO
2007	**MIDYEAR MEETING**, **January 18-20**, Westin Diplomat, Hollywood, FL
	MAY MEETING, **May 10-12**, Grand Hyatt, Washington, DC
	JOINT FALL CLE MEETING, **September 27-29**, Hyatt Regency and Fairmont, Vancouver, BC
2008	**MIDYEAR MEETING**, **January 17-19**, Hyatt Regency and Ritz Carlton, Lake Las Vegas, NV
	MAY MEETING, **May 8-10**, Grand Hyatt, Washington, DC
	JOINT FALL CLE MEETING, **October 9-11**, Hyatt Regency, Chicago, IL

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at least six months after a termination of service.

AMENDING EXISTING ARRANGEMENTS

Employers should review separation plans and employment contracts to ensure that timing of payments as well as the benefits payable under those plans either comply with or are exempt from section 409A. Additionally, if the Service maintains an unfavorable position on good reason provisions, the parties to a severance contract, especially for key employees at public companies, should determine whether the existence of a constructive termination provision is more important than potentially having to wait at least six months for severance payments to begin. The Preamble to the proposed regulations provides that such amendments to comply with section 409A may only be made until December 31, 2006, so employers should undertake such reviews as soon as possible. ■