

The Final Word on Separation Pay Under Tax Code §409A

Problem

Separation pay is ubiquitous. It is paid as a post-termination benefit under employment agreements and written severance plans, as well as under unwritten programs, practices and other arrangements. Until §409A was added to the Internal Revenue Code, few thought of it as “deferred compensation.” But under §409A, if a legally binding right to separation pay is created in one year, and may be paid in another year, it constitutes non-qualified deferred compensation.

Under the final Treasury regulations, issued April 10, 2007, companies have only until December 31, 2007 to bring their employment agreements, plans, programs and practices into full written compliance. The regulations are complex and intertwined. For example, separation pay of key employee of public companies is subject to a six month delay, and these employees must be specifically identified. Also, not every termination of employment is a §409A “separation of service,” permitting separation payments. In addition, each separation payment must specify time and form of payment. “Payable as soon as practicable after termination,” for example, is not sufficient. Finally, reliance on “saving clauses,” which delete and replace non-compliant language, is not allowed, and penalties for violation of §409A are onerous.

How can a company work within or fit under an exception to §409A?

Solution

1. Comply in Writing. This means, among other things, following detailed rules about when and how (i) employee deferral and distribution elections of separation pay will be made; (ii) separation pay and reimbursement or payment of post-separation benefits will be calculated and paid; (iii) key employees will be identified; and (iv) subsequent deferrals will be allowed.

2. Fit Within the Exceptions, Which Can be Stacked, One Atop the Other.

Short term deferral – Applies to any type of separation from service if payment must be made before the later of 2 ½ months following the end of either the employee’s or the employer’s first taxable year (commonly March 15th of the next calendar year), after separation from service. No further deferral is allowed. *Advantage:* Preempts six month delay in separation payments to key employees. *Caveat:* The entire separation payment must be received within the 2 ½ month time period or the exception fails to apply to all payments, both within and outside this period. Also, if the 2 ½ month time period is not in writing, the “fail-safe” provisions of §409A will not apply.

Limited amount/limited period – Applies to payment(s) made due to an involuntary separation of service or a “window” program (e.g., an early retirement program), where (i) payment(s) does not exceed two times the employee’s annualized pay for the year preceding the separation of service, or two times the compensation limit for tax qualified retirement plans in Code §401(a)(17) (\$225,000 in 2007), whichever is less; and (ii) payment(s) is made no later than the end of the employee’s second tax year following separation from service. *Advantage:* Bypasses six month delay in separation pay to “key” executives. Even if the executive’s total payments exceed the limit, the exception applies to those made within the maximum time-frame. Also, a “good reason” separation from service may qualify if it meets §409A’s requirements for “material negative change” in employment relationship. *Caveat:* Public statement and filings must accurately describe a termination as “involuntary.”

Collectively bargained benefits – Applies to severance pay plans or window plan benefits, the subject of good faith bargaining, in a collective bargaining agreement.

Foreign separation pay benefits – Applies to payments required under plans covered by tax treaties, tax equalization agreements, etc.

Non-taxable benefits – Applies to payment for non-taxable items otherwise deductible by the employer. *Advantage:* Covers almost all employer-sponsored health plans.

Reimbursable expenses – Applies to reasonable moving expenses, outplacement services, and loss due to the sale of a primary residence incurred as a direct result of separation from service. Also, taxable medical expense reimbursements during COBRA, if elected. *Caveat:* Expense must be incurred before the employee’s second tax year following separation ends and paid before the third tax year ends.

In-kind benefits – Applies to continued use of company car or aircraft, membership dues, or payment for financial or tax advice. *Caveat:* same as above.

Incidental amounts – Applies to payments not exceeding Code § 402(g)’s limit (the deferral limit applicable to §401(k) plans and other defined contribution retirement plans), which is \$15,500 in 2007.

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