

Morgan Lewis

together

## Final 409A Regulations: Severance and Distribution Issues

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# Agenda

- Overview of 409A Distribution Rules
  - Distributable events
  - Restrictions on distributions to specified (“key”) employees
- Severance
  - Which payments are subject to 409A?
    - May be subject to the six-month delay if made to key employees
  - What flexibility do employers have in structuring severance payments?

# New Code Section 409A: General Rules

- Deferred compensation results in current taxable income as of the date the income is fully earned and not subject to a substantial risk of forfeiture unless the 409A rules are met.

# Failure to Comply

- Compensation deferred under the plan is included in gross income when not subject to a substantial risk of forfeiture (not deferred to time of actual distribution)
- In addition to income inclusion, the following apply (to the individual):
  - Penalty tax of 20% of amount included in income and
  - Interest is assessed on the tax underpayments (at underpayment rate plus 1%)

# 409A Distribution Rules

- Permitted distribution events
  - Specified time or fixed schedule
  - Separation from service
    - Six-month payment delay for “key” employees
  - Death
  - Disability (within the definition of 409A)
  - Change in control (CIC) (within the definition of 409A)
  - Unforeseeable financial emergency
- Can combine events and provide for distribution at the earlier of/after of permitted distribution events

## 409A Distribution Rules

- Plan generally must provide for a single time and form of payment with respect to each payment that is triggered by a specific payment event
  - Cannot provide multiple payment times for same payment type (e.g., lump sum if hostile CIC, installment payments if friendly CIC)

# 409A Distribution Rules

- Participant elections as to form/timing of payment
  - Must be made within 30 days of first eligibility for participation
    - First eligibility based on all similar types of plans that are aggregated for 409A purposes
  - Subsequent changes in form/timing of payment must be made at least 12 months prior to, and must defer payment for at least five years after, time payment would otherwise have commenced
    - Payment means a separately identified amount that may be determined under an objective formula (e.g., 10% of an account balance)

# Key Employee

- A “key employee” of a public company is:
  - An officer having annual compensation greater than \$135,000 for 2005 (up to 50 employees)
  - Employee who is a 5% owner
  - Employee who is a 1% owner and has annual compensation greater than \$150,000

# Severance Pay

- Separation pay - compensation conditioned upon separation from service
  - Includes separation for death or disability
  - Does not include compensation that would also be paid absent separation, e.g. payment upon a CIC
- Requires performance of service until separation
  - Payments may be excluded from 409A under “2½ month rule”

# Separation Pay

- Exceptions to deferred compensation (not subject to six month delay if paid to key employee)
  - Involuntary separation or window programs (separation pay exception)
  - Limited amounts (up to the IRC 402(g) limit, e.g., \$15,500 for 2007)
  - Expense reimbursement or in-kind service arrangements made within a limited period of time

# Separation Pay

- Exceptions to deferred compensation
  - Collectively bargained arrangements
  - Foreign separation pay arrangements
  - Indemnification and liability insurance coverage
  - Legal settlements of bona fide employment-related claims
  - Educational expenses of the employee

## Payments Due Upon Involuntary Termination Excluded from 409A

- Lump-sum payments made within the 2½ month short-term deferral period
- Payments made under the separation pay exception
  - Payments made only on account of (i) an involuntary termination of employment to the extent that they satisfy a dollar threshold and are paid within two years following the year of separation, or (ii) a window program

# Involuntary Termination

- Whether termination is involuntary is based on facts and circumstances
  - Rebuttable presumption that the characterization by the parties given in the documentation is correct

# Involuntary Termination

- “Good reason” termination (voluntary termination for cause) may constitute involuntary termination
  - Avoidance of 409A must not be a purpose of the good-reason condition
  - Must require actions taken by the service recipient resulting in material negative change in employment relationship
  - Other factors taken into account

# Involuntary Termination

- Good reason safe harbor
  - Amount payable only if separation occurs within a limited period (not to exceed one year) following existence of good-reason condition
  - Amount, time, and form of payment upon good-reason separation identical to amount, time and form of payment upon involuntary termination
  - Service provider must give notice and cure period to service recipient

# Involuntary Termination – Good Reason Safe Harbor

- Safe harbor good reason condition may consist of one or more of a material diminution of service provider's:
  - Base compensation (not bonuses or benefits)
  - Authority, duties, or responsibilities (or responsibilities of supervisor)
  - Budget authority
- May also consist of a material change in geographic location or material breach in terms of applicable employment agreement

## Involuntary Termination – Good Reason Safe Harbor

- A good-reason termination clause that does not clearly constitute an involuntary termination event may not be amended now to cure
  - Can't amend to add a substantial risk of forfeiture
  - If the good-reason termination clause does not meet the statutory exception, may still constitute an involuntary termination based on facts and circumstances

# Involuntary Termination

- Does not apply if amounts may be paid for other reasons, even if actually paid for involuntary termination
- Plans that provide payment only upon an involuntary termination are treated as a separate plan for 409A plan aggregation rules
  - Nine plan types; all deferred compensation under each plan type is aggregated. A failure to satisfy 409A under any one plan causes all plans with which it is aggregated to fail as well

# Separation Pay Exception

- Payments due solely to involuntary termination or participation in a window program
- Limited to the lesser of 2X annual compensation or 401(a)(17) dollar limit
  - Lesser of 2X compensation or \$450,000 for 2007
    - Compensation based on annual rate of pay for services (e.g., excluding options) for the taxable year preceding taxable year of separation
- Payable no later than end of second year following the separation from service

## Reimbursement and Fringe Benefit Plans

- Certain reimbursement arrangements are excluded from 409A deferred compensation
  - Reimbursements only for expenses incurred
  - For a limited period of time (generally not more than two taxable years after the separation; provided that medical reimbursements may continue for COBRA continuation of coverage period)
  - Exception applies equally for payments upon involuntary/voluntary termination

## Reimbursements and Fringe Benefits

- If not excluded from 409A, may be structured to satisfy the specified time or fixed schedule of payments requirement
  - Reimbursements/in-kind benefits for an objectively prescribed period
  - Amount of reimbursable expenses incurred (or in-kind benefits provided) in one year cannot affect amount of reimbursable expenses incurred in another year

# Voluntary Termination

- Distributions that are not subject to 409A
  - Small amounts (not in excess of IRC 402(g) limit for the year)
  - Expense reimbursements or in-kind service arrangements made within a limited period of time
- Other payments may constitute deferred compensation, not eligible for 2½-month rule
  - Distribution must conform to 409A rules
    - Subsequent election rules as to time/form of payment apply

# Substitute for or Replacement of Separation Payments

- Forfeiture of deferred amounts/payment of another amount
  - Any amount that acts as a substitute for or replacement of amounts deferred under a separate deferred compensation plan is deferred compensation
  - For a voluntary separation from service, there is a presumption that payment results from acceleration of vesting followed by payment of deferred compensation
  - That presumption may be rebutted
    - Payment would have been made anyway
    - Payment is the type customarily made to all service providers who separate from service (e.g., payment for a release of claims)

# Time and Form of Severance Pay

- Time and form of payment upon a separation from service may vary depending upon whether the separation occurs
  - during a limited period of time
    - not to exceed 2 years after a CIC
  - before or after a specified date and specified period of service
    - determined under a predetermined method or pursuant to a method of crediting service under a qualified plan.

Any change to existing deferral is subject to anti-acceleration and subsequent deferral rules

# Change in Control

- Distributable event:
  - Change in ownership > 50%
  - Change in effective control > 30%
  - Change in ownership of a substantial portion of assets > 40%
    - Determined with respect to service recipient, the company that is liable for the payment of deferred compensation, or majority shareholder of either

# Change in Control

- Payments on account of change in ownership or substantial portion of assets, based on service recipient stock are 409A compliant if paid
  - under the terms and conditions that apply to shareholders or the service recipient under the terms of the agreement, and
  - no later than five years after the CIC event
- These payments may pose issues for escrows, holdbacks, e.g., if tied to continued service

# Change in Control

- Payments made solely on account of a CIC not subject to six-month delay for key employees
- Double-trigger payments (contingent upon a termination of employment after a CIC) are not CIC payments, and may only be made in a manner compliant with 409A

# Mergers and Acquisitions

- “Separation from service” payments
  - **Asset deal**
    - Parties can decide whether to apply the “same desk rule” or to treat employees of the selling company that continue in the same position with purchaser as having separated from service
    - All employees must be treated consistently
    - Deal document must indicate choice

# Mergers and Acquisitions

- Spin-Offs
  - Generally a spin-off of a subsidiary will not result in a separation from service of a subsidiary employee if the employee remains employed by the same employer following the spin-off
    - However, service recipient may terminate and liquidate a plan (including those in the aggregation group) in a CIC event, providing flexibility for payment of deferred compensation in these circumstances

## Flexibility in Structuring and Paying Severance

- Determine which amounts are excluded from 409A
  - Lump sum paid within 2½ -month period
  - Small amounts
  - Reimbursements
  - Separation pay exception (\$450,000)
    - No ordering rule applies

## Flexibility in Structuring and Paying Severance

- Determine which amounts are subject to 409A
  - Delay payment to key employees
  - Watch out for substitution issues

# Immediate Action

- Review arrangements
  - All employment agreements and formal severance plans must be reviewed and revised (as needed) for compliance by December 31, 2007
- Determine which severance benefits are 409A deferred compensation

## Actions by Year End

- Conform 409A deferred compensation arrangements to the timing rules for deferral elections and distributions
- Obtain approval as required from the Board and employee

# Presenters



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