



Impact of New Deferred Compensation Tax Rules on Severance Pay Arrangements

December 30, 2004

The American Jobs Creation Act of 2004, enacted in late October, added new Section 409A to the Internal Revenue Code, which significantly changes the taxation of nonqualified deferred compensation plans. Section 409A imposes restrictions on deferral elections, distribution elections, distribution events and acceleration of payments. Failure to comply with Section 409A will lead to immediate taxation of deferrals, with interest and a 20% penalty. Section 409A is generally applicable to amounts deferred after December 31, 2004, and thus in the context of severance payments would appear to apply to severance amounts payable on or after January 1, 2005 (at least where the severance event did not occur prior to January 1, 2005). For additional details on the overall effect of new Section 409A, see [New Federal Legislation Will Require Review of Deferred Compensation Plans](#).

“Nonqualified deferred compensation plan” is broadly defined to include any plan, agreement or arrangement (including one that covers only one person) that provides for the deferral of compensation, other than a qualified employer plan or a bona fide vacation, sick leave, compensatory time, disability pay or death benefit plan. Section 409A does not contain any specific exception for severance pay arrangements.

The Internal Revenue Service has issued Notice 2005-1, which provides transition guidance under Section 409A and, as to severance pay arrangements, excludes, through the end of 2005, only collectively-bargained severance plans and severance plans in which no “key employees” participate, provided such plans meet certain requirements as to amount (not in excess of two times annual compensation) and payout period (generally not in excess of twenty-four months). The guidance does not otherwise address severance plans, and thus a possible inference is that other forms of severance are subject to these new tax rules. It is not clear whether the exclusions set forth in the transitional guidance will be extended permanently or whether other forms of severance pay arrangements will be excluded when additional guidance is issued.

To the extent that severance pay is treated by the IRS as providing nonqualified deferred compensation and therefore subject to Section 409A, several restrictions may become applicable. For example, the timing of severance payments may have to be selected when the arrangement is initially established and it may not be possible to change such timing, accelerate the payment (even in exchange for consideration) or provide discretion to either the employer or the service provider to choose between a lump sum and installment payments. In addition, severance arrangements for “key employees” at public companies may be subject to the distribution limitations of Section 409A, which require that

distributions to such an executive on account of separation from service may not be made earlier than six months after the date of separation. Finally, payment of severance in connection with a change in control may be subject to restrictions.

It is expected that additional guidance on the application of Section 409A will be issued in the next few months. In the meantime, if you would like further information on the impact of Section 409A, please contact any of the following Morgan Lewis attorneys:

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