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409A Basics | A Webinar Series

# Avoiding 409A Pitfalls in Severance Agreements

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# AGENDA

- How does Section 409A affect severance benefits generally?
- Separation from service requirements to commence severance
- Six-month delay considerations for severance benefits payable to specified employees
- Structuring severance benefits to be exempt from Section 409A
- Postemployment benefits and reimbursements
- Toggle issues
- Payments contingent on a release
- Substitution considerations

# Code Section 409A

- “Deferred compensation” arises where an employee has a legally binding right in one year to receive compensation in a later year
- Severance compensation to be paid under a severance plan or severance agreement (which can include employment agreements, change-in-control agreements, offer letters, etc.) is generally considered deferred compensation, unless an exception exists

# Code Section 409A

- If severance compensation is considered deferred compensation, and no exception applies:
  - Severance pay can be subject to the 409A six-month delay for key employees
  - The agreement must specify the payment date for severance pay
  - Reimbursements for certain benefit coverage, taxes, and other amounts must meet the Section 409A timing requirements

# Code Section 409A

- If the Section 409A rules are not met:
  - Deferred compensation is included in income when no longer subject to a substantial risk of forfeiture
  - Penalty tax to executive of 20% of amount included in income
  - Interest is assessed on the tax underpayments (at underpayment rate plus 1%)

# Separation from Service

- Distribution trigger for Section 409A deferred compensation
- Impact when six-month delay takes effect
- Can be difficult to determine if separation is not complete

# Separation from Service

- The 409A regulations define when there has been a separation from service
  - A separation from service occurs when the level of services is reduced to a level expected to be no more than 20% of the level of services provided during the preceding 36-month period
  - The agreement can provide for a percentage greater than 20% but less than 50%
  - No exception for “payroll continuation”
  - Service as a consultant/independent contractor after termination of employment is considered continued service for purposes of 409A

# Six-Month Delay for Specified Employees

- If a “key employee” of a public company receives deferred compensation upon separation from service, there must be a six-month payment delay
- A “key employee” of a public company is:
  - An officer having annual compensation greater than \$160,000 for 2011 (up to 50 employees)
  - An employee who is a 5% owner
  - An employee who is a 1% owner and has annual compensation greater than \$150,000

# Flexibility in Structuring Severance Pay

- If no existing severance agreement is in effect at the time of termination, the parties can structure severance pay to be paid on specified payment dates without a six-month delay
  - The severance payments cannot be a replacement for forfeited deferred compensation

# Exceptions to 409A Deferred Compensation

- Short-term deferral exception
- Separation pay exception
- Expense reimbursement within a limited period of time after separation from service
- *De minimis* amounts up to \$17,000 (indexed to the 402(g) limit)

# Short-Term Deferral Exception

- Payments made within a short period after vesting
  - Payments made within 2½ months after the end of the year in which the severance pay vests (no substantial risk of forfeiture)
  - For example, March 15 after year of involuntary termination of employment
- Separate payments designation

# Separation Pay Exception

- Severance payments:
  - On account of involuntary termination of employment
  - 2X pay, capped at 2X the Section 401(a)(17) limit (\$250,000 for 2012, or \$500,000)
  - Paid within two years from year of separation

# Involuntary Termination

- In the severance pay context, both the short-term deferral exception and the severance pay exception require involuntary termination of employment
- Whether termination is involuntary is based on facts and circumstances
  - If the public documents describe termination as “mutual” or “voluntary,” the parties should clearly document support for involuntary termination

# Involuntary Termination

- “Good reason” termination may constitute involuntary termination
  - Must require actions taken by the employer resulting in material negative change in employment relationship

# Involuntary Termination

- Good-reason safe harbor
  - Amount, time, and form of payment upon good-reason separation must be identical to amount, time, and form of payment upon involuntary termination
  - Employee must give notice, and employer must have the right to cure during a cure period
  - Separation must occur within a specified period following good-reason event

# Involuntary Termination – Good-Reason Safe Harbor

- Good-reason safe harbor:
  - Material diminution of base compensation
  - Material diminution of authority, duties, or responsibilities (or responsibilities of supervisor)
  - Material diminution of budget authority
  - Material change in geographic location
  - Material breach of terms of agreement

# Involuntary Termination

- An agreement generally will not meet the severance pay exception or short-term deferral exception if severance pay can be paid for other reasons, even if the termination is actually an involuntary termination
  - The existence of a “walk right” provision may cause the entire severance agreement to be subject to 409A

# Involuntary Termination

- Plans that provide payment upon an involuntary termination are aggregated for purposes of the 409A rules
  - This means that all severance arrangements for an employee must be analyzed together for purposes of 409A

# Flexibility in Structuring Severance Pay

- Employment agreement example:
  - Public company
  - Negotiating severance provided in employment agreement for key employee on involuntary termination of \$2.4 million
  - Employer wants to pay in installments over two years (\$100,000 per month)
  - Employee wants to minimize six-month delay

# Flexibility in Structuring Severance Pay

- Alternative 1:
  - \$500,000 can be paid in installments over two years (severance pay exception)
  - The remaining \$1,900,000 can be paid in monthly installments after six months from separation from service (409A deferred compensation)

# Flexibility in Structuring Severance Pay

- Alternative 2:
  - \$500,000 can be paid in installments over two years (severance pay exception)
  - The remaining \$1,900,000 can be paid by March 15 after year of termination (short-term deferral exception)
- It is critical that the agreement provide that each payment is treated as a separate payment under 409A

# Flexibility in Structuring Severance Pay

- Alternative 3:
  - The agreement can provide lump-sum payment of entire \$2.4 million by March 15 after year of termination (short-term deferral exception)

# Postemployment Benefits and Reimbursements

- Certain reimbursements and in-kind benefits are excluded from 409A deferred compensation
  - So long as paid within a limited time following separation
- If reimbursements are not excluded from 409A, they may be structured to comply with the Section 409A payment date rules

# Postemployment Benefits and Reimbursements

- COBRA health benefits
- Medical reimbursements may continue for COBRA continuation of coverage period
- Certain outplacement benefits
- Moving expenses and loss on sale of primary residence
- Nontaxable benefits

# Postemployment Benefits and Reimbursements

- Continued participation by a former executive in the active employees' health plan at active rates creates discrimination issues for a self-insured health plan under Section 105(h)
- It is often difficult/costly to provide continued life and disability coverage after termination of employment

# Toggle Issues

- Agreement generally must provide for a single time and form of payment for each payment event
- Agreement cannot provide multiple payment forms for payment upon separation from service
  - E.g., lump sum if involuntary termination, installment payments if voluntary termination

# Toggle Issues

- Exceptions: Agreement can provide for different forms of payment upon separation from service:
  - within two years after a 409A-compliant change in control
    - *E.g., installments before change in control, lump sum after change in control*
  - following specified age or service, or age and service
  - prior to, or following, a single fixed date

# Payments Contingent on a Release

- If payments are subject to 409A, the payment date must be specified and the employee must not be able to designate, directly or indirectly, the calendar year of payment
- Issue if agreement provides that payment will not be made until an employee signs and does not revoke a release of claims
- IRS Notice 2010-6 takes the position that the following language violates 409A:
  - Payment shall be made within 60 days following separation from service, subject to the employee signing a release and not earlier than expiration of the revocation period for the release.

# Payments Contingent on a Release

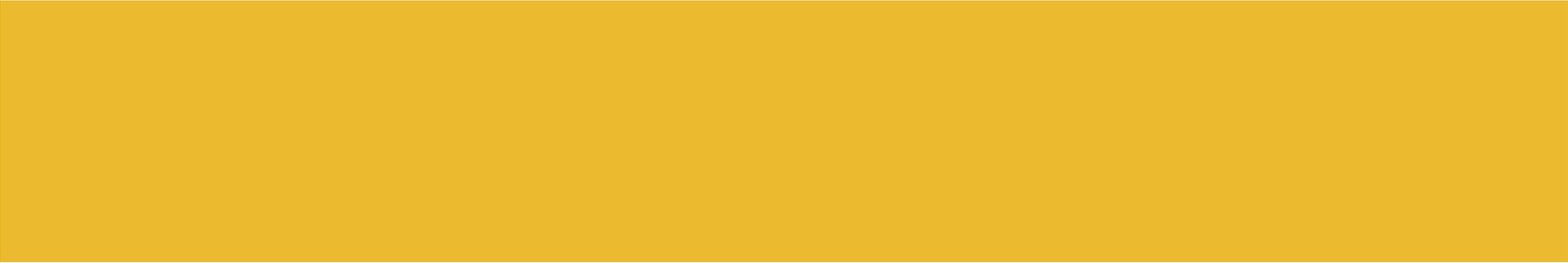
- By the end of 2012, the transition period for correcting release provisions will lapse, so payments of deferred compensation conditioned on payment of a release should be fixed by the end of 2012 to prevent a service provider from controlling year-of-payment timing based on delivery of release. (Notice 2010-80)
  - Specify that payment date is not affected by release timing, or
  - Specify that where release delivery and nonrevocation period span two taxable years, payment will always be made/commence in second taxable year

# Substitution Considerations

- Providing payments in lieu of forfeited amounts
- Renewing or renegotiating severance pay

# Drafting Checklist

- Structuring to identify and maximize exclusions – separate payments designation
- Make 409A payments compliant
- Use 409A compliant definitions, as applicable (e.g., good reason, change in control)
- Eliminate direct or indirect discretion over payment timing
- Six-month delay language (if applicable or even conceivable)
- Reimbursements and in-kind benefits
- Tax gross-ups
- Identify offsets
- Interpretations and savings clause



# Questions?

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