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Executive Compensation

Executive separation agreements raise issues relating to compliance with the election timing and distribution rules of Section 409A of the Internal Revenue Code. This article summarizes potential issues employers and their advisers should look for in these situations.

Spotting Section 409A Issues in Executive Separation Agreements

BY JOHN MCGUINESS

When an executive's employment is terminated, the executive is often asked to sign a separation agreement. Typically, in these agreements an executive waives potential claims against his or her employer in return for severance and other benefits. Advisers for employers and executives in this situation should be aware of potential issues under Section 409A of the Internal Revenue Code. Ensuring strict compliance with the detailed Section 409A rules in these situations can be quite complex. After providing a brief background on Section 409A, this article briefly describes potential Section 409A issues advisers should look for in these situations.

John McGuiness is an attorney with the Groom Law Group, Chartered, Washington, D.C. He heads the firm's executive compensation practice group.

Background on Section 409A. Section 409A was added to the Internal Revenue Code in 2004 and applies to amounts earned under certain executive compensation arrangements. Section 409A applies to arrangements where an executive can elect to defer receipt of compensation to a future year, as well as supplemental retirement plans (i.e., SERPs). Many other types of executive compensation are potentially subject to Section 409A. For example, bonuses and equity compensation awards can be subject to Section 409A. And of immediate concern, severance and other post-termination benefits may be subject to Section 409A.

If Section 409A applies to an arrangement, the following rules apply:

- executive elections to defer payments need to be made by certain deadlines;
- payments can be made only on a specified date or upon the occurrence of certain events defined under Section 409A, such as a ''separation from service,'' death, or disability;

■ the time and form of payments under the arrangement need to be specified in writing up front; and

■ once the time and form of payments have been documented up front, it is difficult for an employer or an executive to change the time or form.

If a violation of Section 409A occurs with respect to an executive's benefits under an arrangement, generally all vested amounts subject to Section 409A under the arrangement and all similar arrangements are taxed to the executive immediately. A 20 percent additional tax is also imposed upon the amount included in the executive's income plus an additional interest penalty. A violation of Section 409A may occur if the documentation for an arrangement is not compliant or if the arrangement is not administered in accordance with the Section 409A rules.

Given the limited flexibility for employers and executives under the Section 409A rules and the very adverse tax consequences for an executive of violating these rules, the parties will normally prefer to keep an arrangement exempt from Section 409A, if possible.

Pre-Existing Severance Pay That Is Subject to 409A. When working on an executive separation agreement, a key step is to determine whether the executive is already entitled to severance benefits based on his or her termination, and if so, whether these benefits are subject to Section 409A. Executives may be entitled to pre-existing benefits under a severance plan, an employment agreement, or a severance agreement.

As noted above, if severance benefits are subject to Section 409A, there should be a 409A-compliant document spelling out the time and form of payments (e.g., bi-weekly installments at separation from service). As indicated above, it is very difficult to change these distribution provisions after they have been ''hard-wired'' up front. Thus, a separation agreement that changes these distribution rules at the time of termination (e.g., provides for a lump sum instead of installments at separation from service) could result in a Section 409A violation.

If an executive already has a right to severance benefits upon his or her termination, the benefits may be exempt from Section 409A if they fit within one of two exemptions. The exemptions are summarized below:

■ ***Two Times Pay Exemption*** – A severance arrangement that provides for payments only upon *involuntary* termination of employment—or pursuant to a ''window program''—may be exempt if the entire amount payable under the arrangement does not exceed two times the lesser of (1) the employee's annual base compensation for the year prior to the year of termination, or (2) the maximum amount of compensation that can be taken into account under a qualified plan for the year of termination ($245,000 in 2009). In addition, the payments must be made no later than the end of the second year following the year in which the termination occurs.

■ ***Short-Term Deferral Exemption*** – A severance arrangement may also fit within the ''short-term deferral exemption'' under the regulations. This exemption may apply if amounts are payable under the arrangement only upon an *involuntary* termination of employment and all severance payments must be made by March 15th of the year after the year in which the involuntary termination occurs.

Thus, pre-existing severance benefits may be subject to Section 409A in a number of situations, such as where:

■ there is a possibility of the severance being paid due to the executive ''voluntarily'' resigning for good reason (e.g., due to a reduction in base pay or change in title), or

■ the severance may be paid over a period that extends beyond the March 15th following the year of termination and the amount of the severance exceeds the lesser of (a) $490,000 or (b) two times the employee's base pay for the year before the year of termination.

Newly Negotiated Severance Pay. If the parties negotiate truly new severance benefits contained in a separation agreement, they need to analyze whether these benefits will be subject to Section 409A, and if so, make the provisions compliant. As indicated above, the new severance may fit within one of the applicable exemptions for severance pay. To avoid Section 409A, the parties may want to tailor the distribution provisions to do so (e.g., ensure that all payments are made by March 15th of the following year).

If the new severance payments will be subject to Section 409A, the parties will need to ensure that the relevant rules are met. Some of the issues that will need to be addressed are as follows:

■ Any deferral election being made by the executive will need to meet the election timing rules (and there is a special rule for severance resulting from bona fide, arm's length negotiations at termination).

■ Distributions need to be made only upon a 409A-specified event, such as a separation from service.

■ Distributions to ''specified employees'' of a public company upon a separation from service need to be delayed six months.

■ If payments are contingent upon execution of a release, the effect the execution date may have on the timing of the distributions must be analyzed.

Post-Employment Benefits and Reimbursements. Separation agreements typically provide for some nonseverance benefits after termination of employment. Fortunately, all nontaxable benefits are exempt from Section 409A, and the Section 409A regulations provide exemptions that can be used for some of the more common post-termination benefits, such as reasonable outplacement and taxable health benefits provided for a limited period of time.

The parties need to examine each taxable post-termination benefit and determine whether it fits within an exemption from Section 409A. If not, the benefit can often be made 409A-compliant without great difficulty. Some benefits on which to focus include (1) health benefits that are more generous than the post-termination benefits available to the rank and file and provided under a self-insured plan, (2) continued taxable in-kind benefits, and (3) allowances for expense reimbursements that could be paid in any one of the next few years.

Payment in Lieu of Forfeited Amounts. In general, any attempt to make a separating executive whole on account of an amount subject to Section 409A that is forfeited upon termination will be presumed to be a substituted payment of the forfeited amount. Often, executive separation agreements will provide for such make whole payments to be paid in a lump sum payment immediately following severance. These types of provisions may thus be viewed by the IRS as a prohibited acceleration of a payment subject to Section 409A.

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The presumption that a payment is a substitution can be overcome by proving the separation payments are not being paid on account of the forfeiture. Certain factors will be considered in determining whether the payment is a substitution, including:

- whether the amount the executive actually receives is materially less than the forfeited amount; and
- whether the payment is the type of payment that is normally made to employees who separate from service (e.g., payment for a release of claims or accrued and unused leave).

Thus, employers and executives need to be careful about providing for payments in lieu of forfeited amounts that were subject to Section 409A (e.g., certain restricted stock units or long-term incentive awards).

Revising Payment Terms Under Retirement Plans. In the past, separation agreements could provide for new payment terms for benefits that had been earned under nonqualified retirement plans, such as deferred compensation plans or SERPs. Since generally all amounts earned under these plans are now subject to Section 409A, changing the 409A-compliant payment provisions in a separation agreement could result in problems for the reasons described above.

Post-Termination Consulting or Other Services. Many severance, retirement and other arrangements subject to Section 409A provide for payments upon a separation from service (SFS) as defined under Section 409A. The Section 409A regulations provide complex rules for determining when a SFS occurs. Generally, a SFS occurs if the facts and circumstances indicate that the employer and employee *reasonably anticipate* that:

- no further services will be performed after a certain date, or
- the level of bona fide services after such date will permanently decrease to no more than 20 percent of the average level of services performed in the prior 36-month period (or, if less, the full period of service with the employer).

A violation of Section 409A may result if payments are made under an arrangement upon an employee's termination of employment and the termination does not qualify as a SFS. This could occur if a separation agreement provides that an executive will continue to provide significant services for the employer or one of its affiliates for some period of time after his or her employment terminates (e.g., as a consultant). In this situation, the parties should try to ensure that these post-termination services do not jeopardize the occurrence of a SFS, perhaps by adding a proviso that the post-termination services will not exceed a specified level (e.g., 15 hours per month). The parties should be aware, however, that if the *actual* services provided after termination exceed a certain level, the Section 409A regulations establish a rebuttable presumption that no SFS occurred.