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View From Groom: Separation Anxiety—Analyzing Separations From Service Under Section 409A

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When an employee leaves a company, there are a number of routine items of business for the company to address, including payment of the employee's unpaid compensation. However, if the employee has earned ''nonqualified deferred compensation,'' the company should take extra care to consider whether the employee has had a ''separation from service'' — or else the employee could face very adverse tax consequences.

Section 409A of the Internal Revenue Code applies to payment of certain types of ''deferred compensation'' (*i.e.*, compensation that is earned in one year but is payable in a later taxable year). Specifically, Section 409A applies to ''nonqualified deferred compensation plans,'' such as supplemental pension plans and elective deferral arrangements. The penalties for failing to comply with Section 409A's strict rules are severe: immediate income inclusion for all vested deferred compensation owed the employee under the plan, plus a 20 percent additional tax on the included compensation and interest.

Section 409A only permits nonqualified deferred compensation to be paid upon certain events (often called ''payment triggers''). Nonqualified plans, including severance and change in control plans subject to Section 409A, are frequently designed to commence benefit payments to an employee after the employee incurs a ''separation from service,'' which is a permissible payment trigger. However, the rules surrounding the Section 409A definition of ''separation from service'' are complex, and it is not always clear when an employee separates from service — and consequently, when the employee's deferred compensation should be paid.[1] This article discusses the Section 409A rules relating to the separation from service payment trigger, and how those rules apply in several scenarios commonly faced by companies.

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Separations From Service Generally

The Section 409A regulations provide two general definitions for ''separation from service'' — one applicable to employees, and one applicable to independent contractors.

Employees. An employee generally incurs a separation from service for Section 409A purposes when the facts and circumstances indicate the employee and the employer both reasonably anticipate that

- no further services will be performed after a certain date, or
- the level of bona fide services performed 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) (the ''prior level of services'').[2]

The ''facts and circumstances'' to be considered include whether the employee is treated as an employee for other purposes (such as continuation of salary and participation in employee benefit programs), whether similarly situated employees have been treated consistently and whether the employee is permitted, and real-

[1] Understanding the separation from service rules is also important when designing ''separation pay plans'' intended to be exempt from Section 409A. *See* Treas. Reg. § 1.409A-1(b)(9).

[2] Treas. Reg. § 1.409A-1(h)(1). A plan may designate a different separation from service percentage ''threshold,'' so long as the percentage is greater than 20 percent and less than 50 percent. *See id.*

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istically available, to perform services for other companies in the same line of business.

In addition to the general rule set forth above, the Section 409A regulations provide two rebuttable presumptions that apply in determining whether a separation from service occurred:

- There is a presumption that a separation from service occurred if services performed by an employee actually decrease to 20 percent or less of the prior level of services.
  - This presumption can be rebutted by demonstrating that the employer and the employee each reasonably anticipated that the services would exceed 20 percent of the prior level of services.
- There is a presumption that a separation from service *did not* occur if services performed by an employee actually continue at a level that is 50 percent or more of the prior level of services.
  - This presumption can be rebutted by demonstrating that the employer and the employee each reasonably anticipated that the services would not exceed 50 percent of the prior level of services.

If the employee actually provides a level of services greater than 20 percent but less than 50 percent of the prior level of services, no presumption applies. For purposes of the foregoing tests, it does not matter whether the post-termination services are performed as an employee or as an independent contractor.

It is unclear from the regulations how frequently the level of post-termination services should be measured, and how long the measurement period should be. For example, measuring a former employee's level of services on a daily basis would be administratively burdensome, but a more practical frequency (e.g., weekly or monthly) would hopefully suffice. Likewise, a one month measurement period is likely too short to provide a realistic picture of the former employee's post-termination level of services, but hopefully one year would be acceptable.

Notwithstanding the unanswered questions, these rebuttable presumptions are useful as guidelines to ensure compliance with Section 409A, and also provide insight into the type of analysis the IRS is likely to perform when reviewing the issue. Based on the regulations, the IRS is likely to first consider whether a presumption applies (*i.e.*, whether the individual actually works below the 20 percent threshold or above the 50 percent threshold after the potential separation from service). If a presumption applies, the IRS would likely next consider whether the presumption may be rebutted based on the reasonable anticipation of the employer and employee at the time of the separation. If a presumption does not apply (*i.e.*, if the employee actually continues to provide services at a level between 20 percent and 50 percent of the prior level of services), the general test based on the parties' reasonable anticipation at the time of the separation should control.

Independent Contractors. The Section 409A regulations generally provide that an independent contractor[3] incurs a separation from service with a company upon the expiration of all contracts under which the contractor performs services for the company, provided that such expiration constitutes a good faith and complete termination of the contractual relationship, *i.e.*, the company does not anticipate a renewal of the contractual relationship and does not anticipate the contractor becoming an employee. If the company intends to contract again for the services provided under the expired contract,[4] the company is considered to anticipate the renewal of the contractual relationship (and consequently, no separation from service has occurred) if neither the company nor the contractor has eliminated the contractor as a possible provider of services under the new contract.

An individual who serves concurrently as *both* an employee and an independent contractor of a company will not be considered to have separated from service until he has incurred a separation from service as both an employee and an independent contractor (the ''dual status'' rule).

Common Scenarios

We address below some common scenarios where companies need to determine whether a separation from service has occurred for Section 409A purposes.

Post-Employment Consulting Arrangements. Employees frequently provide consulting services as independent contractors to their former employers following termination of their employment. If such an arrangement is not carefully planned, there can be uncertainty about whether the employee's termination of employment was a separation from service. As discussed above, in order for there to be a separation from service, the parties must reasonably anticipate at the time of the termination that the employee's consulting services will not exceed 20 percent of his prior level of service. And of course, employers typically have not tracked hours when most such consultants were employed, so an estimate will need to be made for their prior level of service. Ideally, the parties should confirm this understanding in writing at the outset (e.g., ''the consultant shall not be required to work more than 40 hours per month''). Further, the company should periodically measure the level of post-employment services provided thereafter to ensure that this 20 percent threshold is not surpassed.

Post-Employment Board Service. The ''dual status'' rule described above does not apply to employees who are independent contractors of a company solely because of their service on the company's board of directors (or equivalent body). If an individual serves on the company's board while employed, the Section 409A regulations distinguish between the individual's service as an employee and his service as a director. Whether the individual has separated from service for purposes of any deferred compensation plan depends on whether he participates in the plan as an employee (an ''employee arrangement'') or as a director (a ''director arrange-

[3] Section 409A does not apply to certain arrangements between service recipients and independent contractors. See Treas. Reg. § 1.409A-1(f)(2). The rules governing whether Section 409A is applicable to an independent contractor arrangement are complex, and are beyond the scope of this article. The rules discussed in this article apply only to independent contractor arrangements to which Section 409A applies.

[4] A company is considered to ''intend to contract again for the services provided under an expired contract'' if doing so is conditioned only on the need for the services and/or the availability of funds. Treas. Reg. § 1.409A-1(h)(2).

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ment''). An individual's service as a director will not be taken into account when determining whether the individual has had a separation from service for purposes of his employment arrangements. Likewise, his service as an employee will generally not be taken into account when determining whether he has had a separation from service for purposes of his director arrangements, provided that the employee's director arrangements are substantially similar to arrangements that provide benefits to nonemployee directors. Thus, a CEO who terminates employment but who continues to serve on the company's board will incur a separation from service for purposes of his employee arrangements, but not for purposes of his director arrangements.

Leaves of Absence. The Section 409A regulations provide that when an employee is on military leave, sick leave or other bona fide leave of absence, a separation from service does not occur if the period of leave does not exceed six months (which may be extended to 29 months for certain leaves due to long-term disability). A separation from service occurs on the date the period of leave surpasses six months (or 29 months, as applicable). Notwithstanding these time limits, the bona fide leave of absence may continue for longer, so long as the employee has a right to reemployment under an applicable statute or by contract. Importantly, a leave is only bona fide — and hence these rules only apply — if there is a reasonable expectation that the employee will return to perform services after the leave ends.

If there is no right to continued employment, and no reasonable expectation that the employee will return, then a separation from service occurs at the commencement of the ''leave of absence.'' For example, if an employee is entitled to receive a certain period of advance notice prior to involuntary termination, the company may instruct the employee not to perform work for all or part of the notice period, while still keeping the employee on the company's payroll through the last day of the period. Similarly, a company may direct an employee not to perform work for a given period prior to formal termination (''garden leave''), or may allow the employee to remain on payroll while the employee takes significant unused vacation time prior to the official termination date. In all of these scenarios, the employee has no right to return to work after the end of the ''leave of absence,'' and neither party expects the employee to return and/or perform any more services. Therefore, the separation from service occurs for Section 409A purposes when the employee ceases performing work and commences the leave.[5]

Transfers of Employment. Under the Section 409A regulations, a separation from service occurs when an employee separates from service not only with the company for which he directly works, but also from all other entities that are considered a single ''employer'' with the company for purposes of the separation from service rules. However, the rules to determine which companies make up the ''employer'' for this purpose are quite complex. To briefly summarize these rules, a subsidiary that is owned 50 percent or more by a parent company will generally be considered a single employer with the parent company. Thus, an employee who transfers from a parent company to a wholly owned subsidiary generally will not incur a separation from service, but a transfer to a company that is less than 50 percent owned by the parent company will likely trigger a separation from service.[6]

These rules can be particularly confusing because they differ significantly from the normal definition of ''service recipient'' under the Section 409A regulations, which generally tracks the controlled group rules applicable to qualified plans (*i.e.*, the ''80 percent test'').[7] Put simply, two companies that are considered the same ''service recipient'' under the general Section 409A definition will be considered the same ''employer'' for purposes of the separation from service rules. However, the reverse is not always true: in certain circumstances two companies may be considered the same ''employer'' for purposes of the separation from service rules, even if the companies are different ''service recipients'' for purposes of other areas of Section 409A. Thus, when an employee transfers employment from one company to a related company, the Section 409A separation from service rules require close attention, particularly at companies with complex organizational structures.

Rehiring a Terminated Employee. The Section 409A rules do not prevent an employee from returning to work for an employer following a legitimate separation from service and a resulting distribution of nonqualified plan benefits. In fact, the rules specifically address a scenario where the parties reasonably anticipated that an employee would cease performing services, but the termination of the employee's replacement caused the employee to return to employment. The 409A regulations state that a rehire in this type of situation does not ruin a ''good'' separation from service. Importantly, an employee who commences receiving deferred compensation payments upon a genuine separation from service cannot ''suspend'' his payments or otherwise ''undo'' the separation from service by returning to employment with the company.[8] In this situation, the employee's deferred compensation should continue to be paid regardless of the return to employment.[9]

Corporate Transactions. If a company merges with another company or its equity is acquired by another company, the transaction generally does not trigger a separation from service under Section 409A with respect to the merged or acquired company's employees who continue employment after the transaction. Likewise, a spin-off of a subsidiary from a parent company's controlled group will not cause employees of the subsidiary

[5] The preamble to the Section 409A regulations specifically addresses this issue. *See* T.D. 9321, § VII.(C)(2)(d), 72 Fed. Reg. 19,234, 19260 (April 17, 2007). The IRS also addressed this issue in a question-and-answer session put on by the American Bar Association Joint Committee on Employee Benefits. See Question 18 of the 2013 American Bar Association Joint Committee on Employee Benefits – Internal Revenue Service Q&A, available at http://www.americanbar.org/groups/committees/employee_benefits.html.

[6] A plan may designate a different controlled group percentage for this purpose, so long as the percentage is greater than 50 percent and no greater than 80 percent. Treas. Reg. § 1.409A-1(h)(3).

[7] Treas. Reg. § 1.409A-1(g).

[8] The preamble to the Section 409A regulations specifically addresses this issue. *See* T.D. 9321, § VII.(C)(2)(d), 72 Fed. Reg. 19,234, 19,260 (April 17, 2007).

[9] This will be the result notwithstanding that payments may be suspended under a related tax-qualified retirement plan.

to incur a separation from service. In these cases, the employees remain employed by the same employer (although that employer is in a new controlled group).[10]

In the case of a sale or transfer of a company's assets to an unrelated buyer, an employee who leaves employment with the seller and commences employment with the buyer will generally have a separation from service with the seller. However, if the transaction involves a transfer of ''substantial assets'' (such as a plant or division, or substantially all the assets of a trade or business), the parties can choose whether employees of the seller immediately before the transaction who will provide services to the buyer after and in connection with the transaction will experience a separation from service. In order for this election to be effective:

- the parties must specify this election in writing prior to the closing date of the transaction;
- the transaction must result from bona fide, arm's length negotiations; and
- all service providers providing services to the seller immediately before the transaction who provide services to the buyer after and in connection with the transaction must be treated consistently, regardless of position at the seller, for purposes of any nonqualified deferred compensation plan.

[10] The preamble to the Section 409A regulations addresses these issues. *See* T.D. 9321, § VII.(C)(2)(f), 72 Fed. Reg. 19,234, 19,260 (April 17, 2007). A distribution of benefits to such employees may be triggered, however, if their benefits were payable upon a change in control or if the plan is terminated pursuant to a change in control under Treas. Reg. § 1.409A-3(j)(4)(ix)(B).

Conclusion

For all the complexity and nuance of the rules, whether a separation from service occurs under Section 409A ultimately depends on the rights and expectations of the parties. If the service provider is an employee, a key inquiry will be whether both the employee and the employer reasonably anticipate at the time of the potential separation that the level of services to be performed will permanently decrease to no more than 20 percent of the prior level of services. If the service provider is an independent contractor, a key question will be whether the company anticipates renewing the contractual relationship, or that the contractor will become an employee. If an employee is going on a leave of absence, it will be important to know if the employee has a right to return to work, and if the employee is expected to return to work. Companies should therefore carefully consider their expectations whenever a potential separation from service occurs.

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