

Client Alert

New Guidance Clarifies 409A's Application to Separation Pay Arrangements

As we noted in our recent client alerts, the Treasury Department and Internal Revenue Service have issued the long-awaited "second round" of guidance under Internal Revenue Code Section 409A ("409A"). The new guidance, issued in the form of proposed regulations, addresses a number of issues, including issues related to separation pay arrangements.¹ This client alert discusses when and how 409A applies to separation pay arrangements.

Links to 409A Guidance

For a more general summary of the proposed regulations, see our client alert entitled "Treasury and IRS Issue 'Second Round' of 409A Guidance: What You Need to Know and Do Before Year End". For a web link to that and other client alerts on 409A, and to the proposed regulations, Notice 2005-1, and 409A, click [here](#) or go to <http://www.chadbourne.com/409A>.

Introduction

As part of the proposed regulations, the IRS has provided a welcome exemption for certain separation pay arrangements. Given the limited exemption for separation pay arrangements under the IRS' initial guidance, Notice 2005-1, the new expanded exemption will provide employers with greater flexibility in crafting separation packages for employees who are involuntarily terminated.² Also good news is the fact that this exemption applies to both key employees (also referred to as "specified employees" for purposes of 409A) and non-key employees.

The proposed regulations provide relief for certain expense reimbursement arrangements. This aspect of the proposed regulations will make it easier for companies to provide their departing employees with certain separation benefits, such as outplacement services. Finally, the proposed regulations provide employers with some flexibility to extend the exercise period of stock options and stock appreciation rights.

The news on separation pay arrangements and 409A is not all good, however. Initially, the new exemption has a compensation limit that may not be sufficient to exempt arrangements for more highly-paid executives -- which simply means that those executives' separation pay arrangements will need to comply with 409A, and, if applicable, the six-month wait required by the Key Employee Rule (discussed below).

¹ Because the regulations are only "proposed" at this stage, they do not have the force of law. However, the IRS has provided that reliance on the proposed regulations will be evidence of an employer's good faith attempt to comply with 409A. A public hearing on the proposed regulations is scheduled to be held in January 2006, and the regulations are expected to be finalized later in 2006.

² Because the new guidance purposefully uses the phrase "separation pay" rather than "severance," this client alert will do the same.

More importantly, the new exemption only applies to involuntary separations and certain voluntary terminations under a window program (such as a VERP). At this time, the IRS has yet to provide an express exemption for separation pay paid upon voluntary terminations, such as upon a “good reason” departure by an executive. This means that employees who receive separation pay upon a voluntary resignation are more likely to be subject to the rules of 409A.

Background and History

409A was added to the Internal Revenue Code (the “Code”) in October 2004 when President Bush signed the American Jobs Creations Act of 2004 (the “Jobs Act”). The first round of guidance under the Jobs Act was issued by the IRS in December 2004. That guidance was titled Notice 2005-1.

Notice 2005-1 makes clear that 409A generally applied to separation pay arrangements. Notice 2005-1 provides exemptions for separation pay arrangements that are collectively bargained and for arrangements that cover no key employees. As noted above, the new guidance provides more detailed rules regarding the application of 409A to separation pay arrangements and provides for broader exemptions.

Separation Pay Exemptions Under the Proposed Regulations

The new guidance is clear that the mere fact that payments are made upon a separation from service does not automatically cause the payments to fall outside the ambit of 409A. However, the new guidance does set forth certain exemptions.

1. ***The “Two Times Comp within Two Years” Exemption.*** Separation pay arrangements that provide for separation pay upon an involuntary separation from service, or pursuant to voluntary window program such as a VERP, are exempt from 409A if the following conditions are met:
 - the total amount of the separation pay (other than certain reimbursements and other payments discussed below in item (2) of this section) must not exceed the lesser of:
 - two times the departing employee’s annual compensation (as defined in regulations under Code Section 415) from his or her employer for the calendar year prior to the calendar year in which he or she separates from services;³ or
 - two times the maximum amount that may be taken into consideration as compensation under a qualified plan pursuant to Code Section 401(a)(17) for the calendar year in which the separation from service occurs (which is \$210,000 for 2005); and
 - the entire separation pay must be paid out no later than December 31st of the second calendar year following the year in which the individual separates from service.

As a result of the Code Section 401(a)(17) limit, the total compensation that can be paid under this exemption to an employee who departs in 2005 is \$420,000. This limit is indexed and is

³ Earnings from self-employment as an independent contractor for the same employer would also be included in this amount.

expected to increase annually. While \$420,000 is sufficient to exempt the vast majority of separation pay arrangements from 409A, it may not be sufficient to exempt the arrangements of certain highly paid executives. In such cases, the arrangements will likely need to be redesigned to comply with 409A.

2. ***Exemption for Certain Reimbursements and Other Payments and Benefits.*** The following payments made in connection with a separation from service are exempt from 409A:
- reimbursements that are otherwise excludible from gross income;
 - reimbursements for expenses that the individual can deduct under Code Section 162 or 167 as business expenses (ignoring limits on adjusted gross income);
 - reimbursements for reasonable outplacement expenses and reasonable moving expenses actually incurred by the individual;
 - reimbursement for medical expenses incurred and paid by the individual but not allowed as a deduction under Code Section 213 (ignoring the limit on expenses less than 7.5% of adjusted gross income); and
 - other reimbursements, payments, and benefits that do not exceed \$5,000 in the aggregate.

In order for any such reimbursement, payment, or benefit to be exempt, it must be made or provided to the individual by December 31st of the second calendar year following the calendar year in which he or she separates from service. This time limit also applies to the period in which the expense must be incurred. The exemption from 409A applies whether the individual is reimbursed, or the company provides the benefit directly to the individual or makes payment on behalf of the individual directly to the person providing the goods or services.

This exemption should be helpful in providing departing employees with outplacement benefits, moving benefits, and certain other *de minimis* payments without worrying about 409A. It is worth noting that the reimbursements and payments noted in this exemption are not limited to involuntary separations or voluntary window programs. As a result, it appears that these reimbursements and payments could be made to an employee who voluntarily resigns without running afoul of 409A.

3. ***Exemption for Arrangements Under a CBA.*** Separation pay arrangements that are collectively bargained and that provide benefits upon an actual involuntary separation from service (or pursuant to a voluntary window program) are exempt from 409A. This exemption applies only to employees covered by the collective bargaining agreement. There are three conditions that such an arrangement must meet:
- the arrangement must be contained within a collective bargaining agreement;
 - the arrangement must have been the subject of arms-length negotiations; and
 - the circumstances surrounding the collective bargaining agreement evidence good faith bargaining over the separation pay arrangement.
4. ***What is a Window Program?*** The exemptions discussed above in items (1) and (3) of this section make reference to a voluntary window program. A “window program” is defined in the proposed regulations as a program established by an employer, for a period of no more than one year, under which certain employees who separate from service will receive separation pay.

Such programs are often referred to as VERPs (voluntary employee retirement programs). The proposed regulations contain a caveat that, to the extent that an employer demonstrates a pattern of establishing similar programs consecutively, such programs will not be considered to be window programs under the exemptions. This is a facts and circumstances test.

5. ***Exemptions Cannot Be Used to Circumvent 409A.*** The new guidance is clear that the exemptions for separation pay arrangements cannot be used to replace or as a substitute for amounts deferred by an individual under a separate nonqualified deferred compensation. In such a situation, the separation pay arrangement would be deemed to be subject to 409A.

The Short-Term Deferral Exemption

Even if a separation pay arrangement does not meet one of the above exemptions, it can still be exempt from 409A if it satisfies the short-term deferral exemption. Under this exemption, separation pay is exempt from 409A if it is fully paid out to the departing employee by March 15th of the calendar year following the calendar year in which the separation pay is no longer subject to “a substantial risk of forfeiture” (which, in the case of an involuntary termination, generally will be the termination date).⁴ The new guidance makes clear that the separation pay arrangement need not expressly provide that the separation pay will be paid within the applicable time limit for the exemption to apply. It is sufficient if the payment is actually made within that time limit. This is a change from Notice 2005-1.

However, there is a benefit to providing for a specific payment date in the written separation pay arrangement. If such a date is included in the written documentation, and, for any reason, payment is not timely made, then later payment will still be deemed to satisfy 409A if it is made within the same calendar year (or, if later, by the 15th day of the third month following the month in which the payment was scheduled to be made). The inclusion of such a date could also permit a delayed payment where the deduction for such payment would be limited by Code Section 162(m), where the payment would violate a loan agreement or similar contract, and where the payment would violate securities laws, and in each case provided that the terms of the written arrangement permit such delays.

While the express separation pay exemptions discussed above, other than for certain reimbursements and other payments, do not apply upon voluntary terminations, “good reason” separation pay arrangements should be able to comply with the short-term deferral exemption. To be exempt, the arrangement would need to be subject to a “valid” good reason definition that constitutes a “substantial risk of forfeiture.” In other words, the definition of good reason should be narrow and should provide the employer with an opportunity to cure any alleged good reason. If a definition of good reason is so broad that an executive effectively could resign at any time and demand payment (for example, by arguing that his or her duties have been changed to some degree), then such an arrangement would likely be viewed by the IRS as never having been subject to a substantial risk of forfeiture -- in which case the short-term deferral exemption will be of no help.

⁴ If the tax year for the employer is not the calendar year, then, if later, the employer has until the 15th day of the third month following the end of its taxable year in which the separation pay is no longer subject to a substantial risk of forfeiture to fully pay the separation pay.

Other Separation-Related Benefits That Are Exempt from 409A

By definition, 409A does not apply to bona fide vacation leave, sick leave, compensatory time, disability, and death benefit plans. Payments made upon termination of employment in connection with such plans would not be subject to 409A. Also exempt from 409A are medical reimbursement arrangements that satisfy the requirements of Code Sections 105 and 106. Included in this exemption would be reimbursements for certain COBRA premiums.

Certain Extensions of Stock Rights Are Permitted

Under the new guidance, it is not a violation of 409A to extend the time period within which the holder of a stock option or stock appreciation right (referred to together as “stock rights” in the new guidance) must exercise that right to a date no later than the later of (1) the 15th day of the third month following the month in which the exercise period otherwise would have expired, or (2) December 31st of the calendar year in which the exercise period otherwise would have expired. It is also permissible to toll the exercise period during any time period in which the exercise of the stock right would violate securities laws, as long as the extended exercise period does not extend more than thirty days after the date on which the exercise of the stock right would no longer violate securities laws.

This exemption should be helpful to employers who wish to provide their departing employees with a little extra time to exercise their stock rights. It is worth noting that this rule is not restricted to involuntary terminations of employment. Indeed, this rule can be applied even where the stock right will expire for reasons other than termination of employment.

What if 409A Applies?

If one of the above exemptions does not apply, then the separation pay arrangement is likely subject to 409A. The question that arises then is: “What is the impact of 409A on the separation pay arrangement?”

1. ***The Separation Pay Package Must be Paid Upon Separation from Service.*** Once subject to 409A, the separation pay package can only be paid upon certain permissible events, one of which is “separation from service.”⁵ “Separation from service” includes death, retirement, and other terminations of employment.⁶ Absences of six months or less due to military leave, sick leave, or other bona fide leaves will not be considered to be a separation from service, nor will such absences of more than six months if the employee has a contractual or statutory right to re-employment.

Whether an employee has terminated employment is a facts and circumstances test. The new guidance is clear that once the facts and circumstances indicate that an employee has terminated

⁵ The other permissible payment events under 409A are death, disability, a fixed time or schedule, unforeseeable emergency, and a change in control event.

⁶ The preamble to the proposed regulations makes clear that the “same desk rule” -- where no separation from service would be deemed to occur when the identity of an individual’s employer changes but his or her duties and responsibilities do not materially change, for example, following an asset deal -- does not apply under 409A.

employment, then that date will be deemed to be the separation from service date. This is the case even if the employee and employer have entered into an agreement requiring the employee to continue to perform minimal services or simply to be available to perform services. In addressing what constitutes a significant amount of services (or, as the new guidance phrases it, what does not constitute an insignificant amount of services), the new guidance draws the line at 20% -- namely, that an employee must continue to provide at least 20% of the services that he or she previously provided (averaged over the prior three full calendar years) and continue to be compensated at a rate equal to at least 20% of his or her prior annual compensation (again, averaged over the prior three full calendar years) in order to avoid being deemed to have separated from service. If the continued services are being provided other than as an employee, then the 20% minimum becomes a 50% safe harbor (as to both the percentage of services and annual compensation).⁷

This rule is designed to prevent an employer from attempting to avoid the application of 409A by simply keeping an employee on the payroll, under the guise of an ongoing service requirement, and arguing that no separation from service occurred. Rather than calling the arrangement “separation pay” or “severance,” the employer attempts to classify the payments and benefits as compensation in exchange for concurrent services. Such an arrangement is insufficient to avoid the application of 409A.

2. ***No Acceleration of Separation Benefits.*** Except in limited circumstances, 409A does not permit amounts subject to 409A to be paid prior to the permissible payment event and times set forth in the written arrangement. As a result, employers generally could not start to pay a departing employee his or her separation benefits until he or she actually separated from service. This rule should rarely be problematic for employers in the context of separation benefits.
3. ***No Changes to the Time and Form of Payment of Separation Benefits without Complying with 409A’s Rules for Such Changes.*** The new guidance provides that the initial deferral election with respect to separation pay must be made no later than the date on which the employee obtains a legally binding right to the separation pay. That time will generally be upon signing a separation or employment agreement that provides for the separation benefits, or when an individual becomes entitled to separation benefits under a severance plan that covers numerous employees. Once the initial deferral election is made, changes to the separation pay arrangement can only be made by complying with 409A’s “change in election” rules. Those rules provide that a change can only be made if: (a) the arrangement provides that the change will not take effect for twelve months; and (b) the change defers the payment of separation pay until at least five years after the originally scheduled payment date.

Due mostly to the requirement that the separation pay be deferred at least five years, changes to separation pay elections likely will not be desirable for departing employees. This should not present an issue where the separation pay arrangement is negotiated upon the employee’s departure and memorialized in a separation agreement. However, where the separation pay

⁷ Similar rules and safe harbors exist for determining when an independent contractor separates from service. The new guidance is clear that separation pay paid to an independent contractor may also be subject to Section 409A.

arrangement is agreed upon when the employee is hired, as is typically the case when an executive is hired, both parties should be cautious when entering into any such arrangement and should do so with the knowledge that, whatever arrangement is negotiated, the arrangement probably will not be able to be changed without incurring 409A's immediate and additional taxes.

4. ***Six-Month Wait for Key Employees of Public Companies.*** If applicable, the Key Employee Rule will need to be complied with. See the next section for a detailed discussion of the rule and its impact.

The Impact of the Key Employee Rule

409A's Key Employee Rule provides that nonqualified deferred compensation payable to "key employees" of public companies upon a separation from service cannot begin to be paid until six months have elapsed since the separation from service.⁸ As a result, many public companies will need to amend their executive employment agreements and severance arrangements to provide for this six-month wait, unless the arrangement is otherwise exempt from 409A. In amending their arrangements, companies will need to indicate how the six-month wait will be implemented (*i.e.*, all payments will simply be delayed six months, or payments for the first six months will be set aside with a lump sum to be paid on a fixed date following the expiration of the six-month wait).

In a bit of good news, the IRS has informally stated that the various elements of a separation package can be viewed as separate components. This means that, even if one portion of a separation package is subject to the Key Employee Rule, the other 409A-exempt portions of the package will continue to be exempt and will not be subject to the Key Employee Rule's six-month wait.

The new guidance explains how a company determines who its key employees are. Companies are instructed to use the twelve-month period ending on a set "identification date" each year. Unless elected otherwise by the company (and there are restrictive rules as to how this election may be made), the default identification date is December 31st. Any employee who is a key employee on a specific identification date is deemed to be a key employee for 409A purposes for the twelve-month period beginning on the first day of the fourth month following that identification date. For example, key employees on December 31, 2005 (using the 2005 calendar year as the identification period) will be deemed to be key employees under 409A for the period from April 1, 2006 through March 31, 2007. Similarly, key employees on December 31, 2006 will be deemed to be key

⁸ 409A uses the term "specified employee" and defines it by reference to the definition of "key employee" under Code Section 416(i). The definition under 409A includes the following individuals who are employed by a company whose stock is publicly traded on an established securities market: (a) an "officer" (this is a functional test that differs from the definition of officer under securities laws) whose annual compensation is greater than a specified amount (\$135,000 for 2005 and indexed for future years), limited to no more than fifty such officers; (b) an individual who owns at least 5% of the company; and (c) an individual who owns more than 1% of the company and whose annual compensation is greater than \$150,000. Companies must generally include all employees in this determination, although there is an exception under which companies may elect to exclude nonresident aliens.

employees under 409A for the period from April 1, 2007 through March 31, 2008. And so on.⁹ The benefit of this rule is that employers should generally know in advance when separation payments are to be made to key employees for 409A purposes.

Finally, even during the six-month wait, payments may be made to a key employee to comply with a domestic relations order (such as alimony or child support), to avoid conflicts of interest under a certificate of divestiture, and to pay certain employment taxes on amounts deferred.

What to do with “Good Reason” Separation Packages

As we have mentioned, the specific separation pay exemptions under 409A do not apply to voluntary separations, such as resignations due to good reason. The short-term deferral exemption, however, should apply to such arrangements, as long as the definition of “good reason” creates a substantial risk of forfeiture (*i.e.*, the executive should not be all but guaranteed separation pay upon signing his or her agreement because the definition of good reason is so expansive). The preamble to the proposed regulations makes clear that good reason termination provisions do not “categorically” subject the right to separation pay to a substantial risk of forfeiture. The IRS is requesting comments on this issue, and an IRS representative has informally stated that the IRS is open to suggestions for safe harbor definitions of good reason events.

For now, employers should begin to review the good reason termination triggers for their employees and make initial determinations as to whether the good reason definitions are narrow enough to be considered subject to a substantial risk of forfeiture under 409A. At this time, given the lack of guidance on the issue, it is difficult to state what types of good reason events the IRS will consider to constitute a substantial risk of forfeiture. The IRS’ informal position to date has simply been that good reason provisions are problematic under 409A.

Of note is that the IRS has also taken the informal position that any separation pay that is payable upon either a “without cause” involuntary termination or a “good reason” voluntary termination (as is frequently the case in executive employment agreements) may be subject to 409A *even if the separation pay is ultimately paid upon an involuntary termination that would otherwise fit within an exemption*. As a result, those separation payments would need to comply with 409A, including, to the extent applicable, the six-month wait for key employees.

Given the IRS’ request for comments on these issues and the fact that the proposed regulations are not yet final, we are hopeful that the IRS will provide guidance on these issues at the time the regulations are finalized (hopefully, by mid-year 2006). At this time, unless an employer has such a broad definition of good reason that it clearly will not come within a good faith interpretation of “substantial risk of forfeiture,” employers will likely want to wait until the regulations are finalized before revamping their good reason definitions.¹⁰

⁹ The new guidance also provides rules for determining who is a key employee in connection with spinoffs and mergers involving public companies.

¹⁰ Attempting to identify where the IRS will come out on these issues is a difficult task, but it would make sense if one factor the IRS considers is whether the company has a “cure” right under the good reason provision -- *i.e.*, that prior to any event being deemed good reason for the employee to resign, the company has a certain period of time to correct the situation such that no good reason will be deemed to exist.

What employers will want to do now is to make sure that any separation pay triggered by a good reason termination is paid out within the time limit for short-term deferrals (discussed above), even if the written arrangement does not provide expressly for a payment date or schedule (although caution is advised because there is now a rule preventing the application of the short-term deferral exemption for certain accelerations of payment). Alternatively, employers can treat such arrangements as subject to 409A and comply with 409A's rules, including the Key Employee Rule where applicable. Employers should keep in mind that there is currently a good faith obligation to comply with 409A, even though documentary compliance is not required until the end of 2006. In either case, after an initial review is conducted, some communication with the affected executives may be desirable to inform them of how their good reason separation pay arrangements may need to be altered.

Involuntary Separation Pay Arrangements Are Treated Separately Under 409A

One of the more technical aspects of the new guidance provides that involuntary separation pay arrangements (and voluntary window arrangements) will be treated as a separate type of plan apart from account balance, non-account balance, and equity compensation plans. What this means is that if an individual's separation pay arrangement becomes taxable under 409A, his or her other arrangements (such as benefits under a SERP) will not also become taxable under 409A. This rule essentially reduces the punishment for a separation pay plan that runs afoul of 409A by insulating the individual's other nonqualified deferred compensation plans from that 409A violation.

However, "good reason" separation pay arrangements do not appear to be included in new category of plan.

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If you would like to discuss the application of 409A to your separation pay arrangements or have any questions, please feel free to contact us.

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For Additional Information

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