



Separation Pay Options Under Code Section 409A

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Internal Revenue Code Section 409A introduces new rules governing non-qualified retirement plans and other deferred compensation arrangements. In this series of articles, we take an in-depth look at some of the crucial issues involved with bringing your plans and arrangements into compliance with Section 409A.

This article examines methods for providing separation pay consistent with Section 409A, including use of the short-term deferral and safe harbor exceptions, “stacking,” and integrating a release of claims. The attached chart provides analysis and options under various sets of circumstances related to separation pay under Section 409A.

There are several options available for providing separation pay consistent with Internal Revenue Code Section 409A. For this purpose, “separation pay” means an amount to which an individual obtains a right to payment only because of his or her separation from service. If the individual has a right to the amount without regard to separation from service, it is not separation pay. For example, amounts payable under the Deferred Compensation Plan are not treated as separation pay because payment of such amounts, once vested, is not contingent on separation from service—they are payable upon death or a fixed time election by the participant.

Separation pay may derive under:

- A separation or negotiated departure agreement, where there was no previous right to separation pay.
- A severance plan or agreement (including any offer letter or employment agreement that provides severance rights).

In the case of a severance plan or agreement, there may be several ways in which the agreement is structured to trigger the separation pay. These are identified in the attached chart.

See page 4 for an in-depth look at timing alternatives and stacking options under various scenarios related to separation pay.

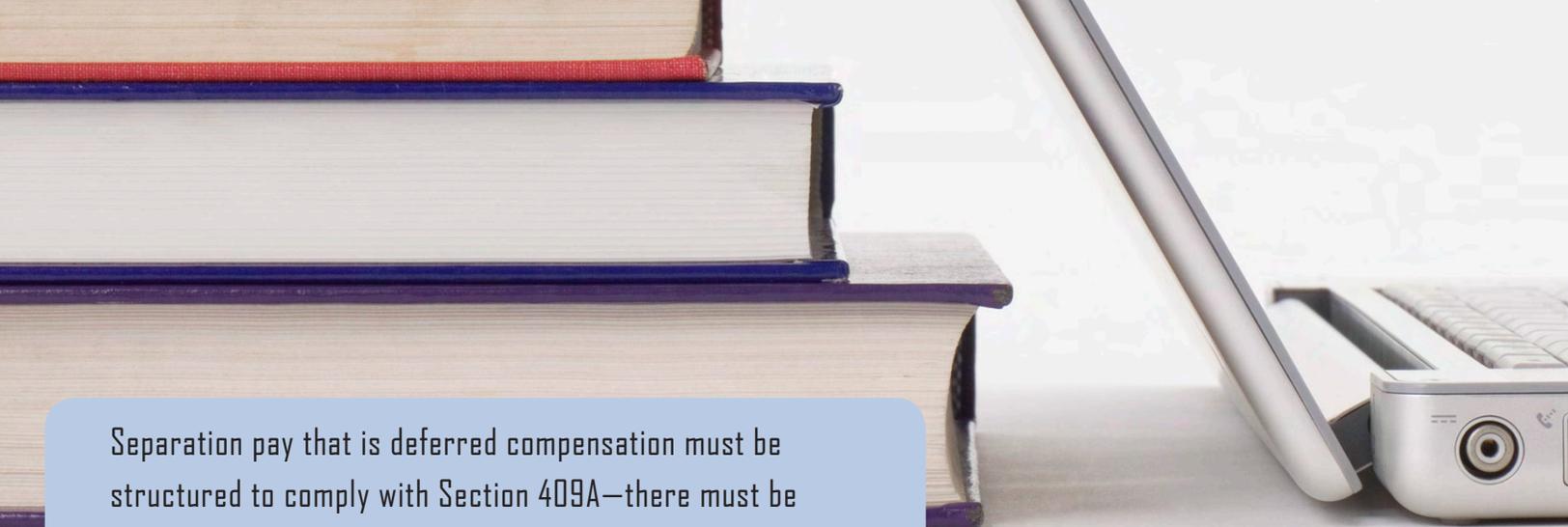
There are two main ways in which separation pay can be structured consistent with Section 409A:

- The separation pay can be structured to avoid Section 409A—that is, structured so that it does not fit the definition of deferred compensation subject to Section 409A. This can be done by structuring the payments to fit within one of the following exceptions to what is considered deferred compensation:
 - The short-term deferral exception; or
 - The separation pay safe-harbor exception.
- The separation pay can be structured to comply with the rules of Section 409A.

The short-term deferral exception and separation pay safe-harbor exception are described in more detail below.

SHORT-TERM DEFERRAL EXCEPTION

Payments to be made not later than 2½ months after the end of the year in which a “substantial risk of forfeiture” lapses (or, stated differently, after the right to the payment “vests”) are not deferred compensation.



Separation pay that is deferred compensation must be structured to comply with Section 409A—there must be objectively determinable payment dates and payment amounts.

Compensation is subject to a substantial risk of forfeiture if:

- The right to payment is conditioned on either the performance of substantial future services (e.g., the employee has to work to get paid) or on the occurrence of a condition related to the purpose of the compensation (e.g., a bonus payable upon achievement of specified goals); and
- There is a real risk that the employee or contractor may not be paid.

Amounts payable upon an “involuntary separation from service” are subject to a substantial risk of forfeiture. A covenant not to compete does not create substantial risk of forfeiture.

An individual is never “vested” before he or she has a right (even if it is a contingent right) to the payment. So, for example, in the case of a negotiated departure where a right to separation pay derives from a contract that was executed around the time of the departure, the right

to the payment arises when the contract is executed. Assuming there is no service contingency or other substantial risk of forfeiture, vesting also occurs at the time the contract is executed. A payment that is to be paid within the short-term deferral period measured by reference to the signature date of the contract is not subject to Section 409A. Scenarios are further described in the attached chart.

Separation Pay Safe-Harbor Exception

Any payment that qualifies under the separation pay safe-harbor contained in the Section 409A regulations is not considered to be deferred compensation subject to Section 409A. This exception is available for separation pay that:

- Is paid only in the case of an involuntary termination;
- Does not exceed, in the aggregate, the lesser of:
 - twice the employees’ annualized compensation for the prior calendar year; or
 - twice the compensation limit

in effect under Code Section 401(a)(17)—currently, such limit is \$225,000 (so twice the limit is \$450,000 for 2007).

- Is paid in full by the end of the second calendar year after the separation from service.

An “involuntary termination of employment” includes being fired by the employer, and it also includes a termination instigated by the employee, provided that there is acceptable “good reason” associated with the decision to leave. The regulations have safe-harbor “good reason” standards, and also a general standard if the parties are bold enough to move outside of the safe-harbor.

STACKING BUT NOT SUBSTITUTING

It is perfectly acceptable to “stack” separation pay—that is, it is permissible to have some separation pay fit under the short-term deferral rule, some under the separation pay safe-harbor, and some separation pay that is deferred compensation and structured to comply with Section 409A.



IRS rules, however, prohibit the “substitution” of amounts that are deferred compensation with amounts that are not deferred compensation. This effectively prohibits offset type arrangements where the amount payable as deferred compensation is offset by a variable amount payable under one of the exceptions. For example, an arrangement may provide that a discretionary amount is payable in a lump-sum promptly upon an involuntary termination, and that payment may qualify for the short-term deferral exception. The arrangement may further provide that fixed payments of a defined amount per month will be made over a period of three years after an involuntary termination, and those fixed payments may be structured to comply with Section 409A. (A six-month delay may apply if the recipient is a key employee of a public company.) However, if the arrangement provided that the amount payable as deferred compensation is a gross amount less the discretionary amount paid under the short-term deferral exception, that would be problematic. In that case, the exercise of discretion to increase the short-term deferral amount would have the effect of substituting something that is not deferred compensation for something that is deferred compensation, which would not be permitted under Section 409A.

INTEGRATING A RELEASE OF CLAIMS

Integrating a release of claims as a condition of receiving severance can present administrative issues, particularly

for payments designed to fall under the short-term deferral exception. In practice, the employer will want to ensure that employees are given the necessary releases at or shortly after the termination date. This will allow for any applicable consideration periods and rescission periods to run, while still giving the employer time to make the severance payment within the 2½-month short-term deferral window.

The plan or agreement should provide for payments at a fixed time or upon a fixed schedule, subject to the employee signing and not rescinding a release of claims.

COMPLYING WITH SECTION 409A

Separation pay that is deferred compensation must be structured to comply with Section 409A. While the full scope of compliance is not discussed here, most importantly for separation pay, there must be objectively determinable payment dates and payment amounts. Also, for a specified employee of a public company, payments must be delayed for at least six months following separation from service.

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SEPARATION PAY: TIMING ALTERNATIVES AND STACKING OPTIONS

NOTE: This chart relates solely to cash severance pay under a separation pay plan as defined in the regulations under Code Section 409A. It does not discuss reimbursement arrangements or provision of in-kind benefits that are sometimes provided in a negotiated departure or as part of a severance arrangement.

SCENARIO

A. Separation agreement executed in connection with a departure—not substitution for any prior severance commitment

TIMING ALTERNATIVES AND STACKING OPTIONS

The “vesting” date will not occur prior to the execution of the separation agreement. The vesting date will either be the execution of the agreement or the termination of employment (if further service or other performance conditions exist prior to the effective date of termination of employment). Note: This assumes that there is no other substantial risk of forfeiture in the agreement that would further delay the vesting date.

Timing Options

The available timing options are:

- The short-term deferral exception is available—payment must be made within same year as vesting date, or within 2½ months into the next year. There is no limitation as to the amount that can be paid as a short-term deferral; such amounts are not deferred compensation subject to Section 409A.
- The separation pay safe-harbor is available if payments are triggered from separation from service rather than execution of the agreement. The separation pay safe-harbor can be used to provide for severance payments in a stream beginning promptly following the date a separation from service* has occurred. (See limitations in accompanying article.)
- Severance amounts can be treated as deferred compensation in compliance with Section 409A:
 - The agreement can provide for payments to be made at a specified time or on a fixed schedule as determined and set forth in the agreement, without regard to the six-month delay for specified employees. This approach is compliant with Section 409A as providing for deferred compensation at a specified time or on a fixed schedule determined at the time the arrangement is entered into.
 - If payment is triggered from termination of employment, then payments must be made at a specified time or on a fixed schedule determinable from the date of termination, and, in the case of specified employees, payments must be delayed for at least six months following separation from service.*

Stacking Options

Any combination of the timing options may be used, but the structure must not provide offsets from one category to another.

(cont.)

A. Separation agreement executed in connection with a departure—not substitution for any prior severance commitment

Example: A fixed amount can be paid within 2½ months after termination of employment (assuming that is the vesting event). Additional amounts above the short-term deferral amount can be paid pursuant to the separation pay safe-harbor, if clearly designated under such safe-harbor and as separate from the short-term deferral amount. Further additional amounts can be paid as deferred compensation if paid at a specified time or schedule set forth in the agreement. Finally, amounts can be paid six months following the date the separation from service occurs (though this may be unnecessary if the severance vests upon execution of the agreement). The plan or agreement cannot provide for offset of amounts between categories.

Caution: Any offsets or substitutions of one form of severance pay for another (e.g., between a severance plan and an employment agreement, or calculations offsetting one category of payments from another) can pose problems under Section 409A and must be carefully coordinated.

* “Separation from service” may be different than termination of employment, and separation from service standard must be used consistent with Section 409A.

B. Severance plan or agreement creating enforceable rights—severance payable upon termination by the company without cause or resignation by employee for good reason—good reason definition satisfies Section 409A

The “vesting” date is the termination of employment date. Note: This assumes that there is no other substantial risk of forfeiture in the agreement that would further delay the vesting date.

The regulations under Section 409A have certain safe-harbor definitions of “good reason” which, if used, will allow for the termination date to be treated as the vesting date. The regulations have more general standards that, if satisfied, also will allow for the termination date to be treated as the vesting date. However, because such standards do not create a safe-harbor, an element of risk necessarily exists with the use of the general standard, with the risk generally increasing as the definitions used diverge from the safe-harbor. Having the termination date as the vesting date is essential to the treatment described in this section. Note: A full discussion of this issue is beyond the scope of this chart and the accompanying article.

Timing Options

The available timing options are:

- The short-term deferral exception is available—payment must be made within same year as vesting date, or within 2½ months into the next year. There is no limitation as to the amount that can be paid as a short-term deferral; such amounts are not deferred compensation subject to Section 409A.
- The separation pay safe-harbor is available—this exception can be used to provide for severance payments in a stream beginning promptly following the date a separation from service* has occurred. (See limitations in accompanying article.)
- Severance amounts can be treated as deferred compensation in compliance with Section 409A—payments must be made at a specified time or on a fixed schedule, and, in the case of specified employees, payments must be delayed for at least six months following separation from service.*

Stacking Options

Any combination of the timing options may be used, but the structure must not provide offsets from one category to another.

(cont.)

B. Severance plan or agreement creating enforceable rights—severance payable upon termination by the company without cause or resignation by employee for good reason—good reason definition satisfies Section 409A

Example: The Example in Scenario A above is instructive, but in this scenario the employer cannot usually rely on a “specified time or schedule” for compliance with Section 409A, since the parties do not know when separation from service will occur and no fixed time or schedule is certain. All other options noted above, however, can be used—short-term deferral, separation pay safe-harbor, and deferred compensation with the six-month delay following separation from service for specified employees. The plan or agreement cannot provide for offset of amounts between categories.

Drafting Note: If any specified employee is likely to be near the maximum limitation on amounts payable under a separation pay safe-harbor, the arrangement can provide for severance in a fixed dollar amount below the limit to be paid during the initial six-month period. Thereafter, additional amounts can be paid as deferred compensation compliant with Section 409A.

Caution: Any offsets or substitutions of one form of severance pay for another (e.g., between a severance plan and an employment agreement, or calculations offsetting one category of payments from another) can pose problems under Section 409A and must be carefully coordinated.

*“Separation from service” may be different than termination of employment, and separation from service standard must be used consistent with Section 409A.

C. Severance plan or agreement creating enforceable rights—severance payable upon termination by the company without cause or resignation by employee for good reason—good reason definition does not satisfy Section 409A

The “vesting” date is the date on which the employee becomes covered under the agreement. Note: This assumes that there is no other substantial risk of forfeiture in the agreement that would further delay the vesting date.

Timing Options

Neither the short-term deferral exception nor the separation pay safe-harbor is available. Rather, all severance amounts must be treated as deferred compensation in compliance with Section 409A—payments must be made at a specified time or on a fixed schedule, and, in the case of specified employees, payments must be delayed for at least six months following separation from service.*

Stacking Options

Not applicable.

* “Separation from service” may be different than termination of employment, and separation from service standard must be used consistent with Section 409A.

D. Severance plan or agreement not creating enforceable rights until termination of employment. For example, plan or agreement allows employer to terminate severance arrangement at will prior to termination of employment.

The “vesting” date is the termination of employment date. Note: This assumes that there is no other substantial risk of forfeiture in the agreement that would further delay the vesting date.

Timing Options

Same as Scenario B above.

Stacking Options

Same as Scenario B above.