

# Managing Change/Reductions in Force Tip of the Month

November 2008

## Severance Plans under Section 409A Reductions in Force Tip of the Month

**Tip:** Employers should immediately review their separation pay arrangements to confirm that they either are not subject to Internal Revenue Code Section 409A or comply with it in all respects. In some cases, action must be taken no later than December 31, 2008.

### What Is Section 409A?

Section 409A places significant new restrictions on the use by employers of “deferred compensation” arrangements, which are defined broadly and include arrangements such as severance or termination agreements and severance plans, arrangements, or practices. These restrictions require, for example, that the time and form of payment be specified in the relevant documents and meet certain requirements. (By way of only one small example, the time and form of payment requirements would prohibit the heretofore common term that severance will commence as soon as practicable after a release is effective.) In addition, these restrictions provide that there must be a six-month delay in certain termination payments to key employees of public companies.

Failure to comply with Section 409A can result in an employee’s immediate income recognition for all deferred amounts, as well as an additional 20% excise tax on those amounts. An employer also would have an obligation to withhold on the amounts taxable to employees and the failure to do so may result in penalties on the employer.

As noted above, to the extent that a severance arrangement is Section 409A-covered, the documentation of such arrangement must be in full compliance starting January 1, 2009. (These arrangements are already required to be in operational compliance.)

However, as described below, if structured appropriately, a severance arrangement may avoid Section 409A coverage altogether.

## **Code Section 409A Exceptions for Separation Pay Plans**

Under its regulations, the IRS has established broad exceptions from the rules of Section 409A for certain types of separation pay. Specifically, the final IRS regulations provide that the following separation arrangements are not considered deferred compensation and, therefore, are not covered under Section 409A:

- certain arrangements providing separation pay due solely to an involuntary separation from service or participation in a window program in limited amounts and for a limited period of time (discussed below);
- certain bona fide collectively bargained arrangements;
- certain foreign separation pay arrangements;
- certain reimbursement arrangements providing for expense reimbursements or in-kind benefits for a limited period of time following a separation from service;
- certain short-term deferrals that provide payment by the March 15 following the year in which a non-forfeitable right is created; and
- certain rights to limited or “safe harbor” amounts of separation pay.

## **Involuntary Separations from Service; Window Programs**

The exemption from Section 409A that most typically would apply to employers’ broad-based severance plans is available for separation pay made solely in connection with an *involuntary separation from service* or participation in a window program, provided that the following conditions are met:

- the separation pay does not exceed the lesser of two times (i) the employee’s annualized compensation, based upon his or her annual rate of pay for the prior taxable year (adjusted for any increase that was expected to continue indefinitely), or (ii) the compensation limitation under Section 401(a)(17) of the Internal Revenue Code for the year in which the employee has a separation from service (\$245,000 for 2009), and
- the plan provides that the separation pay must be paid in full no later than December 31 of the second year following separation from service.

For purposes of these rules, certain employment terminations by the employee for “good reason” are treated as involuntary separations from service. In order for a good reason termination to qualify as an involuntary separation from service, the event must meet certain requirements set out in the final IRS regulations. The final regulations also contain a good reason safe harbor definition that can be used by employers. Use of any definition other than the safe harbor will require a facts and circumstances determination, which, if incorrect, could result in the severance amount not being treated as paid as a result of an involuntary termination.

## **Conclusion**

The requirements of Section 409A and the exceptions summarized above are extremely complicated. Employers should work with legal counsel to consider carefully whether Section 409A will apply to their severance arrangements and, if so, how to ensure full compliance in both operation and documentation.

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