

Congress changes definition of deferred compensation

As the economy has weakened, executive terminations and severance pay issues are becoming more common.

Congress recently enacted 409A of the Internal Revenue Code to comprehensively regulate “deferred compensation.” Previously, most severance arrangements were not taxed as deferred compensation.

As a result, many companies are not aware that separation pay is regulated (and taxed) as deferred compensation unless certain exceptions apply.

And that taxation is brutal: failing to comply with 409A can accelerate taxation of several years’ worth of deferred compensation into a single year and subject it to interest and a 20 percent penalty tax. Although the recipient pays the income tax, interest and penalty, not the company, the IRS may impose the tax due to the presence of the arrangement.

That means current executives may have substantial income tax liabilities for payments that they have never received. And that may cause a serious disruption in the employer-employee relationship that most companies will want to avoid.

TYPES OF SEVERANCE

Obtaining a legally binding right to a compensatory payment in one tax year that is payable in a future tax year creates deferred compensation, even if it is subject to a substantial risk of forfeiture. Describing severance payments in an offer letter, employment agreement or company policy may therefore create deferred compensation.

Recognizing the broad reach of the statute, the IRS provides exemptions that allow several types of severance arrangements to avoid becoming deferred compensation:

- Severance payments made due to an involuntary termination or participation in a reduction-in-force window program that do not exceed the lesser of two times the employee’s annual compensation or \$460,000 for calendar year 2008. The payments also cannot extend beyond the second calendar year following the year of termination. Certain “good reason” terminations may qualify as involuntary, as discussed further below.

- Reimbursement of certain expenses, including those otherwise excludable or deductible from the gross income of the individual, reasonable out placement and moving expenses, and medical expenses. This exemption



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for payments upon an involuntary termination, reduction in force or similar events.

Many executive agreements provide for “good reason” terminations, where negative changes in the authority, title, duties or compensation of the executive constitute an involuntary termination. The IRS provides a safe harbor definition of “good reason” that may allow such terminations to qualify for the involuntary termination exception above.

The “short-term deferral” rule may also exclude many severance payments. Arrangements that pay an individual their full amount of severance within two-and-a-half months of the taxable year that the individual first obtained the right to severance are not deferred compensation. Note that this exception, unlike the involuntary severance payments discussed above, is not limited in amount. “Voluntary” terminations may also qualify for this exception.

If the binding right does not exist until the same year the payment is made then there is no deferred compensation. For example, an employer offers an immediate lump sum payment to a terminating employee in exchange for a release of claims. If before making the offer the employer had no contractual obligation to make such a payment, there is no deferred compensation since the right to payment and its receipt both occur in the same taxable year.

TERMINATION OF EMPLOYMENT

Employees often enter into an arrangement to continue providing services after the normal employment relationship has ended. The IRS presumes that a termination of employment (triggering the severance payment) occurs only if the employee is providing “insignificant services” to the employer.

“Insignificant services” means services pro-

vided and compensation received are less than 20 percent of the amounts prior to termination. The 20 percent time and pay threshold is based on an average of the three years immediately preceding the year in which the termination occurs (or, if the individual provided services for less than three years, such lesser period).

- Severance payments that do not exceed \$15,500 during 2008.

- Collectively bargained arrangements that provide

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Where an individual continues to provide services in a capacity other than as an employee (e.g., a former CEO becomes a consultant or director), the IRS presumes that no termination occurs if the former employee continues to work and get paid at a rate of 50 percent or more of his or her pre-termination levels. If post-termination services are between 20 percent and 50 percent of earlier levels, no presumption applies.

SEVERANCE PAYMENTS

For “key employees” of public companies (and certain affiliates), severance payments subject to 409A are subject to a six month delay after a termination of employment. Key employees are determined similarly to the top-heavy testing requirements applicable to tax-qualified retirement plans.

Section 409A does not limit its scope to just employers and employees. Payments to consultants, directors and even partners or LLC members are potentially subject to 409A. The above exceptions and rules apply to “deferred compensation” regardless of whether the recipient is an employee or not.

Severance arrangements are just one of many areas in the new deferred compensation rules where employers, consultants and employees may unknowingly create trouble. Code 409A does not prohibit severance pay. Rather, it imposes an additional income tax penalty that applies to non-exempt severance arrangements.

Employers will need to analyze severance arrangements to decide if they can be structured to fit into an exclusion, and if not, how to structure the payments to comply with the new rules in order to avoid unnecessary taxation.

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