

Law Creates Brutal Tax on Many Types of Severance Arrangements

By John Walch

Employee Benefits and Executive
Compensation Practice Leader
Ater Wynne LLP



Congress recently enacted §409A of the Internal Revenue Code (the “Code”) to tax “deferred compensation.” Previously, most severance arrangements were not taxed as deferred compensation. As a result, many employers are not aware that severance pay is now 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% penalty tax. Although the recipient, not the employer, pays the income tax, interest and penalty, the IRS may impose the tax due to the *pres-*

ence of the arrangement. That means current executives might have substantial income tax liabilities for payments that they have never received.

Types of Severance Covered by Code §409A

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 might create deferred compensation.

Severance Arrangements Exempt from Code §409A

Several exemptions allow certain types of severance arrangements to avoid becoming deferred compensation, including:

- Payments made due to an *involuntary* termination that do not exceed the lesser of (i) two times the employee’s annual compensation or (ii) \$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 be-

low.

- Reimbursement of certain expenses, including (i) those otherwise excludable or deductible from the individual’s gross income, (ii) reasonable outplacement and moving expenses, and (iii) medical expenses. This exemption applies to both cash and in-kind reimbursements. Some types of reimbursements are limited to expenses incurred by the individual before the end of the second calendar year following the year of termination.
- Severance payments that do not exceed \$15,500 (during 2008).

Many executive agreements provide for “good reason” terminations, where reductions 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.

Arrangements that pay an individual their full amount of severance within 2½ months of the taxable year that the individual first obtained the right to severance are

not 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. Note that this exception, unlike the involuntary severance payments discussed above, is not limited in amount. “Voluntary” terminations may also qualify for this exception.

Termination of Employment – Or Not

Employees often enter into an arrangement to continue providing services after the normal employment relationship ends. The IRS presumes that a termination (triggering the severance payment) occurs only if the employee provides “insignificant services” to the employer. “Insignificant services” means services provided and compensation received are less than 20% of the amounts be-

fore the termination.

Where an individual continues to provide post-termination services in a non-employee capacity (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% or more of his or her pre-termination levels. If post-termination services are between 20% and 50% of earlier levels, no presumption applies and facts and circumstances determine whether a termination has occurred.

Severance Payments to Key Employees

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.

Consultants and Directors

Section 409A does not limit its

scope to just employers and employees. Payments to consultants, directors, partners or LLC members are potentially subject to §409A. The above rules and exceptions apply to “deferred compensation” regardless of whether the recipient is an employee.

Conclusion

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, whether to structure the payments to comply with the new rules.

John Walch is the Employee Benefits and Executive Compensation Practice Leader at Ater Wynne LLP, a West Coast law firm with offices in Seattle, Portland, Menlo Park and Salt Lake City. John can be reached at jdw@aterwynne.com or (503) 226-1191.

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