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# Employee Severance Agreements and Section 409A Deferred Compensation: Withstanding Heightened IRS Scrutiny

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*Employee Severance Agreements and Section 409A Deferred*

*Compensation:*

*Withstanding Heightened IRS Scrutiny*

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## *Introduction*

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### What is Section 409A?

- Congress intends to address Enron and WorldCom
- Enron provided the IRS with the political capital necessary to regulate deferred compensation
- IRS interprets 409A broadly, with a series of regulations and other guidance from the IRS continuing for years

## *Why Do You Care?*

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- Employee penalties are very harsh
- Employers have a reporting and withholding obligation
- Employers sometimes gross employees up
- Employer could have contractual gross up obligation

## *Key Components Of 409A*

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The basic rules are deceptively straightforward

- Code Section 409A is two pages
- Final regulations are 400 pages - and then there are notices

Three basic rules

- Deferral election rules - regulate the timing of deferrals
- Distribution rules - define permissible distribution forms and events
- Modification and amendment rules - define circumstances under which changes are permissible

## *IRS Activity*

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- Plans have been required to be in documentary and operational compliance since January 1, 2009
- Increased audit activity since 2009
- Limited correction program - design and operational issues
  - Correction often involves disclosure to the IRS by both the employer and employee
  - Correction often involves penalties for both the employer and employee
  - Ability to correct can expire. Identify and correct issues as soon as possible
  - Not available if under audit

## *IRS Activity*

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May 2014 - IRS announced first step of an IRS compliance initiative project

Initial audit of no more than 50 companies

- The companies chosen for audit were previously identified for audit on employment tax issues
- Focus was primarily on initial deferral elections, subsequent deferral elections and payouts (including compliance with the six-month delay rule)
- Audits not limited to traditional deferral program

Current activities

## *Severance Agreements: Drafting Considerations*

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Isn't it enough to have a catch-all 409A provision at the end of an severance agreement?

- No. Savings clauses are of limited utility
- 409A is incredibly complex
  - No single catch-all template works for all agreements in all situations
  - Each agreement requires individual attention

With some drafting forethought, many agreements can be drafted to avoid many of 409A's most troublesome pitfalls

## *Corrections*

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Most of what we discuss today is correctable under IRS correction guidelines - two main correction programs:

- Notice 2008-113 (operational failures)
- Notice 2010-6 (documentary failures)

Correcting often requires employer and employee filings with the IRS

No announced intention to afford IRS review/assurance of adequacy of correction

While employer are often reluctant to do corrective filings out of “red flag” concerns, we often still urge formal correction

Early identification and correction can equate to more protection...

Again, once under audit, correction programs are unavailable

## *Permissible Payment Events*

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Amounts that are considered deferred compensation may only be distributed on a “permissible payment event”

- On a fixed date or pursuant to a fixed schedule (not a specified event)
- Separation from service
- Change in control (as defined in 409A)
- Unforeseeable emergency (as defined in 409A)
- Disability (as defined in 409A)
- Death

## *When does a separation from service occur?*

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Separation from service = termination of employment?

Presumption of separation

- If services permanently decrease to 20% or less of average services performed over immediately preceding 36-month period, presumed to be a separation
- If 50% or more, presumed to be no separation

In between 20%-50% -- no presumption

“Plan” may adopt its own rule by setting a level of services - greater than 20% but less than 50% of the average level of services provided over preceding 36 months - that will trigger a separation from service

## *409A – Common Misconceptions*

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### **409A only applies to public companies.**

- Wrong. All of the 409A rules apply to all companies. However, there is one rule (six-month delay required for certain separation payments to “specified employees”) that only applies to public companies.

### **409A only affects executives.**

- Wrong. If there is “nonqualified deferred compensation”, 409A applies.

### **409A only applies to employees.**

- Nope. Directors and other independent contractors are also subject to 409A.

### **409A doesn’t apply to partnerships or LLCs.**

- Wrong. 409A applies to every service recipient, regardless of its form. While the final regulations do not address partnership equity compensation, and the preamble indicates that until guidance is issued, one can rely on Notice 2005-1, for purposes of severance, the form of the company is irrelevant for 409A purposes.

## *409A – Common Misconceptions (Cont'd)*

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409A allows payments to be changed in connection with a change in control anyway.

- Maybe but not necessarily. There are significant restrictions on how a payment that is subject to 409A can be modified. It is true that there is some ability to terminate and liquidate plans in connection with a change in control but this exception to acceleration of nonqualified compensation requires compliance with its own set of requirements, including parameters around payment timing, the requirement that other “similar” plans also be terminated and restrictions of entering into new plans of a similar type following the transaction.

The Company is the party who will have to pay penalties for violations.

- No. Other than penalties for failing to withhold and report income properly, the consequences fall on the service provider, but he/she will often look to the Company to be made whole.

## *409A – Decision Tree*

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Is the severance payment nonqualified deferred compensation?

- If No → Not subject to 409A
- If Yes → Continue to 2. below.

Does the severance payment comply with 409A?

- If Yes → Good job!
- If No → Continue to 3. below.

Is it exempt from 409A?

- Examples:
  - Short term deferrals
  - Separation pay exception
  - Certain health benefits
  - Certain Reimbursements
  - Limited payments
  - Legal settlements
  - Window programs
  - Collectively bargained separation pay plans
  - Foreign plans

## *What is Deferred Compensation?*

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Deferral of compensation exists only if under the relevant facts and circumstances participant has a “legally binding right” during a taxable year to compensation that is or may be payable in a later tax year.

- Simple statement - incredibly broad application

Don't confuse “legally binding right” with “vested”.

- One can have a legally binding (i.e., contractual) right to compensation that will only be payable to the extent a condition is satisfied (i.e., to the extent it vests).
- The legally binding right is what triggers a 409A analysis.
- Example of a legally binding right:
  - “The employee will be entitled to \$X if performance targets XYZ are met.”
- Example of no legally binding right:
  - “The Board may, in its discretion, provide Employee with \$X upon the satisfaction of XYZ.”
- Discretionary vs. Objective Formula

## *Comply or Be Exempt*

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There are several ways to exclude arrangements:

- Per se exclusions - 401(k); other qualified plans; certain foreign plans
- Factual exclusions - short-term deferrals; “separation pay” exemption; restricted property
- Definitional exclusions - no legally binding right

## *How to Comply*

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If a service provider has a legally binding right to deferred compensation that does not fit within one of the stated exemptions from 409A, that amount may only be payable upon:

- A fixed date or pursuant to a fixed schedule (not a specified event)
- Separation from service
- Change in control (as defined in 409A)
- Unforeseeable emergency (as defined in 409A)
- Disability (as defined in 409A)
- Death

## *Compliant Severance*

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Severance is typically paid in connection with a “separation from service” so what is the issue?

- What does it mean to pay severance upon a separation from service?
  - An amount is payable on a permissible 409A trigger if the plan provides the date of the event is the payment date, or specifies another payment date that is objectively determinable and nondiscretionary at the time the event occurs.
  - A plan may also provide that a payment is to be made during a designated period objectively determinable and nondiscretionary at the time the payment event occurs, but only if the designated period both begins and ends within one taxable year of the service provider or the designated period is not more than 90 days and the service provider does not have a right to designate the taxable year of payment.

## *Compliant Severance (Cont'd)*

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- Has there actually been a separation from service?
  - Safe harbor
  - Consulting
- Is the service provider a “specified employee” subject to a six (6)-month delay?
- Is the severance payment tied to the execution of a release?

## *IRC § 409A*

### *Severance*

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Some forms of severance are not deemed NQDC for purposes of 409A

#### Exemptions:

- Short term deferrals
- Two times exception
- Certain health benefits
- Certain Reimbursements
- Limited payments
- Legal settlements
- Window programs
- Collectively bargained separation pay plans
- Foreign plans

## *IRC § 409A*

### *Severance*

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When dealing with severance need to think through:

- Was the severance subject to a Substantial Risk of Forfeiture?
- Was the termination of employment a Separation from Service?
- Was the termination an Involuntary Separation?
- Is the individual a Specified Employee?

## *IRC § 409A*

### *Severance*

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If no right to payment upon separation from service then parties have flexibility to structure time and form of payment

- Note that severance cannot be a substitute for forfeited NQDC

Be careful of payments required to be settled on a separation from service

- RSUs settled on separation from service
- Non-exempt stock options (FMV)
- Traditional NQDC
- If amounts should be settled, but are not settled, then likely 409A problems

## *IRC § 409A*

### *Substantial Risk of Forfeiture*

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Payments made within 2 ½ months after the end of the year in which the severance vests are exempt

In most cases, payments made by March 15 of the year after an involuntary termination of employment will be exempt

This includes payments made in a lump sum or in installments if the plan provides that each payment is a separate payment (stacking of exemptions)

## *IRC § 409A*

### *Separation Pay Exemption*

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The lesser of the following can be treated as not NQDC:

- Two times 401(a)(17) limit for the year of termination
  - This is the amount that can be recognized for qualified pension plans
  - \$285,000 for 2020
- Two times the annualized compensation based upon the annual rate for services in the preceding taxable year

Must be paid by the last day of the second taxable year following the taxable year of separation

## *IRC § 409A*

### *Separation Pay Exemption*

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Must be paid only on an involuntary separation from service

- Termination without Cause
- Termination with Good Reason where the definition of Good Reason is a good 409A definition

Amounts cannot be payable for any other reason, even if the termination is actually an involuntary termination

## *IRC § 409A*

### *Impact of Good Reason*

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Goes to substantial risk of forfeiture

Goes to only being paid on involuntary separation

Regulations provide for safe harbor definition; otherwise facts and circumstances determination

- Material diminution in base compensation
- Material diminution in authority, duties or responsibilities
- Material diminution in authority, duties or responsibilities of supervisor
- Material diminution in the budget over which authority is retained
- Material change in geographic location
- Any other action or inaction that constitutes a material breach of the service agreement
- Notice within 90 days; at least 30 days to cure, separation within 2 years of event

## *IRC § 409A*

### *Impact of Good Reason*

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Short term deferral needs to be based on substantial risk of forfeiture

- Bad “Good Reason” means no SRF

“Two times” exception depends on being payable only on involuntary separation

- Bad “Good Reason” termination means not involuntary separation

Note: There is nothing wrong with having a bad “Good Reason” definition - it just means that the payments must be structured to comply with 409A

*IRC § 409A*  
*Specified Employees*

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If a public company “Specified Employee” is involved, payments that would otherwise be due:

- during the first 6 months after separation need to be delayed until
- the earlier of the end of such 6-month period and death

## *IRC § 409A*

### *Specified Employees*

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Specified employees generally are employees who are

- officers with annual compensation greater than \$185,000 (for 2020),
- 5% owners, or
- 1% owners with annual compensation over \$150,000

Generally, no more than 50 people will be “specified employees”

## *IRC § 409A*

### *Specified Employees*

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- Identification of “specified employees” is based on the 12-month period ending on December 31 (or another identification date chosen by the corporation)
- A persons who is a “specified employee” during that 12-month period is considered a specified employee for the 12-month period commencing on the next April 1 (or sooner, if the plan specifies)

*IRC § 409A*  
*Specified Employees*

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To meet the six-month delay requirement, a plan may provide that:

- any amount payable pursuant to a separation of service due within the six-month period is delayed until the end of the six-month period, or
- each scheduled payment that becomes payable pursuant to a separation from service is delayed six months, or
- a combination of the foregoing

## *Multiple Forms of Payment*

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You are drafting an agreement for a long-serving CEO

- Agreement calls for two years severance (salary continuation) upon voluntary termination
- CEO wants a lump-sum payment upon involuntary termination

Reasonable? Yes. 409A compliant?

## *Multiple Forms of Payment*

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Not 409A compliant

409A generally permits only one form of payment following triggering event, like separation from service

- In other words, all times and forms of payment on account of a type of distribution event must be the same (a.k.a. the “anti-toggling” rule)

A separate toggle permitted for event occurring prior to specified date (or years of service for termination). Example - retirement toggle

An additional toggle for terminations within two years following a 409A change in control

## *Non-Separation from Service Toggle Example*

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- A plan may provide that a service provider will receive a lump sum payment of the service provider's entire benefit under the plan on the first day of the month following a change in control event that occurs before the service provider attains age 55, but will receive five substantially equal annual payments commencing on the first day of the month following a change in control event that occurs on or after the service provider's attainment of age 55
- The toggle is the service provider's age in relation to age 55 at the time of the change in control event
- The plan cannot provide for another payment pattern based on another toggle, such as a change in control event that occurs on or after service provider's attainment of age 65

## *Separation from Service Toggle Rules*

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Special rules apply to a plan that provides for payment upon separation from service

A different time and form of payment may be designated with respect to a separation from service under each of the following conditions:

- A separation from service during a limited period of time not to exceed two years following a change in control event
- A separation from service before or after a specified date, including attainment of a specified age, or a separation from service before or after a combination of a specified date and completion of a specified number of years of service, for example, attaining age 55 and completing ten years of service
- Any other separation from service

## *Multiple Forms of Payment*

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### **Drafting Tip:**

- Some latitude to vary payment forms for exempt arrangements
- Exempting arrangements takes up-front work

## *Medical Continuation After COBRA*

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Your client wants to give an executive two years of severance in an agreement

Executive advocates for continued coverage under medical plan for two year period with employer paid premiums

409A issue?

## *Medical Continuation After COBRA*

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There are potential 409A issues

- Taxable medical premiums after the COBRA period are subject to 409A
- COBRA period (for separation) is generally 18 months
- Premiums are often taxable to employee for self-insured medical plans under non-discrimination requirements

## *Medical Continuation After COBRA*

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Medical premiums after the COBRA period should be structured to meet the reimbursement provisions that are otherwise applicable to taxable reimbursements under 409A

- Several requirements must be met, including that the amount of expenses eligible for reimbursement in a calendar year can't affect amount eligible in another calendar year

In addition to 409A concerns:

- For self-insured plans, be wary of non-discrimination rules
- For insured plans, health reform non-discrimination rules tolled.... for now

## *Acceleration of Vesting*

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Equity-based grants (options, SARs and restricted stock) are, in most cases, exempt from 409A (if SR stock, no deferral feature and granted at price at least = to FMV)

- RSUs will be subject to 409A unless structured to meet an exemption

The acceleration of vesting of an equity grant generally will not cause Section 409A to apply to that award

- This is the rule regardless of whether the acceleration is pursuant to a provision contained in the option at the time of grant and when the acceleration is approved at a later date (e.g., in connection with a change in control)

In the case of a 409A-compliant stock option, the acceleration of vesting generally cannot result in an acceleration of the date of payment (i.e., exercise) of the option

## *409A and Releases*

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### TWO IMPORTANT POINTS:

A requirement that an employee sign a release in order to receive a benefit does not create a substantial risk of forfeiture; this means that payments that are otherwise vested but subject to the execution and delivery of a release should not be treated as unvested.

- Important for purposes of a “short-term deferral” analysis.

## *409A and Releases (Cont'd)*

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Severance that is subject to 409A can be conditioned upon the receipt of a release but the timing of the payment cannot be based upon when the employee provides the release.

- Caution should be taken when drafting provisions for releases to ensure that the payment timing with respect to the provision of the release complies with 409A.
- Agreement must specify window for execution of release if severance commencement is contingent on such release; avoids service provider indirectly choosing tax year of payments.
- Must specify when severance begins and must be within objectively determinable year.
  - Example of Noncompliant Language: “The severance described in Section X shall be payable to Employee pursuant to the Company’s normal payroll practices, commencing following Employee’s delivery of an executed release of claims in favor of the Company.”
  - Example of Compliant Language: “Payment of the severance described in Section X shall commence on the 60th day following Employee’s termination of employment, subject to a release of claims in favor of the Company, provided such release is executed, delivered and no longer subject to revocation, as applicable, within 60 days following such termination of employment.”
    - Alternative if delay is impracticable - Severance shall commence within 90-day window following termination of employment, provided if such 90-day period straddles two calendar years, payment will commence during the second calendar year.

## *Best Practices*

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One size doesn't fit all

Whenever possible, try to fit within an exemption from 409A

- Check definitions against the Treas. Regs.
- Use safe harbors when possible

Include “separate installment” language

Beware of substitutions

Consult an expert