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Re: How the New Code §409A Regulations Apply to Separation Pay

Dear Clients and Other Friends:

The proposed §409A regulations released by the IRS on September 30th contain complex rules affecting a wide range of pay practices. In this letter we will address how these new deferred compensation rules affect separation pay arrangements. In following letters we will consider how §409A affects other types of plans.

Lets look at how §409A affects the following types of separation pay;

- #1 Employer's separation plan provides continued salary for a period of weeks or months after an involuntary termination of employment. Amount typically varies according to the individual's job level and length of service. Employer decides case by case whether to pay this in a lump sum or installments.
- #2 Employer offers special separation pay to employees who sign up for an early retirement window program.
- #3 Employer and departing employee negotiate additional separation pay (beyond the regular plan amount) at the time of the employee's involuntary termination. Additional amount may be intended to help avoid legal claims or otherwise deal with special circumstances.
- #4 Employer agrees to provide special pay (typically around 3 times annual pay) to executives who terminate involuntarily in connection with a change of control. Payment also is made if executive resigns for "good reason" (e.g. reduction in pay or duties) following change of control. These payments will be made in a lump sum promptly after the termination of employment.
- #5 Employer continues certain benefits (e.g. medical coverage) to former employees while receiving separation pay.

#1 Salary Continuation Following Involuntary Termination. In analyzing how §409A applies to the benefits described in #1 above (and also in applying §409A to several other pay types on the list), one very basic question is whether the arrangement involves "deferred compensation". The proposed regulations define deferred compensation generally as

compensation to which an employee or other service provider has a legally binding right during one taxable year, but which is payable in a later year. However, the regulations except many separation payment arrangements from the §409A rules.

First, the proposed regulations provide that amounts subject to a “substantial risk of forfeiture” are not deferred compensation (and therefore are not subject to §409A) if such amounts are paid not later than two and a half months after the end of the tax year in which the substantial risk of forfeiture lapses. Payments that meet these requirements are referred to in the proposed regulations as “short-term deferrals”. For this purpose, a payment that is tied to involuntary termination of employment would be subject to a substantial risk of forfeiture right up until the time the involuntary termination occurs – after all, the individual might never get fired. Instead, he might have a voluntary termination, or leave due to death or disability, in all of which cases he would lose the right to separation pay. If the separation pay plan described in #1 above pays the separation benefits out in a lump sum promptly after the individual has the involuntary termination, these amounts would qualify as short-term deferrals and would not be subject to §409A.

Even if the separation pay is paid more than 2 ½ months after the year of the individual’s termination, it will still be exempt from the §409A requirements if it meets the following amount and timing requirements:

- Amount. To be exempt, the amount payable to a terminating employee must not be more than two times whichever of the following amounts is less:
 - his pay for the calendar year preceding the year of his termination;
 - the Code §401(a)(17) limit for the preceding year (currently \$210,000).
- Timing. Payments must be completed not later than December 31 of the second calendar year after the year in which he terminates.

This exemption allows the employer to choose on a case-by-case basis whether to pay separation pay in a lump sum or installments so long as the amounts and payment periods are within the above limits.

If the amount or payment duration exceeds the above limits, the separation pay is subject to §409A, but the §409A requirements can be satisfied by eliminating any employer or employee discretion regarding the form of payment, and specifying in the plan document how payments will be made (e.g. always pay in installments). Also, if the individual is a high-level executive of a public company, separation pay subject to §409A must not be paid until 6 months after the date he terminated.¹

¹ This restriction generally applies to public company executives who are “key employees” for purposes of the IRS top heavy rules. The regulations go into detail about how to identify these individuals for purposes of §409A. Note, separation pay that met the safe harbor requirements or that qualified as payment of a short-term deferral, would not be subject to the 6-month delay since, in either case, it would not be deferred compensation subject to §409A. A properly structured program, then, should be able to give terminating executives significant immediate benefits that mitigate the effect of the 6-month delay rule.

#2 Window Benefits. Amounts paid to employees who voluntarily terminate through an early retirement window plan also are exempt from §409A, provided they meet the amount and timing requirements described above. Benefits that do not satisfy these requirements will have to satisfy the §409A rules.

#3 Negotiated Separation Pay. The proposed §409A regulations permit separation pay to which an individual had no existing right but which is negotiated with the employer at the time of involuntary separation to be paid at the time or times the parties agree on in the separation agreement. This exemption only applies to additional separation pay beyond any amount to which the individual is entitled under his employment contract or the employer's regular separation pay plan. This exemption allows the employer and departing employee to negotiate whatever payment schedule they want for the additional separation pay.

#4 Payments in Connection with Change of Control. Parachute payments triggered by an employee's involuntary termination of employment in connection with a change of control and paid promptly thereafter also will qualify for the short-term deferral rule and be exempt from §409A. However, the status of payments made if an employee voluntarily terminates for "good reason" after a change of control is not clear. The preamble to the proposed regulations notes IRS concerns about treating good reason terminations as involuntary and has requested comments about that issue.

#5 Benefit Continuation to Former Employees. The proposed regulations provide that medical benefits, outplacement services, and many other types of benefits employers typically provide for brief periods following separation of employment are not subject to Code § 409A. This exemption applies during the year of separation and the two succeeding calendar years.

In summary, while certain types of separation pay are subject to the new deferred compensation rules, the proposed § 409A regulations exempt most separation pay from these requirements and give employers fairly clear direction as to how separation pay arrangements that are subject to §409A can be revised to meet the new requirements.

Separation pay that does not qualify for any of the above exemptions will tend to be a component of the separation package for a senior executive. In such a case, it will be necessary to structure the separation pay program so that the non-exempt pay satisfies the §409A requirements. This can be done by requiring a fixed payment schedule and, for top-level employees at public companies, delaying the first payment until six months after the individual terminates.

Please let us know if you have any questions about this subject.

Sincerely,

A. David Kelly