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

Dear Clients and Other Friends:

The final §409A regulations released by the Treasury Department last month will require significant changes to many severance pay plans. We urge you to take these new rules seriously, because failure to follow them may expose some severance pay recipients to significant penalty taxes. Here is an overview of the new requirements:

1. **Ways to Avoid §409A:** The regulations provide two primary ways for severance pay to avoid the application of Code §409A. First, payments due only upon an involuntary separation from service are exempt from §409A, regardless of amount, if they must be made not later than 2½ months after the year of separation and are actually made by that deadline. This is an application of the general exception for amounts known as “short-term deferrals” that are paid shortly after they vest.

Second, payments due only upon involuntary separation from service also are exempt from §409A if the amount does not exceed a certain level (referred to in this letter as the “409A limit”) and the payments are completed by a prescribed date (referred to in this letter as the “409A deadline”). For 2007, the 409A limit is \$450,000¹ or two times the individual’s annual pay², whichever is less. The 409A deadline is the end of the second year following the year of separation. Severance pay amounts up to the 409A limit that are paid by the 409A deadline can be paid as the employer chooses. It is not necessary for the plan to specify a fixed schedule for such payments.

Payments made using either exemption can begin immediately after termination of employment, even if the recipient is a “specified employee” (the §409A term for certain officers and owners of public companies) whose other non-qualified deferred compensation must be held back for six months following termination. (The six-month rule is discussed further in item 3 below.)

¹ The \$450,000 limit is two times the annual pay limit under Code §401(a)(17) and is subject to a cost of living adjustment for years after 2007.

² The final regulations refer to an individual’s “annual rate of pay”, including increases in the year of separation that were expected to be permanent. Recent informal comments by the drafters have indicated that the definition was meant to exclude unusual payments, such as extraordinary option exercises or deferred compensation payments, but the definition gives no precise description of what can (and cannot) be included.

Severance pay that does not qualify for either exemption is subject to Code §409A and generally must satisfy these §409A requirements:

- The plan must specify and follow a fixed-payment schedule for the non-exempt severance pay.
- For specified employees, the non-exempt severance pay may not be paid until at least six months after the employee's separation from service.

These requirements apply only to the portion of the severance pay that does not qualify for exemption. For example, if a public company specified employee with annual pay of \$600,000 has an involuntary termination in 2007 and qualifies for \$1.2 million of severance pay, \$450,000 of it will be exempt from §409A and can be paid in a lump sum or installments as determined by the employer, provided that payments are completed by the end of 2009. The remaining \$750,000 is not exempt from §409A and must be paid in accordance with a fixed payment schedule that is specified in the plan document. Because the employer is a public company and the employee was a specified employee, this portion of the severance pay may not be paid until at least six months after the month of separation. If the fixed payment schedule for the \$750,000 excess amount required it to be paid in full not later than 2 ½ months after the year of separation, all of the separation pay could be made exempt from §409A (since an arrangement can use both exemptions), and none of it would be subject to the six-month hold-back requirement.

2. **Involuntary Separation from Service:** The regulations go into considerable detail about the definition of involuntary separation from service. If the parties characterize the separation as voluntary (e.g. "Fred is resigning to spend more time with his family"), there is a presumption that the separation really is voluntary, not involuntary. However, that presumption is rebuttable if the facts and circumstances indicate that the employer really intended to let Fred go and Fred was aware that he would be terminated.

The regulations also indicate the circumstances where an employee's resignation for "good reason" will be considered involuntary. The general requirement is that the resignation must be due to a "material negative change" such as an adverse change to the employee's duties or work conditions or a material pay reduction. Other factors to be considered are whether the employee must give the employer notice of the problem and the employer must have a reasonable opportunity to correct it, and whether the amount payable is the same as is paid in the case of other involuntary separations.

In addition to the general rule, the regulations also offer a safe harbor definition of good reason termination. For the safe harbor to apply, the resignation must occur during a pre-determined period of time – not to exceed two years – following one or more of the following adverse changes: (1) material reduction of base pay, (2) material diminution of authority, duties, or responsibilities, (3) material diminution in the responsibilities of the employee's supervisor (e.g. instead of reporting to the CEO, the employee will now report to the manager of the mail room), (4) material reduction in the budget over which the employee has authority, (5) material

change in geographic location, and (6) material breach by the employer of the employee's employment agreement. To use the safe harbor, the employee must notify the employer that there has been an adverse change and the employer must have an opportunity to correct it.

3. **Six-Month Rule:** For public company "specified employees"³, non-exempt severance pay may not begin until at least six months after the month of separation. This requirement does not apply to employees of private companies, nor does it apply to public company employees who are not specified employees. To help individuals affected by this limit buy groceries during the six-month period while their non-exempt severance pay is held back, the regulations allow exempt severance pay to be treated as paid first. The challenge of identifying exactly who is a key employee subject to these requirements is quite complex. The final regulations offer considerable flexibility in making this determination, but some companies are choosing to avoid this issue entirely by applying the six-month hold-back to all employees.

4. **Medical Benefits, Reimbursements and Incidental Benefits:** Medical benefits provided by an employer during the COBRA continuation coverage period following separation from service (whether or not the individual is actually entitled to COBRA coverage) are not subject to §409A. This exemption applies, for example, if the employer chooses to waive the COBRA premium for the 18 months after separation. Certain other expense reimbursements and in-kind benefits provided after termination of employment are also exempt from §409A. Examples include:

- Employer reimbursement of expenses for which the employee might otherwise be eligible for a tax deduction (regardless of whether the amount of the expense is high enough to be deductible), provided the expenses are incurred by the end of the second year after the year of separation and the payments occur by the end of the third year. This category also includes outplacement expenses, moving expenses, and reimbursement for loss on sale of the individual's primary residence incurred in connection with the separation.
- In-kind benefits such as merchandise discounts provided on or before the last day of the second year after the year of separation.
- Other incidental payments, whenever paid, up to the Code §402(g)(1)(B) limit for the year of termination (\$15,500 for 2007 terminations).

These exceptions apply regardless of whether the separation is voluntary or involuntary.

5. **Problem Areas:** A variety of common practices will present problems under the final rules. For example:

³ Specified employees are the "key employees" (as defined in Code §416(i)) of a publicly traded company, as determined under a scheme established by the regulations. Generally this group includes certain owners and up to 50 persons who, during a 12-month period ending on the "specified employee identification date", are officers making more than a specified amount (\$145,000 for 2007).

- (a) **Plan allows employer to decide form of payment.** Many severance pay plans permit the employer to decide at the time an employee terminates whether to pay in a lump sum or installments. This flexibility is permitted for severance pay up to the 409A limit (\$450,000 or two times annual pay, whichever is less) and paid by the 409A deadline (end of the second year after the year of separation), but it does not work at all for amounts in excess of that limit or paid later. The Plan will have to specify a payment schedule for the excess amounts.
- (b) **Public Company Plans.** But for §409A, no public company would automatically hold back severance pay until six months after separation from employment. All public company severance pay plans that pay more than the 409A limit or beyond the 409A deadline will have to address this issue. As noted above, the six-month hold-back will apply to only the portion of severance pay that is not exempt.
- (c) **Written Plan Requirement.** Some employers have relied on unwritten policies or practices to determine severance pay. In most cases, it will be advisable for these employers to adopt written severance pay plans that specify the payment terms. (A written plan will be essential if the plan pays non-exempt amounts.)
- (d) **Reimbursements.** Employers that provide in-kind benefits or expense reimbursements following involuntary termination (e.g. outplacement, home purchase, moving expenses...) will need to specify the payment details in writing.
- (e) **Employment Agreements.** If an individual's severance pay rights are specified in his employment agreement or somewhere else separate from the severance pay plan, the contract must satisfy the §409A requirements.
- (f) **Post-Employment Consulting Arrangements.** Offers of post-employment compensation in exchange for services in a consulting or other non-employee capacity will need to be carefully considered. If the facts and circumstances suggest that the compensation exceeds what might reasonably be paid for services actually rendered, the excess might be recharacterized as additional severance pay which, if not exempt, could trigger a §409A violation.

One additional feature of the regulations regarding severance pay that needs to be mentioned is the rule prohibiting substitution of severance pay for amounts deferred under another nonqualified deferred compensation plan. It is not permissible, for example, to take an obligation to pay \$400,000 of deferred compensation and to recharacterize that obligation as severance pay in order to accelerate payment using the exception for severance less than the 409A limit and paid by the 409A deadline.

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A trickier application of this rule can arise when an employee changes jobs and automatically qualifies for a different severance program with a different payment schedule. According to some of the drafters of the final regulations (speaking informally and subject to the usual disclaimers that they were expressing their personal views and not those of the government), if non-exempt amounts are earned under one severance plan and an employee moves to another severance plan with a different payment schedule, the payment schedule for the non-exempt amounts earned under the first plan may need to be preserved in order to prevent a §409A violation.⁴ If an employer does not maintain a uniform payment scheme across all of its severance plans, this may require tracking severance benefits in a way that few, if any, employers have ever considered necessary.

We believe that §409A compliance with regard to severance pay will be particularly challenging for many employers because the new rules affect and will require changes to many common practices that have not traditionally been thought of as involving deferred compensation. Let us know if you have any questions about these new requirements.

Sincerely,

A. David Kelly

ADK/jks/ram

⁴ For example, if the plan applicable to the employee's old job paid a lump sum benefit of two times salary that exceeded the 409A limit and was payable six months after separation, and the plan applicable to the employee's new job as a senior executive vice president paid a benefit of three times salary over a period of three years, the amount earned under the old job that was not exempt from §409A might still have to be paid in a lump sum six months after separation, and only the additional amounts earned in the employee's new job could be paid in installments (i.e., amounts attributable to the increase in the multiple from two times to three times and amounts attributable to higher pay in the new job).