

First Wednesday

By Anne E. Senti-Willis

A Monthly Discussion of Employment Law Issues and Other Hot Topics for Management

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Employee Severance Agreements — Tax Minefields!

Employers and employees have long negotiated severance agreements, whether at the time employment starts or in connection with a termination of employment. In the past few years, however, there have been new tax issues that can alter the course of those negotiations. Section 409A of the Internal Revenue Code was signed into law in October 3, 2004, and the Department of Treasury issued final regulations, interpreting Section 409A, that became effective January 1, 2008. While Section 409A nominally deals with nonqualified deferred compensation, its reach is broad and includes severance provisions in employment agreements. Section 409A must be considered in negotiations surrounding termination of employment and severance pay.

Effects of Section 409A

Section 409A imposes stringent requirements on “nonqualified deferred compensation plans.” A “nonqualified deferred compensation plan” is any plan that allows compensation that is earned in one year to be paid in a later year, other than a qualified employer plan (such as a 401(k) or other retirement plan) or a bona fide vacation, sick leave, disability pay or death benefit plan. The term “plan” includes an agreement with an individual, and does not require that it apply to a broad group of employees or service providers. If a deferred compensation arrangement does not comply with the provisions of Section 409A, it results in immediate taxation to the employee, coupled with a 20% excise tax. The employee is in effect treated as though she received all of her severance pay on the day the severance agreement is signed. While the ultimate increased tax burden is borne by the employee who receives the benefit subject to Section 409A, the employer is required to report Section 409A compensation on Forms W-2.

The Department of Treasury’s regulations under Section 409A elaborate on the breadth of the law, and make clear that it applies to employee severance payments, whether those are negotiated before, during or at the time of termination of employment.

Involuntary Termination Requirement

Two exceptions to Section 409A may apply to severance arrangements. These are described below. With either exception, the severance may be paid only if the separation is involuntary. A termination by the employer without cause meets this requirement, as do certain terminations by the employee for “good reason.” The Section 409A regulations describe the circumstances that can lead to “good reason” and provide a safe harbor definition that can be used in employment agreements. It must occur during a pre-determined and limited time period (not more than two years) after one or more of the following conditions occurs, without the employee’s consent:

- material reduction in the employee’s base compensation;
- material reduction in the employee’s authority, duties or responsibility;
- material change in reporting structure reducing the authority, duties or responsibility of the employee’s supervisor;
- material reduction in the employee’s budgetary authority;
- material change in geographic location; or
- material breach by employer of employee’s employment agreement.

The employee must be required to give the employer notice of the “good reason” within 90 days of its occurrence and an opportunity to cure it before resignation can occur. Finally, the severance payable following termination for good reason must be substantially identical to that payable for any other involuntary termination.

Exceptions to Section 409A

If an employee’s termination is involuntary, severance payments are not subject to Section 409A if: (1) the “2 in 2” exception applies, or (2) the short term deferral exception applies.

The “2 in 2” exception applies if the total amount of severance that will be paid does not exceed the lesser of twice (a) the employee’s annual compensation or (b) the retirement plan compensation limit (\$230,000 for 2008 and \$245,000 for 2009). The severance must be paid by the close of the second year following the year of the termination of service. Any severance in excess of \$460,000 for 2008 or \$490,000 for 2009 will not qualify for the “2 in 2” exception.

An unlimited amount of severance is exempt from Section 409A if it is paid in a lump sum within the later of (a) 2 ½ months of the employer’s year end or (b) March 15 of the year following termination. Note that, for this exception, while the total amount of severance is unlimited, the time for completion of payment is very specific.

When negotiating severance agreements, employers, employees, and their counsel, should realize that the “2 in 2” and short term deferral exceptions can be combined. For example, if an employee is to receive a substantial lump sum payment at the time of termination or shortly thereafter, followed by a stream of payments that would meet the “2 in 2” exception, the entire package may be excluded from Section 409A. Also, there are further restrictions on timing of payments to certain officers of publicly traded companies.

Characterization of Termination and Settlement Agreements

The exceptions to Section 409A all require that terminations be involuntary, not at the request of the employee. The parties’ characterization of the termination as voluntary or involuntary is presumed accurate, though that presumption can be rebutted. That can be helpful for an employee who was on the verge of termination, but agreed to resign for non-tax reasons, so long as the employee has evidence to rebut the presumption. The opposite also applies if the parties provide that a termination was involuntary, but there is evidence this characterization was not accurate.

Many times, severance pay is negotiated at the time of an employee’s termination or even later. It may be paid as a way to settle an employee’s potential legal claims, including discrimination, harassment or other wrongful termination. Section 409A was not intended to apply to settlements of legal claims. The Section 409A regulations specifically provide that it does not apply to settlements to resolve bona fide legal claims, including payments for legal fees. There is no requirement that suit be brought, just that the claims be bona fide. This holds true even if the amounts paid are treated as compensation or wages for Federal tax purposes. This is a large exemption, and the bona fide claims should be recited in any agreement relying on it.

Beyond severance agreements, Section 409A has broad effects. Though the law is more than four years old, final regulations have been in effect for less than a year, and the Internal Revenue Service has not yet finished issuing its guidance. Any deferred compensation arrangement should be carefully examined to see if it has Section 409A implications.

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