New Considerations for Severance Agreements in Light of IRS Code Section 409A

Counsel should be increasingly cautious when negotiating and reviewing severance agreements for adverse tax consequences. The landscape with respect to severance pay and benefit provisions has changed with the enactment of new regulations under Section 409A of the Internal Revenue Code governing the treatment of deferred compensation. The following discussion is intended to alert employment law practitioners, particularly those representing employees, to Section 409A provisions that may impact severance negotiations so that, when necessary, expert tax and/or employee benefits advice may be secured.

The American Jobs Creation Act of 2004 was signed into law on October 22, 2004. It created a new Section 409A of the Internal Revenue Code, effective January 1, 2005. This Section impacts nonqualified retirement plans and other deferred compensation arrangements, including “severance pay plans” or severance agreements. Its purpose is to eliminate abuses, such as those taken by Enron executives, related to election timing, distribution timing, and the ability to receive accelerated payments. Section 409A’s final regulations, published on April 17, 2007, became effective on January 1, 2008. (72 FR 19234-01, 1.409A-1(b)(9)). See www.ustreas.gov/press/releases/reports/td9321.pdf for a full copy of the final regulations.

Section 409A, including its application to certain severance pay plans, is significant for two reasons. First, it regulates nonqualified deferred compensation through a number of complicated rules and regulations. Second, the rules impose harsh penalties in the event of non-compliance. For example, there is a 20% penalty tax to the employee, not the employer, on the

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particular payment or benefit that fails to comply with Section 409A and, in some instances, underpayment interest plus 1% (26 CFR 1.409A(a)(1)(B)(2005)).

On September 10, 2007, the IRS issued Notice 2007-78, providing plan sponsors an extension to December 31, 2008 to maintain compliance with written documentation relative to deferred compensation plans. However, actual compliance until that date has not been suspended. Therefore, this year is pivotal to ensure that employment contracts and other contractual provisions the employee has entered into with his or her employer are modified to comply with Section 409A. If those modifications have not been made in a timely fashion, penalties will result.

Given the complexity of Section 409A, for the purposes of this article and unless stated otherwise, it is presumed that the employee does not have a preexisting agreement with his or her employer regarding severance pay. In other words, at the time of separation from employment, there is a “clean slate” within which these negotiations commence.

**Legal Settlements.** It is important to recognize that severance agreements that are actually settlement agreements of bona fide legal claims are not considered deferred compensation under Section 409A (72 FR 19234-01, 1.409A-1(b)(11)). These claims may include those based on wrongful termination, employment discrimination, the Fair Labor Standards Act, or workers’ compensation statutes, irrespective of the law under which the claims arise and regardless of the status of the settlement proceeds as compensatory payments. The payment or reimbursement of attorneys fees incurred in connection with the resolution of these claims is also exempt from Section 409A application. Section 409A, however, will apply if the settlement changes the timing of payments of deferred compensation already subject to the
regulation. Whether or not a bona fide legal claim exists is determined based on the particular facts and circumstances. Accordingly, the mere fact that a release is being executed by the employee does not mean that a severance agreement is free of Section 409A scrutiny.

**Separation Pay Constitutes Deferred Compensation Under Section 409A.** “Separation pay” is compensation received by the employee that is conditioned upon his or her separation from employment. Separation pay is distinguished from other compensation the employee could otherwise receive without separating from employment; e.g., an amount also payable upon a change in control or as a result of an unforeseeable emergency. Section 409A applies to severance agreements where the employee acquires a right in one year (i.e., it is no longer subject to a substantial risk of forfeiture), but it is not paid until the next year. Illustrations include the following:

- **Example 1:** Employer promises to pay severance to the employee if she is terminated without cause. Unless one of the exemptions under Section 409A (addressed below) is applicable, this is “non-qualified deferred compensation,” and it must comply with Section 409A.

- **Example 2:** Employee does not have a binding right to severance, but the employer nonetheless pays executive severance upon her termination in the same taxable year as the termination. There is no deferral of compensation into a difference tax year. Therefore, Section 409A does not apply.

- **Example 3:** Employee stops performing service for the employer but is maintained on the payroll until the following year. The final regulations do not treat salary continuation as delaying the actual separation date for Section 409A purposes.

- **Example 4:** Upon employee’s termination, employer agrees to reimburse her county club dues and allow her to use the corporate plane for the next five years. This is considered “non-qualified deferred compensation” and must comply with Section 409A.