Section 409A and Severance Arrangements

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This practice note discusses how the nonqualified deferred compensation (NQDC) rules of I.R.C. § 409A and its implementing regulations (Section 409A) apply to severance arrangements. Section 409A governs the federal tax treatment of a wide variety of NQDC arrangements, which are generally defined as any legally-binding compensation arrangement where payment is or can be made in a taxable year after the taxable year in which the arrangement is created. Section 409A's strict rules limit distributions to six permissible payment events, including a separation from service, which is described in this practice note. As a result, if the severance arrangement (1) has a payment trigger that includes a separation from service and (2) is subject to Section 409A, then the severance arrangement must comply with Section 409A's strict rules regarding the time and form of payment, as well as use a definition of separation from service that meets the requirements of Section 409A. Otherwise, there would be adverse tax consequences for the executive.

Section 409A issues should be considered in advance of granting severance benefits to executives or implementing severance or change-in-control plans, when administering agreements and plans that are subject to Section 409A, and during the due diligence process in the context of corporate transactions to identify potential noncompliance issues.

This note is divided into five main parts:

- Overview of Severance Arrangements Subject to Section 409A
- Short-Term Deferral Rule
- Special Exemptions for Severance Benefits
- Other Key Considerations
- Sample Section 409A Clauses for Severance Arrangements

For further information on I.R.C. § 409A generally, see Understanding Nonqualified Deferred Compensation Arrangements and Internal Revenue Code Section 409A. For additional information on separation arrangements for executives, see Drafting Common Provisions in an Executive Separation Agreement, Strategies for Negotiating Executive Separation Agreements for Employers, and Strategies for Negotiating Executive Separation Agreements for Executives.

Under Section 409A, the term service provider captures executives and other employees as well as certain independent contractors, including directors. Similarly, Section 409A rules use the term service recipient for any entity that retains, hires, or receives services from a service provider (along with affiliated entities within the same controlled group as, or under common control with, the entity). 26 C.F.R. §§ 1.409A-1(f), (g). In this practice note, we use the terms employee (instead of service provider) and company or employer (instead of service recipient) for simplicity. However, please be aware of the broader reach of these rules when drafting or reviewing a severance arrangement.

OVERVIEW OF SEVERANCE ARRANGEMENTS SUBJECT TO SECTION 409A

A severance arrangement, as used in this practice note, refers to any plan, agreement, program, or other arrangement between an employer and one or more employees that provides for the payment of an amount on account of an employee's separation from service. Such an arrangement may be documented in an offer letter, an employment agreement, or a change-in-control agreement with an individual employee, or in severance plans covering a class of eligible employees.

Although severance arrangements do not typically share the same characteristics as traditional NQDC arrangements, they may nonetheless be subject to Section 409A, in whole or in part. A severance arrangement is subject to Section 409A where the legally-binding severance benefits are or can be made in a taxable year after the taxable year in which the arrangement is created, and no exemption applies. 26 C.F.R. § 1.409A-1(b)(1).

As further described below, a severance arrangement that is subject to 409A must comply with strict rules regarding, among other things, the form and timing of payments made to the employee. In addition, the employer and employee will be restricted in their ability to modify such terms at a later time. If, however, a severance arrangement is not subject to Section 409A, then it will avoid the many limitations and other requirements that Section 409A imposes.

Unfortunately, there is no generally applicable exception to Section 409A for severance arrangements. 26 C.F.R. § 1.409A-1(b)(9)(i). As a result, severance benefits are NQDC subject to Section 409A unless the short-term deferral rule applies or a special exemption from Section 409A exists, as discussed later in this practice note.

Section 409A Coverage Requires a Legally Binding Right

Section 409A only applies where the severance arrangement creates a legally-binding right to receive payment(s) that are or can be made in a taxable year after the taxable year in which the arrangement is created. No legally binding right to severance benefits(s) are created if the payments can be reduced or eliminated unilaterally by the employer after the employee performs the services creating the right to the payment. Whether a legally binding right exists depends on the facts and circumstances. 26 C.F.R. § 1.409A-1(b)(1).

However, a severance arrangement creates a legally binding right to receive payment(s) if an employer retains the right to reduce or eliminate a severance benefit upon a condition being met (e.g., if the company's revenues fall under a minimum threshold). This concept of a conditional right to compensation should not be confused with the concept of compensation that is subject to a substantial risk of forfeiture, which is discussed further below, under Short-Term Deferral Rule In addition, the severance arrangement creates a legally binding right if the employer retains discretion to reduce or eliminate the benefit, but that discretionary authority lacks substantive significance (e.g., where the employee is related to, or has authority over, the person responsible for exercising the discretion). 26 C.F.R. § 1.409A-1(b)(1).

Requirements for Severance Benefits Subject to Section 409A

If the severance arrangement creates a legally binding right to severance benefits that are subject to Section 409A and no exemption applies, then the severance benefits must meet several stringent requirements, including:

- The material terms of the arrangement must be in writing and the time and form of payment generally may not be accelerated. Further deferral of payment is only permissible with significant restrictions.

- Payment must be triggered by the occurrence of a permissible payment event under Section 409A, which only include: (1) a fixed date or schedule, (2) death of the employee, (3) disability of the employee, (4) unforeseeable emergency, (5) change-in-control event, and (6) separation from service. For severance arrangements, the trigger is usually a separation from service.
- The arrangement must specify the payment date or a permissible payment period for the severance benefits (e.g., a lump-sum payment within the 90-day period following a separation from service), and the employee may not be permitted to determine the year in which payment actually occurs.
- The arrangement will need to contain Section 409A-compliant definitions, such as for the terms "separation from service" or "change in control", if they are used as permissible payment events.
- The arrangement must, where applicable, provide that no amount is payable upon a separation from service to a "specified employee" (as defined below in the section entitled "Six-Month Delay for Specified Employees of Publicly Traded Companies" under Other Key Considerations) of a publicly traded company until six months after a separation from service.

I.R.C. § 409A(a)(2); 26 C.F.R. § 1.409A-3(a).

Consequences of Section 409A Violations

Compliance failures can result in severe adverse tax consequences for the employee. Specifically, all amounts deferred under the noncompliant arrangement (and, in some cases, amounts deferred under other arrangements that must be aggregated with it) are includible in gross income from the first tax year in which they cease (or ceased) to be subject to a substantial risk of forfeiture. In addition, the employee must pay an additional 20% federal income tax on such amounts and, in some cases, a premium interest tax. The premium interest tax applies to any hypothetical underpayment of the employee's tax liability for a prior year arising from the inclusion of income of any portion of the deferred amount for that year due to the violation. The premium interest tax rate is 1% plus the IRS underpayment rate applied to the amount of the deemed underpayment.

Although the employee bears the additional tax penalties that result from a Section 409A violation, there is potential exposure for the employer for tax reporting and withholding failures. In any case, the employer must report amounts included in income due to a Section 409A violation as wages on Form W-2 (in box 12 of Form W-2 using Code Z for noncompliant deferred compensation), and withhold on such amounts at the supplemental wage rate. I.R.S. Notice 2008-113, 2008-2 C.B. 1367.

Separation from Service under Section 409A

In the context of severance arrangements, the most common permissible payment event is a separation from service. A separation from service occurs under Section 409A shen an employee dies, retires, or experiences a termination of employment with his or her employer. 26 C.F.R. § 1.409A-1(h)(1) (see 26 C.F.R. § 1.409A-1(h)(2) for rules for independent contractors). In the case of a termination of employment, a separation from service generally occurs if the facts and circumstances indicate that the employer and employee anticipate that no substantial further services will be performed after a certain date.

Under these rules, bona fide leaves of absence not longer than six months do not generally result in a separation from service. For longer leaves, the employment relationship remains intact so long as the employee has a right to return to employment under applicable law or the terms of a contractual agreement. Otherwise, a separation from service is deemed to occur on the day following the six-month period of leave. This six-month period can be extended to 29 months when the employee suffers a serious physical or mental impairment that results in the leave of absence. 26 C.F.R. § 1.409A-1(h)(1).

In most cases, whether a separation from service has occurred will not be at issue. When a separation from service is ambiguous, however, the general rule is that an employee is presumed to have separated from service where the level of services performed decreases to 20% or less of the average level of services performed by the employee during the immediately preceding three-year period. On the other hand, an employee is presumed not to have separated from service where the level of services performed is 50% or more of the average level during the previous three-year period. No presumption applies where the level of services falls within these two ranges. In other words, a separation from service generally requires an 80% reduction in the employee's average level of services, but could still exist where there has been a reduction of as low as 50%. 26 C.F.R. § 1.409A-1(h)(1)(ii).

When analyzing whether a separation from service has occurred, other facts and circumstances you should consider include whether the employee:

- Continues to be treated as an employee for other purposes (such as continuation of salary and participation in employee benefit plans)
- Is treated consistently with other similarly situated employees who have terminated employment
- Is permitted, and available, to perform services for other employers in the same line of business

26 C.F.R. § 1.409A-1(h)(1)(ii).

If an employee ceases to be employed by a company but begins providing the same services at the same level to the same employer as an independent contractor (or its affiliate in the same controlled group), the employee will not be considered to have a separation from service.

The determination of whether a separation from service has occurred is important since the IRS could find a Section 409A violation has occurred under a severance arrangement subject to Section 409A if the benefits are intended to be triggered by a separation from service and either the benefits are (1) paid prematurely because a qualifying separation did not occur when the parties thought it did, or (2) not paid when due under the arrangement because the parties did not properly treat a termination as a separation from service when they should have.

Separation from Service in Asset Deals

In the context of an asset purchase transaction, a separation from service typically occurs by operation of law if the transaction documents are silent on the matter. This means that employees of the seller are deemed to be terminated by the seller at the closing of the transaction even if they continue providing the same services for the buyer post-closing. However, Section 409A provides that as part of a sale of substantially all the assets by the seller to an unrelated buyer, the seller and the buyer may choose to specify whether an employee will experience a separation from service for purposes of Section 409A in connection with the transaction under such circumstances. In order to exercise this discretion, all of the following requirements must be met:

- The transaction must be the result of bona fide, arm's length negotiations.
- All employees must be treated consistently from the seller to the buyer for purposes of applying the provisions of any NQDC arrangement.
- Such treatment must be specified in writing by the closing date of the transaction.

26 C.F.R. § 1.409A-1(h)(4).

The IRS has clarified that a stock sale that is treated as an asset sale under *I.R.C. § 338* isnot considered an asset sale for purposes of determining whether an employee has a separation from service. *Prop. Treas. Reg. § 1.409A-1(h)(4)*, 81 Fed. Reg. 40,569, 40,580 (June 22, 2016).

Corrective Procedures for Impermissible Separation from Service Definition

The IRS has provided guidance on how to voluntarily correct certain plan document failures under Section 409A. See I.R.S. Notice 2010-6, 2010-1 C.B. 275 and I.R.S. Notice 2010-80, 2010-2 C.B. 853 (hereinafter referred to as Notice 2010-6 and Notice 2010-80, respectively). In general, to be eligible for correction, the defect must be unintentional, neither the employer nor employee may be under IRS examination regarding nonqualified deferred compensation, and the parties must take certain steps, including reporting the violation to the IRS. More information on Section 409A correction programs can be found at Lexis Tax Advisor – Federal Topical § 1C:6.04, paragraph [8][f].

If a severance arrangement provides for payment upon a termination of employment that fails to qualify as a separation from service under Section 409A, the error may be corrected by (among other things) amending the arrangement, with immediate effect, to provide for a payment event that satisfies the requirements of Section 409A, as long as (1) the amendment does not either expand the definition to include any event that was not a payment event under the plan before the amendment, or (2) narrow the definition to eliminate as a payment event any event that was a payment event under the plan before the amendment, except as necessary to satisfy the requirements of Section 409A (without reference to any permissible alternative definition of separation from service under Section 409A). However, the arrangement must be amended prior to the occurrence of any event constituting a separation from service under the arrangement.

If, within one year following the date of correction, an event occurs that (1) is not a separation from service under Section 409A but would have required payment under the arrangement prior to the correction, or (2) is a separation from service under Section 409A but would not have required payment under arrangement prior to the correction, and results in the corrected plan provision being applied to avoid a payment that would have been due prior to the correction or results in the corrected plan provision being applied to make a payment that would not have been due under the arrangement prior to the correction, then 50% of the amount deferred under the plan to which the pre-correction plan provision would have applied must be included in income under Section 409A by the affected employee in the service provider's taxable year within which the event occurs. That amount would be subject to the 20% additional tax under Section 409A (but not the interest penalty). Notice 2010-6, Part V.A.2

Example (bad separation from service definition). An employer consists of one parent corporation and two 80% owned subsidiaries. An employee of the parent has an employment agreement providing for severance benefits equal to 12 months' base salary payable when the employee separates from service (as defined under Section 409A) from the parent corporation or is transferred from the parent corporation to either of the subsidiaries. The transfer provision violates Section 409A because the transfer would not constitute a separation from service (or any other permissible payment event), but the agreement could be amended to cure the violation under Notice 2010-6, if eligible. On January 10, 2017, the employer transfers the employee to one of the subsidiaries before the agreement is amended. Since the provision was not corrected before the transfer, the agreement is no longer eligible to be corrected, regardless of whether the employee is paid the severance amount. The arrangement thus fails to satisfy the requirements of Section 409A for 2017 and all previous years in which the agreement contained that provision, and the employee must include the deferred amount in income and pay the additional 20% tax and premium interest tax under Section 409A accordingly. If the parties had corrected the agreement under the IRS program shortly before the transfer, the employee would only have had to recognize only 50% of the deferred amount in income (and no interest penalty would apply). See Notice 2010-6, Part V.C.

SHORT-TERM DEFERRAL RULE

There are several ways in which severance benefits can avoid Section 409A altogether. One of them is the so-called short-term deferral rule. This rule and the special exemptions described later in this practice note can be combined when determining whether a severance amount is subject to or exempt from Section 409A. This is known as stacking.

As noted above, NQDC arrangements, including severance arrangements, are only subject to Section 409A if the NQDC arrangement creates a legally binding right to receive payment(s) that are or can be made in a taxable year after the taxable year in which the arrangement is created. However, Section 409A provides for relief, even where there is a legally binding right, for so-called short-term deferrals, where payment must be made within a short period of time after the severance is no longer subject to a substantial risk of forfeiture.

Under the short-term deferral rule, there is no deferred compensation subject to Section 409A under a severance arrangement if the terms of the arrangement require the amount of severance to be paid (under all circumstances)—and the amount actually is paid—no later than the 15th day of the third month following the end of the employee's or employer's taxable year (whichever ends later) in which the right to the severance is no longer subject to a substantial risk of forfeiture (often referred to as vesting for purposes of Section 409A). 26 C.F.R. § 1.409A-1(b)(4)(i)(A). (For simplicity, the remaining discussion in this practice note refers to March 15 of the year following the vesting year as the end of the short-term deferral period, assuming that both the employee and employer have calendar tax years.)

In other words, if the NQDC arrangement provides that the severance payment will be made on a date that must occur before March 15 of the year after the year in which the severance payment vests and the amount is in fact timely paid, then the payment will not constitute deferred compensation.

There are a few limited circumstances in which a payment that is delayed beyond the end of the short-term deferral period will not jeopardize the arrangement's short-term deferral status (e.g., due to unforeseeable events making timely payment administratively impracticable, where payment would threaten the employer's ability to continue as a going concern, or where payment would violate applicable law). See 26 C.F.R. § 1.409A-1(b)(4)(ii) and Prop. Treas. Reg. 26 C.F.R. § 1.409A-1(b)(4)(ii), 81 Fed. Reg. 40,578–79.

The short-term deferral rule is often referred to as an exemption to Section 409A, but it is distinguishable from the special exemptions discussed later in this practice note because a severance payment that meets the requirements of the short-term deferral rule does not constitute deferred compensation under Section 409A and therefore is not subject to Section 409A in the first place. The special exemptions, on the other hand, generally come into play for severance benefits that are otherwise subject to Section 409A.

Substantial Risk of Forfeiture

The existence of a substantial risk of forfeiture (SRF) is a key factor in determining whether the short-term deferral rule applies to an amount that would otherwise be subject to Section 409A. Under Section 409A, an employee's right to compensation is subject to a SRF if the employee's right to the compensation (1) is conditioned on the future performance of substantial services by the employee or the occurrence of a condition related to a purpose of the compensation (e.g., achievement of a performance goal) and (2) in either case, the possibility of forfeiture is substantial. I.R.C. § 409A(d)(4); 26 C.F.R. § 1.409A-1(d)(1).

The substantiality of the forfeiture risk is measured in two ways:

- Likelihood of the occurrence of the event resulting in a forfeiture
- Likelihood of enforcement of the forfeiture condition upon the occurrence of a relevant event (see 26 C.F.R. § 1.409A-1(3)

26 C.F.R. § 1.409A-1(d)(1).

A simple example of a SRF condition is a service requirement under a retention agreement where the retention bonus is payable only if the employee remains continuously employed through a designated future date. The Section 409A rules also provide that severance benefits which are conditioned on an **involuntary** separation from service (discussed in the next section) are considered subject to a SRF so long as the risk of forfeiture is substantial, until the occurrence of such a separation. Id.

A severance payment is not subject to a SRF merely because the right to the payment is conditioned, directly or indirectly, upon the employee refraining from the performance of services. This means that simply signing a non-competition agreement in which the employee promises not to perform services for certain competitors will not create a substantial risk of forfeiture for purposes of Section 409A. 26 C.F.R. § 1.409A-1(d)(1).

To illustrate, consider a severance agreement that conditions payment on both an involuntary termination of employment and compliance with a six-month post-employment non-compete restrictive covenant. The terms of the agreement provide for payment in a lump sum at the expiration of the non-compete period. This arrangement would not qualify as a short-term deferral because the SRF ceases upon the termination date (and not the end of the non-compete period since the non-compete obligation itself does not give rise to a SRF). Since, under some circumstances, the payment would be made later than the short-term deferral period (e.g., an October 5 termination date would result in payment on April 5 of the following year, which is later than the end of the short-term deferral period on March 15 of that year). Thus, this arrangement would need to comply with the requirements of Section 409A (unless another exemption was available).

For further information on the concept of a substantial risk of forfeiture under Section 409A and other Internal Revenue Code provisions, see Substantial Risk of Forfeiture.

While Section 409A allows for the deferral of compensation for income tax purposes beyond the vesting date of the amount deferred, there are employment tax obligations that may arise when an amount is no longer subject to a substantial risk of forfeiture. So vesting acceleration may trigger reporting and FICA tax obligations. See ¶ 1404.6 of Employee Compensation and Benefits Tax Guide P 1404.

Involuntary Separation from Service

The short-term deferral rule is generally only available for severance benefits that are conditioned on an involuntary separation from service, as defined under Section 409A. Accordingly, if an employee's severance arrangement provides for severance payments upon any termination of employment, including a voluntary separation from service (e.g., the employee has a "walkaway" right), the short-term deferral rule would not apply as there is no SRF, and the payment could be deferred to a date that is later than the March 15 of the year following the year in which the agreement is finalized (i.e., when the employee obtains the legally binding right)..

Under Section 409A, an involuntary separation from service means a separation from service due to the employer's independent exercise of its authority to terminate the employee's services, other than due to the employee's implicit or explicit request, where the employee was willing and able to continue performing services; in other words, where the employer fires the employee. 26 C.F.R. § 1.409A-1(n)(1). However, an involuntary separation from service under Section 409A can include a bona fide "good reason" termination provision (as discussed in the next section), so severance agreements containing such provisions may still be eligible for the short-term deferral rule.

An involuntary separation from service may include the employer's failure to renew the employment agreement at the time it expires, provided that the employee was willing and able to execute a new agreement under substantially similar terms. The determination of whether a separation from service is involuntary is based on the facts and circumstances of each case. 26 C.F.R. § 1.409A-1(n)(1).

Separation from Service for Good Reason

While severance arrangements with employees typically provide for severance benefits upon an involuntary separation from service, key employees also often negotiate for and receive severance benefits upon a resignation for good reason, also known as a constructive termination. Notwithstanding that the short-term deferral rule only applies to an involuntary separation from service, Section 409A does provide a limited exception where a voluntary separation from service for good reason will be treated as an involuntary separation from service. The exception applies if the employee is eligible for severance on a resignation for good reason and the definition of good reason under the employee's agreement either meets the Section 409A definition of good reason or satisfies the Section 409A good reason safe harbor. 26 C.F.R. § 1.409A-1(n)(2). A Section 409A-compliant good reason definition is important when drafting severance arrangements since using a noncompliant definition can take the arrangement out of eligibility for the short-term deferral rule, which could, depending on the other terms of the arrangement, result in a Section 409A documentation or operational violation.

Section 409A Good Reason Definition

A Section 409A-compliant good reason definition must require that the employer take actions resulting in a "material negative change" to the employment relationship with the employee. In analyzing if there has been a material negative change, key factors to take into consideration include:

- The duties to be performed by the employee
- The conditions under which such duties are to be performed –and–
- The compensation that the employee would receive for performing services

Other factors include the extent to which the severance benefits payable upon a separation from service for good reason are payable under the same terms (e.g., amount, timing, and form of payment) as in an actual involuntary separation from service, and whether the employee is required to give notice of the conditions that led to resignation for good reason and a reasonable opportunity for the employer to remedy the conditions. 26 C.F.R. § 1.409A-1(n)(2)(i).

Due to the ambiguity of these criteria, practitioners typically advise their clients to use a definition that satisfies the Section 409A safe harbor.

Section 409A Good Reason Safe Harbor

To qualify as an involuntary separation from service under the good reason safe harbor (and therefore be substantially certain to qualify for the short-term deferral rule, assuming that the timing of the payment otherwise complies with the rule), the good-reason trigger must be one or more of the following conditions arising without the consent of the employee:

- Material diminution in the employee's base compensation (note that a diminution in incentive compensation is not a safe harbor good-reason trigger)
- Material diminution in the employee's authority, duties, or responsibilities

- Material diminution in the authority, duties, or responsibilities of the employee's supervisor, including a requirement that an employee report to a corporate officer or employee instead of reporting directly to the board of directors or managers
- Material diminution in the budget over which the employee retains authority
- Material change in the geographic location at which the employee must perform services (a threshold of 50 miles is typical)
- Any other action or inaction that constitutes a material breach by the employer of the agreement with the employee

26 C.F.R. § 1.409A-1(n)(2)(ii).

In addition, three further requirements must be satisfied for the Section 409A good reason safe harbor to apply:

- The employee must resign within a specified period following the relevant good-reason trigger, which period may not exceed two years.
- The amount, time, and form of the payment for the separation from service for good reason must be substantially identical to the amount, time, and form of payment made on an actual involuntary separation from service.
- The employee must give notice of the existence of one of the good reason conditions within 90 days after the condition first occurs, and the employer must have at least 30 days to cure the condition.

26 C.F.R. § 1.409A-1(n)(2)(ii).

For a sample Section 409A-compliant safe harbor good reason definition, see Sample Section 409A Clauses for Severance Arrangements below.

Short-Term Deferral Eligibility Pitfalls

The short-term deferral rule, along with the separation pay exemption discussed below, is an effective method for severance arrangements to avoid the restrictions and consequences of being subject to Section 409A. As part of your analysis of whether a severance arrangement is eligible for short-term deferral, you should consider the following pitfalls.

Walkaway Rights and "Bad" Good Reason Pitfalls

As noted above, the short-term deferral rule only applies to severance benefits payable upon an involuntary separation from service, which generally means either dismissal by the employer or the employee's resignation for good reason (under a Section 409A-compliant definition). A severance arrangement will not be eligible for the short-term deferral rule, however, if the severance arrangement provides that the severance benefits vest and can be paid outside of the short-term deferral period, even if the employee's ultimate termination is an involuntary separation from service. Therefore, one pitfall to avoid is allowing the employee to simply walk away with severance benefits intact. Good reason definitions that permit a key employee to quit for any reason following a change in control and still be entitled to severance are uncommon, but such arrangements will not be deemed an involuntary separation from service.

For example, assume an employee has an employment agreement that provides a severance payment if the employee voluntarily terminates within one year following a Section 409A-compliant change-in-control event. In this case, the severance payment ceases to be subject to a SRF at the time of a change-in-control event, and the employee would have a walkaway right for a full year thereafter. This agreement would not be eligible for the short-term deferral rule and would be subject to Section 409A. On the other hand, if the walkaway period were limited to two months following the change in control, then the arrangement could still qualify as a short- term deferral because the payment would in all cases be made within the short-term deferral period following the change-in-control.

Frequently, severance arrangements that are intended to qualify as a short-term deferral will contain a good reason definition that calls into question whether the payment is limited to an involuntary separation from service. As noted above, due to the inherent ambiguity of the general rule for good reason clauses under 26 C.F.R. § 1.409A-1(n)(2)(i), it is a best practice for Section 409A compliance to rely on the safe harbor under 26 C.F.R. § 1.409A-1(n)(2)(ii). Even the safe harbor uses subjective materiality thresholds, however (e.g., how distant must a workplace relocation be before it is material?). Practitioners should remain mindful of the potential Section 409A noncompliance implications when negotiating these agreements since overly employee-friendly good reason triggers could jeopardize short-term deferral status.

Installment Payments Pitfall

The short-term deferral rule generally applies if the severance payment must be made on or before March 15 of the year after the year in which the severance payment vested (assuming the employer has a calendar tax year). Under Section 409A's default rules, if a severance arrangement provides for severance payable in installments (which is a common form of payment), all of the installments are treated as a single payment, some of which will be paid outside of the short-term deferral period. As a result, none of the payments would qualify under the short-term deferral rule. 26 C.F.R. §§ 1.409A-1(b)(4)(i)(F), (G).

Notwithstanding the default rule, however, a plan may provide that the right to receive a series of periodic substantially equal installment payments (other than annuity payments) will be treated as a right to a series of separate payments for the application of Section 409A. 26 C.F.R. § 1.409A-2(b)(2)(iii); see 26 C.F.R. § 1.409A-1(b)(4)(i)(F). This means that if the arrangement contains language stating that the installment payments will be treated as separate payments, then each payment will be analyzed separately to determine if the short-term deferral rule applies. Therefore, you should include a provision in the severance arrangement stating that each installment will be treated as a separate payment for purposes of Section 409A, where applicable, so as to permit at least those installments paid before March 15 to be eligible for short-term deferral. This can be helpful when applying a stacking strategy to avoid application of Section 409A when used in combination with one of the special exemptions discussed in the next section.

SPECIAL EXEMPTIONS FOR SEVERANCE BENEFITS

If a severance arrangement is not eligible for short-term deferral, it nevertheless may be eligible for a special exemption from Section 409A. The following summarizes these special exemptions.

Exemption for Involuntary Terminations

The most significant Section 409A severance-related exemption is for separation pay paid on an involuntary termination. To have a chance to qualify for this exemption, the separation pay must be paid **only** on account of a separation from service, whether voluntary or involuntary. 26 C.F.R. § 1.409A-1(m). For example, an amount payable under an employment agreement that provides amounts to be payable on the earlier of a specified time (such as reaching the age of 55) or separation from service will not be treated as separation pay, even if the amounts are ultimately paid upon separation from service. This is the case because the right to the amount does not arise solely due to a separation from service since the amounts could have been paid at the specified time (which could have occurred prior to the separation from service).

If that hurdle is met, then the exemption requires that the severance pay:

- Is due solely to an involuntary separation from service
- Does not exceed (1) two times the lesser of the employee's total annualized compensation and (2) two times the compensation limit for qualified plans under *I.R.C. § 401(a)(17)* –and–
- Is paid within two years from the year that the separation from service occurred

26 C.F.R. § 1.409A-1(b)(9)(iii).

Involuntary Separation from Service Trigger

The first condition to the exemption is that the separation pay must only be payable on an involuntary separation from service, as defined under 26 C.F.R. § 1.409A-1(n). As noted above in the discussion of SRF under Short-Term Deferral Rule, an involuntary separation from service occurs due to the employer's independent exercise of its authority to terminate the employee's services, other than due to the employee's implicit or explicit request, where the employee was willing and able to continue performing services. Thus, this exemption does not apply if the severance benefit is payable under circumstances such as a voluntary resignation or retirement.

It also does not apply to severance amounts that are payable upon a termination of employment due to the employee's disability. This does not meet the involuntary separation from service criterion because the disabled employee in that case is not "willing and able" to continue performing services. This is a common pitfall in severance agreements intended to rely on this special exemption.

Two-Times Limit

This exemption (and the one for window programs discussed below) only applies to the extent that the severance payments are less than (1) two times the lesser of the employee's annual compensation for the year immediately prior to the year of termination and (2) two times the qualified plan annual compensation limit under *I.R.C. § 401(a)(17)*, as adjusted for annual cost-of-living adjustments. Thus, the separation pay exemption will only apply for a separation occurring in 2018 up to the lesser of (1) $550,000 (2 x $275,000) and (2) two times the employee's annual compensation, determined as described below. Severance payments over this limit will not be exempt from Section 409A under the separation pay exemption, but may still be exempt under the short-term deferral rule or another available exemption.

For purposes of the two-times limit, an employee's annual compensation is based on the annual rate of pay for the year prior to the year of separation from service, adjusted for any increase during that year which was expected to continue indefinitely if the employee had not separated from service. 26 C.F.R. § 1.409A-1(b)(9)(iii)(A)(1). The regulations are not entirely clear as to whether annual compensation for this purpose includes income deferred under, for example, qualified or nonqualified deferred compensation plans and equity-based compensation, or whether and how to account for variable incentive compensation. A reasonable position is to include in the prior year compensation any amounts to which the employee obtained a vested legally binding right, and to take into account any incentive compensation opportunity that would have been substantially likely to be paid if the employment relationship continued (e.g., bonus amounts under an annual bonus program that the employee customarily received).

If the employee was not employed for any portion of the previous year, then annual compensation is based on the year of termination. *Prop. Treas. Reg. § 1.409A-1(b)(9)(iii)(A)(1)*, 81 Fed. Reg. 40,580.

Payment Period Limit

The separation pay for involuntary termination exemption (and the window program exemption) only applies to the extent that the terms of the agreement provide for payment by the end of the second taxable year following the year in which the separation occurs. For example, if the employee experiences an involuntary termination on June 1, 2017, and the agreement provides for severance consisting of continued base salary payments in accordance with the company's payroll for the 36-month period immediately following termination (assuming that the two-times limit were met), then any amount paid during the final six months after December 31, 2019, will not qualify for this exemption. Under a narrow reading of the Section 409A regulations, this bifurcation into an exempt portion and non-exempt portion would depend on the arrangement explicitly stating that installment payments are to be treated as separate payments for purposes of Section 409A, as discussed above in the section entitled "Installment Payments Pitfall" under the Short-Term Deferral Rule discussion.

The actual length of the period during which the severance payment may be exempt will vary somewhere between two and three years, depending on when the separation from service occurs. In the above illustration, if the termination date had been January 1, 2017, instead of June 1, then the entire amount paid under the 36-month period would have been exempt (subject to the two-times limit). Note that although only the portion of the severance within the exemption period will qualify for the separation pay exemptions, other exemptions could apply to the remaining portion and be combined with the separation pay exemption as described in the next section.

Stacking

In your analysis of severance arrangements, keep in mind that the exemptions may be stacked with each other or combined with the short-term deferral rule when determining whether a severance amount is subject to or exempt from Section 409A. The following example illustrates this concept.

Example (separation pay exemption and stacking). An executive's employment agreement provides for a lump-sum severance benefit if the executive has an involuntary separation from service (within the meaning of Section 409A). The severance amount is $600,000, payable in 10 equal monthly installments of $60,000 each, beginning one month following the termination date. The employer terminates the executive's employment without cause in December 2018. The executive's annual compensation for 2017 (the taxable year preceding the year of termination) is $290,000. Under these facts, the maximum amount that can be exempt from Section 409A due to the separation pay plan exemption is $550,000 due the two-times limitation. This is determined as the lesser of (1) two times the executive's prior year annual compensation (2 x $290,000 = $580,000) and (2) two times the qualified plan annual compensation limit for 2018 (2 x $275,000 = $550,000). The excess $50,000 over the exempt amount is not eligible for the separation pay exemption. However, the severance right may nevertheless avoid Section 409A coverage, depending on the terms of the agreement:

- **Scenario 1 (default rule for installments; no stacking).** Under the default rule, installment payments, like those in the example, are treated as a single payment for purposes of Section 409A. Since this payment can occur (and under these facts did occur) on a date later than the March 15 of the year following the year of termination, no part of the severance is eligible for treatment as a short-term deferral, and the arrangement would provide for a compensation deferral of $50,000 that is subject to Section 409A ($600,000 less $550,000 exempt as separation pay).
- **Scenario 2 (separate payment election; stacking).** If the employment agreement provides that each severance installment payment is to be treated as a separate payment for purposes of Section 409A, then you analyze each installment separately. Since the severance period begins one month following termination and the shortest possible short-term deferral period (December 31 through March 15) is two and one-half months, then at least the first two installments will be paid within the short-term deferral period under all

circumstances arising under the terms of the agreement. Since each installment is treated as a separate payment, the first two installments are eligible for short-term deferral treatment, even though the third and later installments are not. Through stacking, then, $120,000 is exempt from Section 409A as a short-term deferral, and the remaining $480,000 is exempt under the separation pay exemption.

Exemption for Window Programs

Severance pay under a window program (as defined below) may also be exempt from Section 409A. The same two-times limit and payment period limit that applies to the separation pay exemption, described in the preceding section also applies to the window program exemption. That is, the exempt amount (1) is capped at the lesser of two times annual compensation and two times the *I.R.C. § 401(a)(17)* limit, and (2) must be paid by the end of the second year after the year of separation from service. 26 C.F.R. § 1.409A-1(b)(9)(iii).

Window Program Definition

Section 409A defines a window program as a program established by an employer in connection with an impending separation from service to provide separation pay, where both:

- Participation is limited to employees who separate from service, or separate from service under specified circumstances (e.g., meet age or service eligibility requirements) during a limited period of time.
- The period of time is no longer than 12 months.

26 C.F.R. § 1.409A-1(b)(9)(vi).

However, a program will not be considered a window program if an employer establishes a pattern of repeatedly providing for similar separation pay in similar situations for substantially consecutive, limited periods of time. Whether the recurrence of these programs constitutes a pattern is determined based on the facts and circumstances. Relevant factors include:

- Whether the severance benefits are on account of a specific business event or condition
- The degree to which the separation pay relates to the event or condition
- Whether the event or condition is temporary or discrete or is a permanent aspect of the employer’s business

26 C.F.R. § 1.409A-1(b)(9)(vi).

The window program exemption typically arises in the context of a program established by an employer to provide separation pay in connection with a pending reduction in force, voluntary early retirement initiative, or a significant corporate transaction (such as the sale of a division of the employer).

Exemptions for Certain Expense Reimbursements and In-Kind Benefits

A severance arrangement that provides for any of the following types of reimbursement and in-kind benefits (whether upon a voluntary or involuntary separation from service) will be exempt from Section 409A:

- Reimbursements for:
    - Business expenses that the employee could deduct under *I.R.C. §§ 162* or *167* (disregarding income limits) if the employee had paid for by the employee directly
    - Reasonable separation-related outplacement expenses and moving expenses provided that the expenses are incurred by the end of the second year after the year of separation from service, and the

reimbursements are made no later than the end of the third year after the year of the separation from service

- Reimbursements for medical expenses allowable as a deduction under *I.R.C. § 213* (disregarding the 7.5% threshold) incurred during the period in which the employee would be entitled to COBRA continuation coverage under a group health plan
- Benefits described in the items above provided by the company in-kind

26 C.F.R. § 1.409A-1(b)(9)(v)(A) through (C).

If reimbursements are not exempt under Section 409A because they do not meet these conditions may still be exempt under another rule (e.g., the exemption for limited payments described below).

Continued medical coverage is not subject to Section 409A if it is not includible in the employee's income. 26 C.F.R. § 1.409A-1(a)(5). However, you need to watch for the situation where a highly compensated employee continues to participate in the former employer's self-insured health plan following a separation from service and the employee receives benefits under the plan that are more generous than those received by rank-and-file employees under the same plan. This would likely violate the IRS non-discrimination rules under *I.R.C. § 105(h)* and cause such benefits to become includible in the highly compensated employees' income, and therefore subject to Section 409A. If it's unclear whether the medical coverage in this case is includible in income, a best practice is to draft the arrangement to ensure that it will comply with Section 409A.

Exemption for Limited Payments

You can treat benefits under a separation pay plan (i.e., separation pay triggered by an involuntary separation from service or a window program) as exempt from Section 409A to the extent the payments, in the aggregate, do not exceed the deferral limit under *I.R.C. § 402(g)(1)* for the year of the separation from service ($18,500 for 2018). 26 C.F.R. § 1.409A-1(b)(9)(v)(D).

Exemption for Foreign Separation Pay Plans

Another severance-related Section 409A exemption applies to foreign separation pay plans. A separation pay plan (including a plan providing payments upon a voluntary separation from service) does not provide for deferred compensation to the extent the plan provides for amounts of separation pay required to be provided under the applicable law of a foreign jurisdiction. This exemption only applies to legally mandated benefits, not discretionary severance benefits. 26 C.F.R. § 1.409A-1(b)(9)(iv).

Exemption for Collectively Bargained Separation Pay Plans

Section 409A also provides for an exemption for certain collectively bargained separation pay plans. Conditions for this exemption are that the severance benefit is:

- Provided under a bona fide collective bargaining agreement, for which the severance benefit was the subject of arm's length negotiations under circumstances evidencing good faith bargaining between adverse parties –and–
- Payable only due to an involuntary separation from service or pursuant to a window program

26 C.F.R. § 1.409A-1(b)(9)(ii).

The collectively bargained separation pay plan exemption is more expansive than the regular separation pay for involuntary termination and window program exemptions insofar as there is no cap or time limit on payments.

OTHER KEY CONSIDERATIONS

Below is a summary of some key points to consider when drafting severance arrangements subject to Section 409A.

Beware of the Toggle Rules

Subject to limited exceptions, a NQDC arrangement subject to Section 409A is not permitted to use a different time or form of payment for the same permissible payment event . For example, a severance arrangement triggered by a separation from service cannot toggle between a lump-sum payment if the separation was an involuntary termination and installment payments if the separation was due to the employee's resignation or retirement. Although this is a practical arrangement that was common, it is prohibited under Section 409A. 26 C.F.R. § 1.409A-3(c).

The regulations provide two exceptions for this rule. For permissible payment events other than a separation from service or a fixed date or schedule, one other (and not more than one) different time or form of payment may apply to a permissible payment event depending on whether the payment event occurs before or after a designated date (e.g., the employee obtaining a certain age). For example, a plan may provide that a service provider will receive a lump-sum payment following a change-in-control event that occurs before the employee attains age 45, but will receive five substantially equal annual payments following the change-in-control event that occurs on or after the service provider attains age 45. The addition or deletion of any time or form of payment after the fact is subject to Section 409A's rules on making subsequent elections. 26 C.F.R. § 1.409A-3(c)(1)).

A more lenient exception applies to separation from service-triggered payments. You can toggle the time and form of payments for this trigger depending on whether the separation from service occurs under one or another of any of the following conditions:

- During a limited period of time following a Section 409A-compliant change in control (capped at two years)
- Before or after a designated date (e.g., employee's attaining a certain age or service period)
- At a time not described by either of the foregoing

26 C.F.R. § 1.409A-3(c)(1) through (3). Similar to the above exception, the addition or deletion of any time or form of payment after the fact is subject to Section 409A's rules on making subsequent elections. 26 C.F.R. § 1.409A-3(c)(1)).

Therefore, for example, a severance arrangement subject to Section 409A can provide for (1) an immediate lump-sum payment upon the occurrence of a Section 409A compliant change-in-control event, (2) a lump-sum severance paid two years following an involuntary separation from service (say, after the expiration of a non-compete period during which the amount is forfeitable) if the separation occurs within 10 years after entering into the severance agreement (and clause (1) does not apply), or (3) five equal annual installment payments commencing on a separation from service that occurs in circumstances other than those described in clauses (1) and (2).

Severance Benefits in Connection with a Change in Control

Another permissible payment event that is frequently used in the context of severance arrangements is a change-in-control event. This is important because many high-level employees have change-in-control provisions in their employment agreements (or other arrangements) that provide for severance benefits payable either upon (1) the occurrence of a change in control (single trigger) or (2) a separation from service within a certain period before or after a change in control (double trigger).

In general, a single-trigger arrangement must either be exempt from Section 409A or have a Section 409A compliant payment trigger. Accordingly, if the single-trigger arrangement is subject to Section 409A, it must define the change-in-control event so as to meet the Section 409A standard, described in the next section (or use another permissible payment event to determine when payment will occur). A double-trigger arrangement usually does not need to use a Section 409A compliant change-in-control definition because the separation from service provides an independent permissible payment event for purposes of Section 409A. 26 C.F.R. § 1.409A-3(a)(1). (However, be aware of the toggling rules described above if there are different times or forms of payments used.)

Of course, if Section 409A does not apply to the arrangement, then it does not matter whether either trigger is a permissible payment event under Section 409A. So, for example, an agreement providing a transaction bonus to a key employee if a change in control of the company occurs within five years, payable within 30 days after the transaction closes would be exempt from Section 409A as a short-term deferral, regardless of the change-in-control definition, if it also conditions payment on the employee's continued service through the date of the transaction. As discussed above, this arrangement would qualify as a short-term deferral because the right to the payment is subject to a SRF through the date of change in control and the timing of the payment would fall within the short-term deferral period.

Section 409A Change-in-Control Event

A Section 409A change-in-control permissible payment event can include any of the following:

- A change in the ownership of a company (based on a transfer of more than 50% of the total fair market value or total voting power of the company's stock)
- A change in the effective control of a company (based on a transfer of at least 30% of the total voting power of the company's stock or of a majority of the board of directors during a single 12-month period by directors who were not endorsed by the prior board)
- A change in the ownership of a substantial portion of the assets of a company (based on a transfer of assets with a total gross fair market value of at least 40% of the company's total assets)

I.R.C. § 409A(a)(2)(A)(v); 26 C.F.R. § 1.409A-3(i)(5)(v), (vi), (vii).

Note that these are threshold definitions. An arrangement can specify higher percentages or more stringent requirements. For example, a change in the ownership of a company can be defined as occurring if a third party acquired stock that constituted more than 75% (instead of 50%) of the total fair market value of the stock of the company. For a detailed analysis of the types of permissible Section 409A change in control payment events, see Section 409A Change-in-Control Payment Events.

Toggle Rule Exception for Double Trigger Arrangements

As noted above in the toggle rule discussion, a double-trigger change-in-control severance arrangement is one of the exceptions to Section 409A's general anti-toggling rule for payments triggered by a separation from service. Under the exception, you can pay separation from service-triggered payments at a different time or in a different form based on whether the separation from service occurs within a period of up to two years following a Section 409A-compliant change in control or otherwise. A common example is a severance provision that provides for installment severance payments over a period of years as a default, but provides for a lump-sum payment within a short period after termination if the separation from service occurs within a year or two after a change in control. To rely on this exception, however, the change in control definition in the arrangement must be Section 409A compliant.

Corrective Procedures for Impermissible Change-in-Control Events

If a severance arrangement provides for payment upon a change-in-control event that fails to meet the Section 409A definition, the error may be corrected by (among other things) amending the arrangement, with immediate effect, to provide for a payment event that satisfies the requirements of Section 409A in accordance with the IRS correction program. However, the arrangement must be amended prior to the occurrence of any event constituting a separation from service under the arrangement.

If, within one year following the date of correction, an event occurs that (1) is not a change-in-control event under Section 409A but would have required payment under the arrangement prior to the correction, or (2) is a change-in-control event under Section 409A but would not have required payment under arrangement, 25% of the amount deferred under the plan to which the pre-correction provision would have applied must be included in income under Section 409A by the affected employee in the taxable year within which the event occurs. That amount would be subject to the 20% additional tax under Section 409A (but not the premium interest tax). Notice 2010-6, Part V.B.2.

Example (bad change-in-control definition). An employment agreement provides for a severance payment upon the earliest of a separation from service, the employee attaining age 65, death, or a change in control of the employer. The agreement's definition of change in control does not comply with Section 409A solely because the definition includes an initial public offering of more than 30% of the stock of employer. On February 15, 2017, when the employee is age 50, the employer amends the agreement to eliminate initial public offerings as a payment trigger. The employer has an initial public offering of its stock on July 1, 2017. The employer and the employee corrected the provision before the initial public offering, but the initial public offering occurred within one year following the date of correction. Provided that the employer does not pay the employee any amount under the agreement due to the event, the employer reports 25% of the amount deferred under the agreement to which the pre-correction provision applied as an amount includible in income under Section 409A for 2017, and the employee includes 25% of the amount deferred in income under Section 409A and pays all applicable Federal taxes, including the additional 20% tax on such amount (but not the premium interest tax). The employee will not be required to include in income any further amount solely as a result of the pre-correction provision. Notice 2010-6, Part V.D.

More information on Section 409A correction programs can be found at Lexis Tax Advisor – Federal Topical § 1C:6.04, paragraph [8][f].

Severance Benefits Contingent on a Release of Claims or Other Conditions

As mentioned above, if severance benefits are subject to Section 409A, then the payment date must be specified in the written agreement in a manner that complies with the Section 409A payment timing rules. This can give rise to drafting issues when receipt of severance is contingent on the execution (and non-revocation) of a release of claims against the employer, as is common for executive severance arrangements, or on other actions to be taken by the employee.

In general, Section 409A arrangements can provide for payments to be made on a specified date or during a designated period that occurs after the payment event. If a payment period is used, it is limited to 90 days, unless the entire period falls within a single calendar year. For payment periods that can cross into a new calendar year, the employee may not have any discretion to determine whether payments will occur before or after the new year. 26 C.F.R. § 1.409A-3(b). It is Section 409A's prohibition on the employee having discretion over the year of payment that complicates certain severance provisions where the employee is given a period of time post-termination in which to sign a general release, enter into a noncompetition or nonsolicitation agreement, or perform some other action as a condition precedent to receiving payment.

The typical situation is severance conditioned on the execution and non-revocation of a general release of claims, since the Age Discrimination in Employment Act (ADEA) and other laws impose minimum consideration and revocation periods for an enforceable waiver of age discrimination or certain other claims. See 29 U.S.C. § 1625.22(e).

For example, assume a severance arrangement provides for a payment to be made within 60 days following an involuntary separation from service, subject to the employee signing (and not revoking) a general release, and the company terminates the employee on December 5. Under the terms of the release agreement, the employee has 21 days to consider whether to sign the release and 7 days after execution during which he or she may revoke it. Under these facts, the employee could sign the release right away to ensure that payment was made in the year that includes the separation. Alternatively, the employee could cause the severance to be paid in the year following the year of termination by delaying execution of the release until December 26, the end of the 21-day consideration period. Naturally, the company will not pay the severance until after expiration of the mandatory 7-day revocation period, when the general release becomes fully binding, so that payment would be deferred until the following year.

The IRS takes the position that the terms of such an arrangement would violate Section 409A because of the employee's power to essentially decide which year that payment will be made. (The fact that the employee cannot force the employer to make the payment in the first year does not alleviate the impermissible discretion.) See Notice 2010-6, Part VI.B.

To avoid this pitfall, you must draft the agreement so that there is no employee discretion. The simplest way to do so is to delay the actual payment until the latest possible date the contingency could be fulfilled (e.g., the end of a general release's revocation period assuming the employee executes the release on the last day of the consideration period). Executives generally don't like this approach since in most cases it will unnecessarily delay payment of severance benefits. A more tailored alternative is to employ the same approach, but only have it apply in cases where the payment period crosses two calendar years. A third option—and the most employee friendly since it can result in an even shorter delay—is to provide that, when the payment period crosses two calendar years, the payment will be made as soon as possible after all the conditions have been satisfied, but in no event earlier than the first day of the second year.

Section 409A Plan Aggregation Rules

The Section 409A plan aggregation rules state that all separation pay plans that provide for deferred compensation payable solely upon an involuntary separation from service are treated as a single plan (except for plans that provide for in-kind benefits or reimbursements). 26 C.F.R. § 1.409A-1(c)(2)(i)(D).

In practice, it is often the case that an employee's rights to compensation upon an involuntary termination of employment are outlined in more than one document, such as an employment agreement, a change-in-control agreement, an equity award, and a SERP. Under the plan aggregation rules, therefore, to the extent such agreements provide for a right to nonqualified deferred compensation, they would be grouped together, and a Section 409A violation of one plan may negatively affect the employee because the severance compensation payable under all aggregated plans may become includible in income and subject to the additional 20% tax and premium interest tax. Note, however, that the plan aggregation rules do not apply in the case of a Section 409A violation arising from the failure to comply with the written plan requirements. 26 C.F.R. § 1.409A-1(c)(3)(viii).

Severance Benefits as a Substitute for Deferred Compensation

Historically, it was not uncommon for an employer and employee to agree at the time of a separation from service that the employee will forfeit an existing right to receive a payment of deferred compensation and receive instead separation pay, or an enhanced severance, as a substitute for the deferred compensation. Consistent with Section 409A's general "no substitution" rules, this is expressly prohibited under Section 409A. 26 C.F.R. §§ 1.409A-1(m), 1.409A-3(f). The payment of severance as a substitute for a payment of nonqualified deferred compensation is treated as a payment of the deferred compensation under the terms of the original agreement. Therefore, payment at the time of separation will most likely be an impermissible acceleration, causing the agreement to violate Section 409A and give rise to the Section 409A penalties. This rule limits the ability of the parties to modify existing arrangements in the context of a separation from service and circumvent Section 409A.

Six-Month Delay for Specified Employees of Publicly Traded Companies

Since severance plans that are subject to Section 409A typically use separation from service as the permissible payment event, compliance with the six-month delay rule is of particular relevance. Generally, under this rule, no payment of deferred compensation triggered by a separation from service can be paid for at least six months following the separation from service if both:

- The company is a publicly held entity.
- The payment is to a so-called specified employee.

26 C.F.R. § 1.409A-3(i)(2).

An employee is a specified employee, if he or she is a key employee of a publicly held entity or a member of its controlled group at any time during the relevant 12-month determination period for the separation date. Key employee status is defined by reference to the top-heavy rules for qualified plans under I.R.C. § 416, and generally means:

- An officer whose annual compensation exceeds the statutory threshold, as adjusted for inflation ($175,000 for 2018), limited to the top-paid:
  - 50 officers, for organizations having more than 500 employees –or–
  - Number of officers that is equal to 10% of all employees (or three officers, if greater), for organizations having 500 or fewer employees
- A 5% owner of the company –or–
- A 1% owner of the company with annual compensation greater than $150,000 (not adjusted for inflation)

I.R.C. § 416(i)(1)(A).

For more information on the six-month delay rule, see Identifying Specified Employees and Six-Month Delay Rule Compliance under I.R.C. § 409A and Section 409A Six-Month Delay Rule Flowchart and Exceptions Chart for Separation Benefits.

Equity-Based Compensation upon a Separation from Service

Many employees have severance arrangements that provide for the acceleration of vesting and/or acceleration of payment for outstanding equity awards upon an involuntary separation from service. These rights may be found in the equity award agreement itself, in an employment or separation agreement, in a change-in-control agreement or plan, or in other agreements. You need to take care when drafting such provisions that they work in coordination with any existing documents governing the grants, both as a general matter and specifically for purposes of compliance with Section 409A or eligibility for an exemption. Similarly, when conducting a Section 409A review of existing grants, make sure you examine all relevant documents to determine if the equity-based compensation is subject to Section 409A and, if so, whether the documentary and operational compliance requirements are satisfied.

Accelerated Vesting and Accelerated Payment Issues

As noted below, many equity grants (including most stock options and stock appreciation rights (SARs) as well as restricted stock) are exempt from Section 409A. For such exempt arrangements, acceleration rights as severance benefits generally will not raise any Section 409A issues, even if those rights are added to the arrangement after the grant is made. This is not necessarily the case for other types of grants that are subject to Section 409A.

Consider a restricted stock unit (RSU) award, granted to an executive upon hire, that vests on the three-year anniversary of the grant date, subject to continuous service with the employer, and is settled in cash on the five-year anniversary of the grant date or, if earlier, upon a Section 409A-compliant change in control. Section 409A applies here as there is no special exemption for RSUs, and, in this case, the arrangement is not a short-term deferral since the settlement date could occur as much as two years after the RSUs are no longer subject to a substantial risk of forfeiture (which ceases to exist on the vesting date).

Accelerated vesting. If the executive later renegotiates his employment agreement to provide for accelerated vesting of the RSUs in the event of an involuntary separation from service prior to the vesting date, no Section 409A compliance issues arise since Section 409A is primarily concerned with payment timing rather than vesting, and the RSUs are still settled on the five-year anniversary of the grant date (or the change in control), even though the executive may no longer be employed by the company.

Under different facts, however, a change in the vesting date may be significant if the vesting date is important for eligibility for short-term deferral treatment. For example, an RSU that both vests (subject to continuous employment) and is paid two years following the grant date is eligible for short-term deferral, but if the terms are changed to provide for accelerated vesting for an involuntary separation from service, but the accelerated vesting provision includes a “bad” good reason trigger that is treated as an involuntary separation, then the modified arrangement would be pulled into Section 409A. This may or may not be of consequence, depending on whether all of the Section 409A documentation and operational requirements are satisfied.

Accelerated payment. Accelerated payments are generally prohibited for Section 409A arrangements and can result in the adverse tax consequences for an operational violation of Section 409A. 26 C.F.R. § 1.409A-3(j) (see 26 C.F.R. § 1.409A-3(j)(4) for limited exceptions). Therefore, if the parties changed the terms of the RSU to provide for both accelerated vesting and immediate settlement of the RSUs upon an involuntary separation from service, a Section 409A violation would result. 26 C.F.R. § 1.409A-3(j)(2). Note, however, that it would have been permissible to make the original RSU grant with this provision (i.e., to provide that settlement will occur on the earliest of the five-year anniversary of the grant date, a Section 409A-compliant change in control, or the executive’s involuntary separation from service). 26 C.F.R. § 1.409A-3(b).

Accelerated vesting resulting in accelerated payment. It is possible in certain circumstances for a payment to be accelerated without violating Section 409A due to an acceleration of vesting. This occurs when the arrangement complies with Section 409A, including by designating a permissible payment event (including a separation from service), and there exists a condition to payment (such as a service requirement), which is waived by the employer. For example, if the terms of an RSU provide for annual pro rata vesting over 10 years and settlement of the vested benefit upon a separation from service (the permissible payment event), then the employer can at any time waive the vesting condition so that the employee could receive full payment of the RSU upon a separation of service that occurs prior to the end of the original 10-year vesting term. If, on the other hand, the RSU provided for settlement on the 10th anniversary of the grant date (i.e., a fixed date permissible payment event), the employer could still waive the vesting condition, but it could not accelerate the payment to a date earlier than the original settlement date. 26 C.F.R. § 1.409A-3(j)(1).

Section 409A Exempt Stock Rights

Special exemptions from Section 409A exist for several types of compensatory stock rights. In addition, Section 409A does not apply to compensatory transfers of property governed by I.R.C. § 83. Therefore, the following types of equity grants do not typically raise any Section 409A issues for special severance rights:

- Nonqualified stock options (NQSOs) and SARs that are granted with an exercise price that is no less than fair market value of the underlying stock (i.e., are not in the money) and meet certain other requirements
- Statutory stock options (incentive stock options under *I.R.C. § 422* and qualified employee stock purchase plan options under *I.R.C. § 423*)
- Restricted stock, profits interests in partnerships or limited liability companies, and other compensatory property transfers, even if not vested on transfer
- Trust or annuity plan transfers subject to I.R.C. §§ 83, *402(b)*, or *403(c)*

26 C.F.R. § 1.409A-1(b)(5), (6).

Of course, you can also design equity-based awards to qualify for other available exemptions, including for short-term deferrals and certain types of separation pay, as discussed earlier.

If an NQSO or SAR is exempt from Section 409A, then an acceleration of the exercise period will not make it subject to Section 409A, but an extension of the exercise period could result in a modification that causes the stock right to become subject to Section 409A as of the original grant date. 26 C.F.R. § 1.409A-1(b)(5)(v).

For more information on this topic, see Understanding Types and Taxation of Equity Compensation and Stock Option, SAR, and RSU Grant Drafting Checklist (Section 409A Compliance).

SAMPLE SECTION 409A CLAUSES FOR SEVERANCE ARRANGEMENTS

Below are several key sample clauses that you can use when drafting Section 409A-related provisions for severance arrangements, keeping mind that modifications may be needed for use in a particular employment agreement, change-in-control agreements, or other document providing for severance benefits that may implicate Section 409A.

General Section 409A Compliance Clause

Practitioners should include a clause in their severance arrangements that explicitly states that it is intended that, where applicable, the arrangement will comply with, or be exempt from, Section 409A and it will be administered and interpreted on a basis consistent with such intent. A Section 409A general compliance clause is unlikely to override a provision that explicitly violates Section 409A. But where a provision can be interpreted to be either compliant or not compliant with Section 409A, the IRS has stated that “If the plan also contains a provision requiring that the term be interpreted to comply with the requirements of Section 409A (or a plan provision with the same effect) . . . the provision is not ambiguous and complies with the requirements of § 409A and § 1.409A-3(a)” (although operational compliance is also required). Notice 2010-6, IV.B.1.

For example, assume an employment agreement provides for severance benefits upon a termination of employment, but does not define the term “termination of employment.” The use of termination of employment as a payment event in the agreement without being defined is a common occurrence. Without the savings clause, the term could be interpreted to mean only events that constitute a separation from service for purposes of Section 409A, but it could also be interpreted to include events that do not constitute a separation from service for such purposes (e.g., where the employee switches to a consulting role and continues to provide substantial services). If the agreement contains a Section 409A general compliance clause, then the term will be interpreted to comply with the meaning of separation from service under Section 409A. The arrangement must still be administered in accordance with the Section 409A-compliant term to avoid a violation.

Sample general compliance clause (employer-favorable):

> It is intended that this Agreement will comply with Section 409A of the Internal Revenue Code of 1986, as amended (the "Code"), and the interpretive guidance thereunder, including the exemptions for short-term deferrals, separation pay arrangements, reimbursements, and in-kind distributions, and this Agreement shall be administered accordingly, and interpreted and construed on a basis consistent with such intent. To the extent that any provision of this Agreement would fail to comply with the applicable requirements of Code Section 409A, the Company may, in its sole and absolute discretion and without requiring Employee's consent, make such modifications to the Agreement and/or payments to be made thereunder to the extent it determines necessary or advisable to comply with the requirements of Code Section 409A; provided, however, that the Company shall in no event be obligated to pay any interest, compensation, or penalties in respect of any such modifications. Employee acknowledges that the Company is authorized to amend this Agreement, to void or amend any election made by Employee under this Agreement, and/or to delay the payment of any amount or benefit under this Agreement, in each case, in such manner as may be determined by the Company, in its sole and absolute discretion, to be necessary and appropriate to comply with Code Section 409A. Employee hereby releases and holds harmless the Company, its directors, officers, and stockholders from any and all claims that may arise from or relate to any tax liability, penalties, interest, costs, fees, or other liability incurred by Employee as a result of the application of Code Section 409A. Nothing in this Agreement shall be construed as a guarantee of any particular tax effect for the Employee's compensation and benefits and the Company does not guarantee that any compensation or benefits provided under this Agreement will satisfy the provisions of Code Section 409A.

Sample general compliance clause (employee-favorable):

> It is intended that this Agreement will comply with, or be exempt from, Section 409A of the Internal Revenue Code of 1986, as amended (the "Code") and the interpretive guidance thereunder, including, without limitation, the exemptions for short-term deferrals, separation pay arrangements, reimbursements, and in-kind distributions, and this Agreement shall be administered, interpreted and construed in a manner that does not result in the imposition of additional taxes, penalties or interest under Section 409A. The Company and Employee agree to negotiate in good faith to make amendments to the Agreement, as the parties mutually agree are necessary or desirable to avoid the imposition of taxes, penalties or interest under Section 409A. Neither the Company nor Employee will have the right to accelerate or defer the delivery of any such payments or benefits except to the extent specifically permitted or required by Section 409A.

Limits of Savings Clauses

As distinguished from a general compliance clause, a savings clause attempts to void any term or action that would violate the requirements of Section 409A. For example, a savings clause may state that "Notwithstanding any other provision of this agreement, no election shall be permitted, and no payment shall be made that would violate the requirements of Section 409A." However, practitioners should not use savings clauses to attempt to satisfy the requirements of Section 409A because Section 409A explicitly provides that, for purposes of determining the terms of a plan, general provisions that purport to nullify noncompliant plan terms (i.e., a savings clause) are disregarded. 26 C.F.R. § 1.409A-1(c)(1).

Separate Payments Clause

This language is used to reverse the default rule under Section 409A, whereby an employee's right to receive a series of payments is treated as a right to receive a single payment. Explicit language must be included in the arrangement to cause installment payments to be treated as separate payments for purposes of determining whether the short-term deferral rule or a special exemption will apply.

Sample separate payments clause:

> If an amount to be paid under this Agreement is payable in two or more installments, each installment shall be treated as a separate payment for purposes of Section 409A.

Short-Term Deferral Clause

If you are drafting a severance arrangement that provides for benefits upon an involuntary separation from service, the most effective way to remove the arrangement from the Section 409A rules is to ensure that it qualifies for short-term deferral. It may help to include a short-term deferral clause designed to ensure that payments will be made within the required period under any circumstances.

Sample short-term deferral clause:

> Any amount described in Section ___, to the extent earned, shall be paid to Employee in no event later than the fifteenth day of the third month following the end of the year in which such amount was no longer subject to a substantial risk of forfeiture, within the meaning of Code Section 409A, except as may be permitted pursuant to Treasury Regulation Section 1.409A-1(b)(4)(ii).

Safe Harbor Good Reason Definition Clause

If is often the case that employers enter into severance arrangements with key employees that allow the employee to receive severance benefits upon a resignation for good reason in addition to an involuntary termination without cause. As discussed above, Section 409A provides a safe harbor good reason definition pursuant to which a voluntary separation from service will be treated as an involuntary separation from service.

Sample good reason definition clause consistent with Section 409A safe harbor:

> "Good Reason" shall mean any of the following circumstances that, if curable, has not been cured by the Company within thirty (30) days of the Company's receipt of notice thereof from Employee, which notice was provided within ninety (90) days of the date on which the circumstance or event constituting Good Reason first came into existence, provided that Employee separates from service within two years following the initial existence of such circumstance or event: (i) a material reduction in Employee's Base Salary; (ii) a material diminution of Employee's titles, duties, responsibilities, or authorities as set forth in this Agreement or Employee being required to report to another person other than the Board; (iii) a material diminution in the budget over which Employee retains authority; (iv) a material change in the location of the Company's offices where Employee is required to work; or (v) a material breach by the Company of this Agreement.

Separation from Service Clause

Payments under a nonqualified deferred compensation plan subject to Section 409A generally may only be made upon certain permissible payment events. In the context of severance arrangements, the most common permissible payment event is a separation from service. Separation from service is a defined term under Section 409A, yet market practice still has not adopted this term in most contracts with employees. The majority of agreements still use the term termination of employment. As a result, it is recommended that you include a separation from service clause to ensure compliance with Section 409A.

Sample separation from service clause:

> A termination of employment shall not be deemed to have occurred for purposes of any provision of this Agreement providing for the payment of any amounts or benefits subject to the requirements of Code Section 409A upon or following a termination of employment unless such termination is also a "separation from service" within the meaning of Code Section 409A, and, for purposes of any such provision of this Agreement, references to a "termination," "termination of employment," or like terms shall mean a "separation from service" within the meaning of Code Section 409A.

Change-in-Control Definition Clause

A common permissible payment event that arises in the context of severance arrangements is a change-in-control event. As discussed above (see section entitled "Severance Benefits in connection with a Change in Control" under Other Key Considerations), a double-trigger change-in-control agreement may not need to use a Section 409A-compliant definition of change in control because the separation from service trigger works as the permissible payment event. However, a compliant change-in-control definition is required in other circumstances, such as a single-trigger transaction bonus agreement relying on the change in control as the permissible payment event or an agreement that provides for two different times or forms of payment depending on whether an employee has a separation from service in connection with or not in connection with a change in control.

The following example is consistent with the most expansive definition permissible under Section 409A. A narrower definition can be used instead; that is, you can use higher transfer-of-ownership thresholds, impose additional limitations or carve-outs, and/or eliminate one or more of the categories (e.g., so that only a stock sale qualifies, but not a board changeover or asset sale).

Sample change-in-control definition clause:

> A "Change in Control" shall occur for purposes of this Agreement upon the first to occur of any of the following dates:
>
> (i) the date any Person (as such term is defined in Section 3(a)(9) of the Securities Exchange Act of 1934 (the "Exchange Act") and as used in Sections 13(d)(3) and 14(d)(2) of the Exchange Act) or more than one Person acting as a group (as determined under Treasury Regulation Section 1.409A-3(i)(5)(v)(B)), acquires ownership of the stock of the Company that, together with stock held by such Person or group, constitutes more than fifty percent (50%) of the total fair market value of the stock of the Company;
>
> (ii) the date any one Person, or more than one Person acting as a group (as defined under Treasury Regulation Section 1.409A-3(i)(5)(v)(B)), acquires (or has acquired during the twelve (12)-month period ending on the date of the most recent acquisition by such Person or Persons) ownership of stock of the Company possessing thirty percent (30%) or more of the total voting power of the stock of the Company;
>
> (iii) the date that a majority of members of the Board is replaced during any twelve (12)-month period by directors whose appointment or election is not endorsed by a majority of the members of the Board prior to the date of the appointment or election; or
>
> (iv) the date that any Person or more than one Person acting as a group (as defined under Treasury Regulation Section 1.409A-3(i)(5)(v)(B)) acquires (or has acquired during the twelve-month period ending

on the date of the most recent acquisition by such Person or Persons) assets from the Company that have a total gross fair market value equal to or more than forty percent (40%) of the total gross fair market value of all assets of the Company immediately before such acquisition or acquisitions. For purposes of this subsection (iv), gross fair market value means the value of the assets of the Company, or the value of the assets being disposed of, determined without regard to any liabilities associated with such assets.

For additional Section 409A-related sample clauses, see Section 409A Clauses for Compensation Agreements.