

SEVERANCE PAY AS NONQUALIFIED DEFERRED COMPENSATION

Are your severance pay arrangements regulated by the new tax penalties for nonqualified deferred compensation? **Action steps:**

- Avoid the penalties by reviewing your arrangements that provide severance pay after 2004, to determine whether they must comply with the new law imposing the penalties
- For arrangements that must comply with the new law, amend them by December 31, 2006, to comply, and until then anticipate these amendments by administering the arrangements in compliance with the new law

Typical severance pay arrangements

Severance pay arrangements that could be regulated by the new law include:

- Employment agreements and personnel policies providing additional pay after voluntary or involuntary separation from service
- Window programs providing additional pay to employees who separate during a limited time
- Individually negotiated severance packages, including agreements negotiated to settle claims arising during employment
- Business acquisition agreements providing compensation to former employees

The rest of this notice summarizes how the new law applies to severance pay arrangements for employees. The new law applies in a similar manner to severance pay arrangements for certain independent contractors.

Why you care about the new law

Not complying with the new law would result in the following tax penalties:

- Immediate tax. The employee would be taxed immediately on all vested nonqualified deferred compensation that has not previously been taxed.

- Additional 20% tax and interest. The employee would owe, in addition to the regular tax, an additional 20% tax on the taxed nonqualified deferred compensation, and also interest on the deferred tax for the period that taxation of the compensation has been deferred.

The new law (Section 409A) applies to severance pay that is nonqualified deferred compensation

The new law is Section 409A of the Internal Revenue Code. Section 409A applies to severance pay that is nonqualified deferred compensation. Generally, *nonqualified deferred compensation* is compensation payable under any arrangement that defers the receipt of the compensation to a later year. For example, severance pay to be paid in a later year could be nonqualified deferred compensation. *Nonqualified deferred compensation* excludes, however, compensation payable under:

- Qualified retirement plans
- Bona fide vacation leave, sick leave, compensatory time, disability pay, and death benefit plans
- Medical savings accounts, health savings accounts, medical reimbursement plans, and health reimbursement arrangements that satisfy tax-qualification requirements
- Arrangements under which compensation is paid by the 15th day of the 3d month after the end of the later of the employee's or employer's taxable year in which the compensation vests, if the arrangement does not provide for payment after this 15th day (severance pay for a voluntary separation from service generally vests when the employee could separate and receive the pay)
- Collectively bargained arrangements paying compensation conditioned on involuntary separation from service or separation pursuant to a window program
- Non-collectively bargained arrangements paying compensation conditioned on involuntary

separation from service or separation pursuant to a window program, if the compensation must be paid by the end of the second calendar year after the separation and may not exceed twice the employee's compensation, up to a statutory limit, for the calendar year before the separation

- Arrangements reimbursing certain expenses, conditioned on separation from service, if reimbursement is made (and the expenses are incurred) by the end of the second calendar year after the separation (covered reimbursements include non-taxable reimbursements, reimbursements for deductible business expenses incurred in connection with the performance of services, reimbursements of qualifying outplacement, moving, and medical expenses, and reimbursements that do not exceed \$5,000 in the aggregate)

Grandfathered nonqualified deferred compensation

Section 409A does not apply to nonqualified deferred compensation that was earned and vested on December 31, 2004, unless the arrangement under which the compensation is deferred is materially modified after October 3, 2004. Section 409A applies to all other nonqualified deferred compensation.

What Section 409A requires

Section 409A restricts, in the following ways, severance pay that is nonqualified deferred compensation:

- When elections to defer may be made. Generally, employees may elect to defer compensation only before their taxable year in which they earn the compensation. As an exception, where an employee separates from service pursuant to a window program, the employee may elect to defer severance pay up to the time the employee's participation in the window program becomes irrevocable. Where an employee separates involuntarily and the severance pay is the subject of bona fide arm's length negotiations, the employee may elect to defer the severance pay up to the time the employee obtains a legally binding right to the severance pay.
- When nonqualified deferred compensation may be paid. Severance pay that is nonqualified deferred

compensation may be paid only at certain times or upon certain events.

- When the time and form of payment must be specified and may be changed. Generally, the time at which nonqualified deferred compensation is to be paid (e.g., at termination of employment or age 65), and the form in which it is to be paid (e.g., lump sum or installments), must be specified before the employee's taxable year in which the employee earns the compensation. Permitted changes to the time and form of payment are limited, and generally may not accelerate payment. As an exception, where an employee may not elect the time or form of payment, the time and form must be specified by the time the employee first has a legal right to the compensation. An employee's legal right to severance pay under an employment agreement or personnel policy may arise when the employer enters into the agreement or adopts the policy.
- Assets must be in the United States; no financial health trigger. Assets set aside to pay nonqualified deferred compensation must be located in the U.S. and may not be restricted to paying nonqualified deferred compensation if the employer's financial health changes.

Section 409A also adds requirements for information reporting of nonqualified deferred compensation and for withholding income tax on nonqualified deferred compensation that violates Section 409A.

Deadline to comply with Section 409A

By December 31, 2006, all nonqualified deferred compensation arrangements to which Section 409A applies must be amended to comply with Section 409A. Also, these arrangements must be administered during and after 2005 in compliance with Section 409A.

Getting help

This notice gives you a general description of how Section 409A applies to severance pay arrangements for employees. This notice is not legal advice. For help with severance pay and nonqualified deferred compensation, please contact one of the following attorneys in our Employee Benefits Group:

Craig Smith
Everett Moreland
Vicki Rees