

## § 409A SEPARATION AGREEMENTS

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### **Introduction**

Unless it meets one of the exceptions described in Reg. § 1.409A-1(a), any plan that provides for the deferral of compensation is a “nonqualified deferred compensation plan” subject to the requirements of § 409A. The exceptions are as follows:

- Qualified employer plans, including retirement plans and plans described in § 457(b)
- Certain foreign plans
- Certain welfare benefits such as vacation leave, compensatory time, disability or death benefits
- Health Savings Accounts
- Medical and health reimbursements which are excluded from the recipient’s income under §§ 105 and 106.

### **Plan**

For these purposes a plan can be any agreement or arrangement, even if it only applies to one person and even if adopted unilaterally.

### **Deferral of Income**

According to Reg. § 1.409A-1(b)(1) if a service provider obtains a legally binding right to compensation that will, or may, be payable in a subsequent year, the plan under which he obtains this right will be considered to provide for the deferral of compensation.

A service provider does not have such a right, if it can be unilaterally reduced or eliminated by the service recipient.

Generally, a right to a payment that is excludable from income will not be treated as a deferral of income. However, except for participation in a § 125 plan, this will not hold true if the employee had a right to taxable compensation, and exchanged it for a benefit that would be excluded.

Reg. §§ 1.409A-1(b)(3) through (12) describe types of payments and circumstances that will not be considered to provide for the deferral of income, and therefore will not be subject to § 409A. These exceptions include the following:

- Payments made pursuant to the service recipient's customary payment timing
- Payments made within 2 ½ months of the service recipient's year-end will generally not be treated as having been deferred, if the plan itself does not otherwise provide for a deferred payment
- Stock options, appreciation rights and other equity based compensation (see separate material on this topic)
- Separation pay plans meeting the tests described in Reg. § 1.409A-1(b)(9)(ii)-(v)
- Certain indemnification and liability insurance plans
- Legal settlements
- Certain educational benefits

### **Separation Plans:**

Under the definitions and rules described above, a separation plan, or agreement, may well be subject to the rules and restrictions of IRC § 409A

Among the circumstance in which these may come into play are:

- Agreements entered into upon termination of an employee
- Agreements entered into upon the hiring of an employee, or during an employee's tenure, that provide for payments in the future upon the occurrence of an event (such as the employee's termination from service)
- Noncompetition agreements

The regulations make it clear that if a possible future payment is contingent on a future event (separation from service), the plan would be deemed to provide for a deferral of compensation (Reg. § 1.409A-1(9)(i)).

If it can be determined that a separation agreement, negotiated subsequent to an existing deferred compensation plan, provides a substitute for benefits that were forfeited under the terms of the prior plan, such payments will be treated as having been made under the prior plan.

For example, assume that under an existing employment agreement an employee was to receive a \$100,000 payment if still employed on December 31, 2009. If the employee terminates prior to December 31, 2009, and under a new separation agreement he is paid \$100,000, such payment may be treated as having been made under the original plan. The significance of such treatment is that it probably will be treated as an acceleration of benefits under the original plan, which has repercussions under § 409A.

The determination as to whether a paid benefit is to be treated as being paid under a new separation agreement, or as paid under an earlier existing plan is based on a facts and circumstances analysis of the situation. However, where the separation from service is voluntary, the presumption will be that the payment is an acceleration of benefits under the old plan. Reg. § 1.409A-1(b)(9)(i) sets forth circumstances in which the presumption may be rebutted.

Additionally, there are four arrangements under which separation plans will not be treated as providing for the deferral of income:

- Collectively bargained separation pay plans
- Involuntary separation or participation in a window program
- Foreign separation plans
- Reimbursements and certain other separation payments

Collectively bargained plans:

A qualified collectively bargained plan will not be treated as providing for the deferral of compensation if it only provides for benefits upon involuntary separation from service or from participation in a window program.

Involuntary separation, or participation in window program:

Reg. § 1.409A-1(n) defines “involuntary separation” from service as being an action initiated by the service recipient, where the service provider was willing and able to continue working. It includes simply failing to renew a contract.

Under certain circumstances a service provider’s voluntary separation will be treated as involuntary. These include situations where a service recipient makes a “material negative” change in the service provider’s duties, responsibilities, compensation or location where the services are to be provided.

Separation pay that meets the following tests will not be treated as deferred compensation:

Dollar limit:

Up to the lesser of two times:

- The service provider's annual compensation for the year prior to the termination;
- The maximum amount of compensation taken into account for retirement plan contributions (\$225,000 in 2007)

Time limit:

- Must be paid by end of service provider's second tax year after the year of separation from service

Foreign Separation Plans:

This applies to payments that are required under the laws of a foreign jurisdiction.

Reimbursements and certain other separation payments:

Certain expenses, including outplacement fees and moving costs can be reimbursed to the service provider for a limited time, without being subject to § 409A.

Medical costs of the service provider can be reimbursed during the period of time in which the service provider would be subject to COBRA coverage.

There is also an exception for payments, up to \$15,500, that do not fit into any of the other exceptions.