bodman

An Update From Bodman PLC

Bodman PLC | [All Employee Benefits Articles Found Here] September 23, 2020

Severance Benefits and the Short Term Deferral Rule

By: David Walters, Co-Chair, Employee Benefits and Executive Compensation Practice Group

Employers frequently desire to soften the harsh economic consequences that can arise when an employee is terminated by offering the departing employee a payment on account of the termination. When doing so, employers need to consider, among other things, the tax implications of the payment. The tax considerations should extend beyond the mere reporting and withholding requirements. In particular, employers need to consider Internal Revenue Code (Code) Section 409A in order to avoid unintended tax consequences.

Severance arrangements are treated as a form of deferred compensation[1] and are generally subject to Code Section 409A. There is no blanket exception from Code Section 409A for severance arrangements.[2] For purposes of analyzing severance arrangements, it should be assumed that a severance arrangement will be subject to Code Section 409A, unless one of the limited exceptions applies or the arrangement satisfies an exemption.[3] One of the exemptions is commonly referred to as the short term deferral rule or the vest and pay rule. If the short term deferral rule applies, then the severance arrangement does not have to comply with the rigorous requirements of Code Section 409A.[4]

Short Term Deferral Rule. Simply stated, there is no deferred compensation subject to Code Section 409A under a severance arrangement if the terms of the arrangement require the severance to be paid under all circumstances, and the amount is actually paid no later than the 15th day of the third month following the end of the employer's or employee's taxable year, whichever is later, in which the severance becomes vested.[5] The short term deferral rule only has two conditions, both of which must be satisfied in order for the rule to apply. The first condition is related to the timing of the severance payment. The second condition is related to whether the employee has a vested interest in the severance payment.

The timing condition can be summarized as follows, assuming the employee's taxable year is a calendar year. If the employer's taxable year is a calendar year and the severance payment will be paid on a date that must occur, in all circumstances, before March 15 of the calendar year after the year in which the employee vests in the severance payment, the timing condition would be satisfied. Alternatively, if the employer's taxable year is a fiscal year, then the severance payment must be paid, in all circumstances, on a date that is no later than the later of March 15 or 2½ months after the end of the employer's fiscal year.[6] For calendar year taxable years, this generally means the payment must be made by March 15 of the calendar year following the year in which the severance payment vests.

The second condition relates to vesting. Vesting for this purpose means when the right to the severance payment is no longer subject to a substantial risk of forfeiture. A substantial risk of forfeiture exists if the severance is conditioned on the performance of future substantial services and the possibility of forfeiture is substantial.[7] An involuntary separation from service[8] or separation for good reason[9] can constitute a substantial risk of forfeiture. However, there is no risk of forfeiture for this purpose if the severance is conditioned on a termination for any reason including a voluntary termination, death or disability.

The two requirements are deceptively simple. The following examples are intended to illustrate some common pitfalls associated with the short term deferral rule as applied to severance arrangements. For all of the examples, it is assumed that the employer and employee have a calendar year as their respective tax year.

<u>Example 1</u>. Pursuant to a preexisting severance arrangement, an employee will receive a lump sum payment at the time of an involuntary termination of employment. The employee experiences an involuntary termination of employment. The employee receives the severance payment at the time of the involuntary termination. The terminated employee's right to the severance payment will vest at the time of the involuntary termination of employment. Because the payment is actually made contemporaneously with the vesting event (e.g., involuntary separation from service), the payment will occur before March 15 of the calendar year following the calendar year in which the involuntary termination occurred (Short Term Deferral Period). The short term deferral rule would apply and the payment would not be subject to Code Section 409A.

<u>Example 2</u>. Assume the same facts as in Example 1, except that in lieu of the payment occurring contemporaneously with the involuntary termination of employment, the severance arrangement specifies a payment date (e.g., the 60th day after the involuntary termination). The severance payment is actually paid on the stated date. The terminated employee's right to the severance payment will vest on the termination date. Because the payment is actually made on the stated date and the stated date for payment must occur in all circumstances before the end of the Short Term Deferral Period, the short term deferral rule would apply and the payment would not be subject to Code Section 409A.

<u>Example 3</u>. Assume the same facts in Example 1, except that in lieu of a lump sum payment the amount of the severance will be paid in monthly installments over a 12 month period. The employee would vest on the date of the involuntary separation from service. Since installment payments could be made later than the end of the Short Term Deferral Period, the short term deferral rule would not apply, even if all of the payments were actually paid before the end of the Short Term Deferral Period. The severance arrangement would need to comply with Code Section 409A, unless another exception was available.[10]

<u>Example 4</u>. Pursuant to a preexisting severance arrangement, an employee will receive a lump sum payment provided that they experience an involuntary termination of employment and if they comply with a 6 month non-compete following the involuntary termination of employment. The employee experiences an involuntary termination of employment and abides by the non-compete terms. The employee receives the severance payment upon the expiration of the non-compete

bodman
ATTORNEYS & COUNSELORS

period. The terminated employee's right to the severance payment will vest at the time of the involuntary termination of employment. The non-compete condition is not a substantial risk of forfeiture for these purposes and will not affect when vesting occurs.[11] Since the lump sum payment could, in certain circumstances, be made beyond the end of the Short Term Deferral Period (e.g., October 31 termination date with a payment date of April 30), the short term deferral rule would not apply and the severance arrangement would need to comply with Code Section 409A, unless another exception was available.

<u>Example 5</u>. Pursuant to a preexisting severance arrangement, an employee who experiences an involuntary termination of employment will receive a severance payment within 60 days following the involuntary termination subject to execution and non-revocation of a general release of claims. The release provisions give the employee 21 days to consider whether to sign the release and 7 days after execution in which to revoke the release. The employee is terminated on November 30. Even though the payment would comply with the short term deferral rule, the payment would nevertheless violate Code Section 409A. On these facts, the employee could, in effect, control which of the two different tax years the payment would be received in. If the employee acted quickly, the payment could be made in the year of separation. If the employee delayed action, it could be paid in the year following the year in which separation occurred. The ability to exercise discretion over the timing of the payment, when the payment period crosses two tax years, is what causes the Code Section 409A violation.[12]

<u>Example 6</u>. Pursuant to an executive's employment agreement, the executive is entitled to severance pay if the executive resigns for any reason within one year following a change in control event (as defined by Code Section 409A). The right to the severance pay vests on the date of the change in control event.[13] Because the executive could resign after March 15 of the year following the year in which the change in control event occurred, the short term deferral rule would not apply and the arrangement would be subject to Code Section 409A even if the severance payment actually occurred before March 15.

Comment: When designing severance arrangements, employers should be mindful of the tax pitfalls that can occur even when the employer is attempting to take advantage of the short term deferral exemption from Code Section 409A. Employers should consult with competent counsel in the design process to avoid unintended consequences that can arise from an inadvertently flawed arrangement.

David Walters is an Attorney with Bodman PLC in Troy, Michigan. You can reach him at dwalters@bodmanlaw.com. Bodman cannot respond to your questions or receive information from you without first clearing potential conflicts with other clients. Thank you for your patience and understanding.

---

[1]A legally binding right to a payment which is created in one taxable year with the right to the payment capable of payment in a subsequent taxable year. Treas. Reg. §1.409A-1(b)(1).
[2] Treas. Reg. §1.409A-1(b)(9)(i).
[3] The exceptions include the severance pay exception, Treas. Reg. §1.409A-1(b)(9)(iii); window program exception, Treas. Reg. §1.409A-1(b)(9)(vi); collectively bargained separation pay plan exception, Treas. Reg. §l.409A-1(b)(9)(ii); and foreign separation pay plan exception, Treas. Reg. §1.409A-1(b)(9)(iv). The short term deferral rule is an exemption to Code Section 409A. Treas. Reg. §1.409A-1(b)(4). For this purpose, the distinction between an exception and exemption is not relevant.
[4] The requirements for a severance arrangement which is subject to Code Section 409A include the following: 1) the material terms of the arrangement must be in writing; 2) the time and form of payment must be specified and the

payments may not be accelerated; 3) deferral of the payment is subject to significant restrictions; 4) the amount may only be paid upon separation from service (there is a special Code Section 409A definition); 5) the arrangement must specify the payment date or permissible payment period and the employee may not be permitted to determine the tax year in which the payment occurs; and 6) no amount may be paid to certain employees of publicly traded companies until 6 months after separation from service. Treas. Reg. §1.409A 3(a).

[5] Treas. Reg. §1.409A-1(b)(4)(i)(A).

[6] *Id.*

[7] Treas. Reg. §1.409A-1(d)(1). Substantiality is measured in two ways, the likelihood of the occurrence of the event resulting in a forfeiture and the likelihood of enforcement.

[8] An involuntary separation from service under Code Section 409A means a separation from service due to the employer's independent exercise of its authority to terminate the employee other than due to the employee's implicit or explicit request, where the employee was willing and able to continue to perform service. Treas. Reg. §1.409A-1(n)(1).

[9] Treas. Reg. §1.409A-1(n)(1). Not every termination for "good reason" will be treated as an involuntary termination for this purpose. A compliant "good reason" definition is key to maintaining eligibility for the short term deferral rule if a "good reason" termination is utilized. There is a safe harbor definition of "good reason" termination for purposes of Code Section 409A. The parameters of the "good reason" safe harbor are beyond the scope of this article.

[10] For purposes of Code Section 409A, the default rule is that installment payments are treated as a single payment. Treas. Reg. §§1.409A-1(b)(4)(i)(F), (G) and 1.409A-2(b)(2). In this case, since some of the payments could fall outside of the Short Term Deferral Period, none of the installments would be eligible for the short term deferral exception. The plan can provide that a series of periodic installments will be treated as the right to a series of separate payments. Treas. Reg. §1.409-2(b)(2)(iii). In this case, if the election were applied, the installment payments received before the end of the Short Term Deferral Period would be eligible for the short term deferral rule. This can be helpful in situations when determining whether a severance is subject to or exempt from Code Section 409A.

[11] Treas. Reg. §1.409A-1(d)(1).

[12] Treas. Reg. §1.409A-3(b) and Notice 2010-6, Section VI, B. To solve this problem the severance arrangement would have to be drafted so that there is no possibility that the employee could exercise this discretion. For example, the severance arrangement could specify the date of payment (e.g., the last day of the release period regardless of when the release becomes irrevocable).

[13] This assumes that the change in control event would satisfy the substantiality requirement of the substantial risk of forfeiture rule.