PUBLICATION

New IRS Rule Governing Severance Payments Goes Into Effect

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In 2004, Congress enacted Internal Revenue Code (the "Code") § 409A to provide rules regarding the taxation of deferred compensation. Code § 409A applies to all types of “deferred compensation,” including certain severance pay arrangements. For these agreements to comply with § 409A, the time, form and triggering event for deferred compensation payments must be established at the outset. Once established, subsequent changes in the form or time of payment or payment triggers are heavily restricted. Non-compliant deferred compensation must be included in gross income immediately, even if not yet paid, and that compensation is subject to a special tax of at least 20% of the amount of compensation at issue, in addition to normal income taxes.

A new IRS Notice 2010-6 (the "Notice") clarifies when a payment of covered severance pay is permissible and provides a limited correction procedure for existing severance arrangements which are not compliant with the new IRS position.

The new IRS position acknowledges that severance arrangements sometimes condition payment upon an employee's execution of a noncompetition, nonsolicitation or similar agreement, or on a release of claims. These arrangements may now fail to comply with Code § 409A and its regulations unless the arrangements do not allow recipients to change the timing of the payment – such as where payment timing is based upon when the required agreement or release is signed and returned. The IRS's concern appears to be that, in some circumstances, recipients are taking advantage of loose language in severance plans to alter the calendar year in which they receive their payments in order to defer or decrease their tax obligations.

For example, imagine a deferred compensation severance arrangement provides for payments within 60 days after an employee's separation from service, but not until the employee signs and returns a release of claims and the revocation period of the release has expired. Such an agreement technically allows payment to occur any time between two weeks and two months of the employee's last day of work. The new IRS guidance requires this agreement to read that the payment will be made on the 60th day after separation from service, provided that the employee has signed and returned the required release and the period for revocation has already expired.

Existing deferred compensation plans containing now-prohibited provisions may be corrected before the end of 2010 if they are also amended before the severance event. To do so, employers must amend the relevant documents to remove a recipient's ability to unilaterally delay or accelerate payment. If payment under the agreement is due within a specified period after the occurrence of a permissible payment event, the agreement must now provide for payment on the last day of the originally designated period. If a payment period is not designated, the amendment must provide for payment on either the 60th day or the 90th day after the permissible payment event. If an amendment is adopted after the service provider separates from service, the IRS will honor the correction, but 50% of the severance payment will be subject to the 20% penalty tax under Code § 409A.

Employers should act now to ensure their severance arrangements are compliant with Code § 409A if employees have any ability to influence the date of actual payment. If you need assistance with these or any labor and employment issue, do not hesitate to contact your Baker Donelson attorney or any of our nearly 70

Labor & Employment attorneys, located in *Birmingham, Alabama; Atlanta, Georgia; Baton Rouge, Mandeville* and *New Orleans, Louisiana; Jackson, Mississippi;* and *Chattanooga, Johnson City, Knoxville, Memphis* and *Nashville, Tennessee*.

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