

PUBLICATION

New IRS Position Governing Severance Payments Goes Into Effect

May 24, 2010

In 2004, Congress enacted Internal Revenue Code (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 such 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, the time of payment, or the payment itself, are heavily restricted. Non-compliant deferred compensation must be included in gross income immediately, even if not yet paid; and that non-compliant compensation is subject to a special tax of at least 20% of the amount of compensation at issue, in addition to normal income taxes. IRS Notice 2010-6 (Notice) establishes a new position which clarifies when a payment of § 409A-covered severance pay is permissible. The Notice also 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 prohibit recipients from having any control over the timing of the payment – such as where the timing is based upon when the required agreement or release is signed and returned. The IRS's concern appears to be that, at least in some circumstances, recipients are taking advantage of loose language in severance plans to alter the calendar year in which they receive their severance payments in order to defer or decrease their tax obligations.

For example, consider an existing deferred compensation severance arrangement that provides for payments within 60 days after an employee's separation from service, but in any event not until (i) the employee signs and returns a release of claims and (ii) the revocation period (assume it is 7 days, as would be required for releases of ADEA claims) for the release has expired. Such an agreement technically allows payment to occur at any time between approximately two weeks and two months of the employee's last day of work. The new IRS position requires this type of provision to be modified to require that the payment will be made, if ever, 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.

Under the Notice, existing deferred compensation plans containing such timing provisions may be corrected before the end of 2010, assuming the provision is 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. In essence, 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 to be made on the last day of the originally designated period (e.g., the 60th day in the example above). If a payment date or commencement date is not designated in an existing agreement, the amendment must provide for payment on either the 60th day or the 90th day after the permissible payment event. Any such amendment may not otherwise change the time or form of payment. If a corrective amendment is adopted after the service provider separates from service, the IRS will honor the correction, but 50% of the severance payment will still be subject to the 20% penalty tax under Code § 409A.

New severance arrangements which are subject to § 409A similarly may not allow the service provider to affect the time of payment by the timing of any required consents, waivers, etc. For new arrangements to comply with § 409A, there must be a specified or objectively determinable date for payment, without the exercise of any discretion.

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. For more information, please an attorney in the Firm's Tax Department.