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*NOT ADMITTED IN THE DISTRICT OF COLUMBIA

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Salary Continuation Arrangements

Still Viable – But Proceed With Caution Under Final Code §§ 409A and 415 Regulations

Many larger employers that maintain traditional qualified defined benefit plans provide “salary continuation” or “payroll continuation” arrangements that allow separating employees to qualify for subsidized early (or “full”) retirement benefits even after they have stopped providing services to the employer. The arrangements give employers flexibility to extend early-out offers to a category of near-retirement-age employees who otherwise would be unlikely to accept such offers. Two sets of final IRS regulations issued in April have made implementation of salary continuation arrangements more treacherous.

First, the good news: Salary continuation arrangements were not banned by the new regulations. The final § 409A regulations confirm that if salary continuation pay is provided at the discretion of the employer upon separation – *i.e.*, there is no salary continuation or severance plan or arrangement that would (or would in the future upon vesting) entitle an employee to separation

pay absent an offer by the employer at the time of separation – then the payment amount and schedule generally can be established at the time of separation. *See* Treas. Reg. § 1.409A-1(b)(9)(i). In fact, an employee typically could even be given a choice of when and in what form separation pay will be provided, for example as a lump sum or salary continuation payments through early retirement eligibility. *See* Treas. Reg. § 1.409A-2(a)(11). The final § 409A regulations also confirm that an employer generally can extend continued medical and life insurance coverage and certain other fringe benefits during the period of salary continuation. *See* Treas. Reg. §§ 1.409A-1(a)(5) and -1(b)(9)(v).

Where to tread with caution:

The final § 409A regulations confirm that salary continuation payments that are scheduled to extend past March 15 of the year following an employee's actual separation from active service generally will have to contend with § 409A. Specifically, installments scheduled to be paid after March 15 of the year following an employee's actual separation from active service generally will constitute deferred compensation subject to § 409A. This is because employees who receive salary continuation typically do not perform any services for the employer, which means the "salary continuation" is treated as post-termination separation (*i.e.*, severance) pay under the regulations. *See* Treas. Reg. § 1.409A-1(h)(1). Separation payments that are scheduled to be paid after March 15 of the year following separation (from a calendar year employer) is by definition deferred compensation. *See* Treas. Reg. § 1.409A-1(b)(4).

The result is that:

- Salary continuation installments scheduled to be paid *on or before* March 15 of the year following separation generally are not deferred compensation subject to § 409A,

provided the plan by its terms treats each installment as a separate payment. *See* Treas. Reg. § 1.409A-2(b)(2)(iii). Thus, these installments could be paid without regard to the 6-month waiting period for top officers. Payment of these installments also could be accelerated at the employer's discretion anytime before March 15, even after payments have begun – for example, upon the employee's acceptance of a job at another employer.

- Salary continuation installments scheduled to be paid *after* March 15 of the year following separation generally are deferred compensation subject to § 409A. So a top officer who separates in December 2008 could receive monthly salary payments on January 31 and February 28, 2009, but would then have to wait for the March – May payments until June 30, 2009. Payments slated to be paid after March 15 generally could not be accelerated but would have to be paid pursuant to the original schedule.
- Importantly, from the IRS's point of view, the employee's separation from employment begins when the employee stops performing services, even though he or she remains on the active payroll because of salary continuance. As a result, any employee who is covered under a separate deferred compensation plan that begins payout upon separation from employment would be required to commence distributions immediately (except for employees subject to the 6-month delay rule, whose payments would begin 6 months after separation). *See* Treas. Reg. § 1.409A-1(h)(1). Similarly, employees would not be permitted to defer salary continuation payments under a nonqualified plan.

The final § 415 regulations provide that salary continuation payments that are paid after separation from (actual) service does not constitute “compensation” within the meaning of § 415 for periods following separation. *See* Treas. Reg. § 1.415(c)-2(e)(3)(iv). This means that separated

employees cannot continue to participate in the employer's 401(k) plan, making elective deferrals from their salary continuation payments. Similarly, employees may not become entitled to profit-sharing or ESOP allocations on account of post-separation salary continuation payments.

As a final note of caution, remember that salary continuation arrangements continue to pose other challenges under the qualified plan rules. For example, does the plan by its terms really credit service for the post-separation salary continuation period even though an employee is not actually providing services? And how are post-separation accruals treated for Code § 401(a)(4) testing purposes? As before, these and other challenges remain but are not insurmountable.

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This communication has not been written as a formal opinion of counsel. Accordingly, IRS regulations require us to state that any tax advice contained herein was not intended or written to be used and cannot be used for the purpose of avoiding federal tax penalties.