

§ 409A: Five Points That May Surprise You

A significant portion of the payments made under a typical *ad hoc* separation agreement, whether voluntary or involuntary, are not deferred compensation subject to § 409A

- Payments under these arrangements, which are negotiated (and therefore become “legally binding”) in the calendar year of separation, are not deferred compensation to the extent the payments are scheduled to be paid in the calendar year of separation or in the first 2-½ months of the following year. This is the case even if other payments under the agreement – including payments that are part of the same payment stream – are scheduled to be paid after the 2-½ month period.
- Examples include salary continuation payments, retirement bridge payments, retirement transition payments, and the like.

Similarly, a portion of the payments made under certain salary deferral plans and SERPs may be exempt from § 409A

- Under the proposed regulations, compensation paid within 2-½ months following the year in which an employee obtains a legally binding vested right to the compensation generally is exempt from § 409A – *unless* the employee at any time had a vested right to receive the compensation after the 2-½ month period. Under the exception, if compensation was at any time scheduled to be paid after the 2-½ month period, a payment can not be accelerated to occur within the 2-½ month period to avoid application of § 409A.
- On the other hand, if an employee has not yet obtained a vested right to receive payment of an identifiable amount of compensation after the 2-½ month period, that compensation is exempt from § 409A if it is in fact paid within the 2-½ month period. For example, take a SERP or salary deferral plan that provides for payment only upon separation from service. If compensation was accrued or deferred under such a plan in 2005 and the employee then terminates employment on March 1, 2006, the plan could pay an amount equal to the 2005 accrual or deferrals immediately (plus any January and February accruals or deferrals) without regard to § 409A.

As a result, the 6-month payment delay requirement for “key employees” does not necessarily preclude immediate payment under many *ad hoc* separation arrangements, SERPs and salary deferral plans. These payments are exempt from other § 409A requirements as well.

- Because a significant portion of the payments under a typical *ad hoc* separation agreement are not subject to § 409A, payments under such an agreement generally may begin immediately – even if some of the payments scheduled under the agreement are very large and/or extend for many years. Lump sum separation amounts are almost always payable immediately. Installment (*e.g.*, salary continuation) payments also can begin immediately in most cases – though under some fact patterns, payments may need to be suspended for a short period after 2 or more initial payments are made.
- In a SERP or salary deferral plan that pays out only upon separation from employment, payment of the most recently accruals or deferred amounts generally need not be delayed for 6 months even for specified employees. A similar result may apply even if there are other distribution options.

On a different point: If a payment is scheduled to be made in a lump sum upon vesting, the employer typically can accelerate payment *at its discretion* by accelerating the vesting date

- If payments were originally scheduled to be paid (upon vesting) in installments over a period of years, rather than as a lump sum, the employer generally may not accelerate payment in this manner.

2006 is a “good faith” compliance year. To establish good faith, you must take into account the guidance in Notice 2005-1. You may also take into account the proposed regulations, but this is not required

- Thus, for example, certain extensions of the exercise period for a stock option might be permitted during 2006. (However, if the extension allows exercise after 2006, the extension may need to be “cured” for exercises that occur on or after January 1, 2007.)

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