



FENWICK & WEST LLP

# Executive Compensation and Benefits

## Internal Revenue Code Section 409A: Severance Guidance

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On September 29, 2005, the Treasury Department released the much anticipated proposed regulations to Section 409A of the Internal Revenue Code (the “Proposed Regulations”). This is a brief summary addressing severance compensation (and certain restricted stock unit payments upon termination of employment) in the context of Section 409A and the Proposed Regulations. If severance compensation qualifies as deferred compensation, and it does not comply with the Proposed Regulations, it will be subject to an additional 20% tax.

### Public Companies

#### *Involuntary Terminations—409A Exempt Arrangements*

- Public company arrangements providing for severance as a result of an involuntary termination are exempt from Section 409A where such severance is paid out in full either (1) in the year of such involuntary termination of service or (2) prior to the later of (a) March 15 of the following year or (b) 2 1/2 months following the end of the fiscal year of the employer in which the involuntary termination occurs (the “**Short-Term Deferral Exemption**”). As explained below, involuntary termination does not include a voluntary termination for “Good Reason” or a “Constructive Termination.” The term “Termination of Service” includes a termination of employee status.
- Public company arrangements providing for severance as a result of an involuntary termination that is paid after the end of the Short-Term Deferral Period are exempt from Section 409A where the aggregate amount of payments do not exceed a

specified amount over a specified time period. The specified amount is the lesser of (1) two times the service provider’s annual compensation or (2) two times the limit on annual compensation that may be taken into account for qualified plan purposes under Section 401(a)(17) (for 2005, \$210,000) for the calendar year preceding the year in which the separation from service occurs. The specified time period is the period that commences with the date of involuntary termination of service and ends no later than the end of the second calendar year in which the separation from service occurs (the “**Two Times Exemption**”). This Two Times Exemption will permit installment payments to coincide with any noncompetition or nonsolicitation conditions.

#### *Involuntary Terminations—409A Compliant Arrangements—No Specified Employee*

Public company arrangements providing for severance to an employee as a result of an involuntary termination that does not meet the Short-Term Deferral Exemption or the Two Times Exemption discussed above are not exempt from 409A and must comply with 409A’s rules. Such severance is 409A compliant provided the payments are not made to (1) a “Specified Employee” (defined below) and (2) are paid pursuant to a fixed payment schedule. If these two rules are met, no further 409A limitations apply. This is the case even when payments are made as a result of voluntary termination for “Good Reason.”

The term “**Specified Employee**” means, only with respect to a publicly traded employer, any employee who is (1) an officer of the employer with annual compensation greater

than \$130,000, (2) a 5% owner of the employer or (3) a 1% owner of the employer having annual compensation greater than \$150,000. A Specified Employee is identified during a 12-month “look-back” period designated by the employer.

***Other Terminations—409A Compliant Arrangements—  
Payments to Specified Employee Following a “Good Reason”  
or Constructive Termination***

Public company arrangements providing for severance to a Specified Employee upon a voluntary termination for “Good Reason” or upon a “Constructive Termination” are not exempt from, and will need to comply with, Section 409A. Such severance arrangements will comply if no payments are made for a period of at least **six** months following a termination of service and are otherwise made pursuant to a fixed payment schedule (the beginning of which must be at least six months following the termination of service). The Proposed Regulations do not view a termination for “Good Reason” or a “Constructive Termination” as an involuntary termination of service. There remains an issue as to whether an agreement that provides for severance upon **both** an involuntary termination or upon a termination for “Good Reason” needs to comply with the six month rule where the termination is involuntary (i.e., “Good Reason” is not triggered). We are concerned that final regulations will require a six month deferral of payment.

**Private Companies**

***Involuntary Terminations—409A Exempt Arrangements***

Private company arrangements providing for severance as a result of an involuntary termination of service that satisfies either the Short-Term Deferral Exemption or the Two Times Exemption (both described above), are exempt from 409A.

***All Other Terminations—409A Compliant Arrangements***

Private company arrangements providing for severance to an employee as a result of an involuntary termination that do not meet the Short-Term Deferral Exemption or the Two Times Exemption discussed above are not exempt from 409A and must comply with 409A’s rules. Such severance

is 409A compliant provided the payments are paid pursuant to a fixed payment schedule regardless of whether a “Good Reason” or “Constructive Termination” occurs. Since the concept of a “Specified Employee” does not apply to private companies, there is no requirement that any payments be delayed for six months.

It may be advisable, however, to build in a six month delay for payments to one who would otherwise qualify as a “Specified Employee” at such time as the company becomes publicly traded where an arrangement provides for payments upon a voluntary termination for “Good Reason” or upon a “Constructive Termination.” This will avoid potential 409A issues at such later time.

**Definition of Severance**

It is important to note that severance includes not only cash payments, but payments of restricted stock units that vest on termination of service (whether or not after a change of control) and other forms of deferred compensation.

**Reimbursement Arrangements**

Reimbursement arrangements that cover only expenses incurred and reimbursed before the end of the second calendar year following the calendar year in which the separation from service occurs are generally exempt from 409A. Qualifying reimbursements include payments: (a) excludable from gross income, (b) for expenses that can be deducted as business expenses incurred in connection with the performance of services (ignoring any applicable limitation based on adjusted gross income), (c) outplacement expenses related to the separation from service, (d) moving expenses related to the separation from service, (e) medical expenses and (f) employer in-kind benefits, as well as any other type of payments that do not exceed \$5,000 in the aggregate during any given taxable year. The exemption from 409A for reimbursement arrangements does not require that the separation from service be “involuntary.”

## What Should Be Done Now

- Review and identify all severance arrangements (including severance plans, policies and arrangements and employment agreements and offer letters) that provide for severance benefits.
- In the event “Specified Employees” received severance upon termination of employment in 2005, such termination should be discussed with counsel to verify compliance with the Proposed Regulations or good-faith compliance with Notice 2005-1.
- We recommend that arrangements should not be formally amended until the Treasury Department provides further clarification and the regulations finalized.

If you have any questions regarding this notice please call Scott Spector at (650) 335-7251 or e-mail [sspector@fenwick.com](mailto:sspector@fenwick.com).

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