

PRACTICAL 409A



Modified Work Arrangements for Employees Under Code Section 409A

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Internal Revenue Code Section 409A introduces new rules governing non-qualified retirement plans and other deferred compensation arrangements. In this series of articles, we take an in-depth look at some of the crucial issues involved with bringing your plans and arrangements into compliance with Section 409A.

This article examines the application of Section 409A to modified work arrangements—on-call or reduced time work arrangements, consulting arrangements, leaves of absence, rehire situations and other employment-related changes.

Internal Revenue Code Section 409A allows a “separation from service” to be a payment trigger for deferred compensation, including separation pay, supplemental retirement benefits, account-balance deferred compensation and other payments.

If separation from service is a payment trigger, the payment date must be “objectively determinable” at the separation date and must be nondiscretionary. This requirement can be met by specifying a payment date(s) or a payment year(s) by reference to the separation date (e.g., first day of the third month following separation from service; or annual payments each year for five years starting with the year following separation from service) or specifying a payment date range by reference to the separation date (e.g., payment within three months following separation from service). In the case of a payment date range, the range must either end within the same calendar year it starts, or not exceed 90 days in length.

Accelerating or delaying a scheduled payment date can mean trouble under Section 409A. It forces deferred compensation arrangements to fix the payment date(s) at the time the amounts are deferred in the first instance, with very limited ability thereafter to alter the fixed payment date(s). Section 409A also prohibits a “specified

employee” of a public company from receiving deferred compensation payments during the first six months following separation from service. This prohibition applies only to deferred compensation amounts for which separation from service is the payment trigger. Section 409A forces deferred compensation arrangements to include this delayed payment requirement to prevent executives from bailing out of a sinking ship in order to get at their deferred compensation.

ON-CALL OR REDUCED-TIME WORK ARRANGEMENTS

When a separation from service is the trigger event for payment of deferred compensation, it becomes necessary to identify when that event has occurred. A “separation from service” occurs as of the date after which the employer and employee “reasonably anticipate” that either:

- The employee will perform no services; or
- The level of bona fide services the employee will perform (in any capacity—employee or contractor) will permanently decrease to no more than 20 percent of his or her past service schedule. The relevant past service schedule is the average level of bona fide services performed over the immediately preceding 36-months.)



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The sole relevant factor is what the parties reasonably anticipate—that is, what they expect or intend—the level of services to be in the future. This is determined by the facts and circumstances of the situation.

If an employee is put on a reduced-time work schedule, and the parties intend that the employee continue above the 20 percent threshold, then it would be inappropriate to pay deferred compensation that is triggered by separation from service because there has been no separation from service under Section 409A. Conversely, if the parties intend that an on-call or reduced time employee provide services below the 20 percent threshold, then it would be inappropriate not to pay deferred compensation that is triggered by separation from service because a separation from service has occurred for purposes of Section 409A.

Presumptions as to Intent

If challenged by the Internal Revenue Service, it may become necessary to prove intent. In this regard, a set of presumptions applies under Section 409A:

- If the level of services actually performed is below the 20 percent threshold, there is a presumption that the parties intended that the services would be below the 20 percent threshold.
 - If the level of services actually performed is 50 percent or more of the employee's past service schedule, there is a presumption that the parties intended that the services would be above the 20 percent threshold.
 - There is no presumption in between.
- If a presumption applies, the party who wishes to take the opposite position has the burden of proof. Being able to demonstrate intent based on the facts and circumstances may be very important. The following facts and circumstances may bear on intent (none of which is determinative):
- A contract expressing the intent and understanding certainly would be helpful.
 - Continuing full-time pay or benefits may suggest an intent not to reduce service levels.
 - Cutting off access to resources and facilities may suggest an intent that no services will be provided.
 - The employee taking a job with another employer, or moving to a different part of the country, may suggest an intent that no services will be provided because the employee is not available to provide them.
 - If more services are rendered than anticipated because a hired replacement quits unexpectedly, that may help overcome a

presumption that there was no intent to reduce services to below the 20 percent threshold.

The 20 percent standard can be modified by the terms of the contract or plan to be a level somewhere between 20 percent and 50 percent. For example, an employment contract may indicate that a reduction in the service schedule to 30 percent of the prior work schedule, as measured over the 36 months immediately prior to the separation from service, will be deemed to constitute a separation from service. Any such special contract or plan provision generally must be in place at the time the deferral occurs under the contract or plan in the first instance. However, the provision can be added by Dec. 31, 2008 under transition rules applicable under Section 409A.

CONSULTING ARRANGEMENTS

A separation from service may not have occurred where an individual has ceased to be an "employee" but continues on as a contractor with the employer. Whether there has been a "separation from service" is determined by reference to the service schedule, and what the parties expect or intend the service schedule to be, and not by reference to whether the relationship is structured as an employer/employee or contractor relationship.



It would be inappropriate to pay deferred compensation that is triggered by separation from service merely because the relationship changes from an employment to a contractor relationship, unless the parties reasonably expect that the service level will be below the 20 percent threshold.

The legal form that is used to provide the consulting services is not relevant for purposes of determining whether a separation from service has occurred—the only thing that is relevant is the expectation of the parties as to the services to be provided by the individual in question. An individual may cease to be an “employee” but continue to provide services, either as an individual or through a corporation or other business entities. In the later case, the now former employer contracts with the business entity for the services and the business entity is the “service provider.” However, for purposes of determining whether the separation from service has occurred, it is the services to be provided by the individual that must be evaluated.

NON-WORK PERIODS (LEAVES OF ABSENCE)

An employee who is absent from service—be it vacation, military leave, sick or disability leave or voluntary leave—certainly is not performing services. A “separation from service” is considered to have occurred for purposes of Section 409A on the first day following the expiration of six months of continuous absence except in the following cases:

- If the employee has a right to re-employment under applicable law (e.g., for military leave) or by contract, there has been no separation from service for as long as the employee has that right.
- If the employee is on disability leave, the separation from service will be treated as having occurred at 29 months, or any earlier date on which employment is terminated by the employer or employee. For this purpose, a disability exists if the employee is unable to perform the duties of his or her position of employment by reason of a medically determinable physical or mental impairment that can be expected to last for a continuous period of not less than six months (or result in death).

Only a “bona fide” leave can be recognized, even for purposes of the six-month period. A leave is considered bona fide only if there is a reasonable expectation that

the employee will return to service after the leave. Thus, a leave of absence taken at the end of employment is not considered a bona fide leave and the separation from service will have occurred when the employee stops performing services.

REHIRE

Once a separation from service has occurred, payment dates must be objectively determinable and unchangeable (except in accordance with the stringent rules of Section 409A). A rehire cannot result in a suspension of scheduled deferred compensation payments to be paid at a later point in time. This does not preclude a contract provision where the right to deferred compensation in the first instance is contingent on the individual not being rehired—that is, where payments are forfeited if the individual is rehired, and not merely deferred to a later point.

OTHER SITUATIONS/ISSUES

Vacation

A separation from service is determined by reference to the service level and the parties’ expectations regarding the service level. Vacation that is taken at the end of employment does not operate to extend the separation date if there is no reasonable expectation that the employee will return to employment at the end of the period. It is not clear what work period is expected following a return from a vacation to allow the vacation period to be counted—for example, what if an employee is expected only to return to work for one day?

Pay in Lieu of Notice

A separation from service is determined by reference to the service level, and the parties’ expectations regarding the service level. If pay is provided in lieu of a contractual termination notice, the “separation from service” must be recognized as having occurred for deferred compensation purposes as of the date services end.

In the context of a negotiated departure, with respect to payments that are agreed to in connection with the departure and that are not provided as a substitute for existing deferred compensation, it is possible to use the fixed payment schedule rules of Section 409A to set the payment date in advance, without the payments being on account of the separation from service. For example, negotiated payments can be contracted to start on

Nov. 1 even if the “separation from service” date under Section 409A—that is, the last day worked—occurs in July with the individual remaining as an employee through the end of October. In such a case, there is a scheduled payment date consistent with Section 409A, and separation from service is not the payment trigger. However, any pre-existing deferred compensation where payment is triggered by separation from service must look to the separation from service date under Section 409A.

Employment Changes Within a Controlled Group

Whether a separation from service has occurred is determined by reference to the “controlled group” of companies that includes the employer. Thus, an employment change from one company to another within the same controlled group is not considered to be a separation from service.

The qualified plan rules generally are used to define controlled group status, except that a 50 percent or more ownership standard is used instead of an 80 percent or more

ownership standard. However, a plan can specifically provide (actual plan language is necessary to accomplish this) that a standard anywhere between 20 percent and 80 percent be used for this purpose, instead of 50 percent. A percentage less than 50 percent may be considered appropriate, for example, in the context of a joint venture operation. Any special language of this nature should be added to the plan by Dec. 31, 2008.

Asset Purchase Transactions

In the context of an asset transaction (e.g., sale of a plant, division or substantially all assets of a trade or business) between unrelated parties, the buyer and seller can retain the discretion in the purchase agreement to determine whether employees who are terminated in connection with the transaction have had a separation from service, provided that all employees of the seller who accept positions with the buyer are treated consistently (regardless of position). The actual decision of the buyer and seller in this regard must then be reduced to writing by the closing date.

Otherwise, an asset sale generally results in a separation from service with respect to those employees who are terminated in connection with the sale, regardless of whether the individual goes to work for the buyer. To avoid contract claims regarding benefit entitlement, an employer who wishes to preserve the option to transition benefits to an asset purchase should reserve that right by the contract or plan.

Stock Purchase Transactions

In the context of a stock transaction, there has been no separation from service. However, it is possible that the stock transaction is a “change in control” that would justify a payment of deferred compensation under the change in control provisions of Section 409A, or under special rules that allow termination and payout of deferred compensation in the case of a change in control event.

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