SEPARATION AGREEMENTS
CENTRAL NEW YORK SALES & MARKETING EXECUTIVES

"The employer-employee bond is sometimes difficult to sever."

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CNY SALES & MARKETING EXECUTIVES: SEPARATION AGREEMENTS

By:

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SEPARATION AGREEMENTS: BREAKING UP IS HARD TO DO

By:

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Employers often offer severance benefits to sweeten the pot when attracting employees or to soften the blow of termination. Paying severance also increases morale and employee relations and serves as an important human resource tool. Employers may also employ severance pay as a means to avoid future employment-related litigation by requiring exiting employees to execute releases and waivers of claims. However, paying severance also raises unique legal issues and employers and their advisors often fail to recognize the pitfalls.

This memorandum addresses several of those pitfalls including the application of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), the enforceability of releases and waivers, new tax law to consider in designing and administering separation pay and reimbursing expenses in connection with severance.

I. Goodbye: Essential elements of severance agreements.

A. Is your severance arrangement/policy an ERISA "plan"?

The provision of severance benefits may constitute an ERISA plan and therefore such arrangements may be subject to the statute's requirements. Although case law provides guidance to employers, ultimately the facts and circumstances of the particular severance arrangement will dictate ERISA's application. While severance arrangements that provide ongoing benefits to a number of employees will very likely be treated as a plan subject to ERISA, other severance arrangements pursuant to employment or severance agreements may or may not be subject to ERISA.

ERISA § 3(1)(B) defines an employee benefit plan, in part, as "any plan, fund, or program…established or maintained by an employer…for the purpose of providing its participants or their beneficiaries…" certain benefits. Since ERISA does not provide a definition for the term "plan," the U.S. Supreme Court issued guidance in Fort Halifax Packing Co. v. Coyne where it held that a "one-time, lump sum [severance] payment triggered by a single event requires no administrative scheme whatsoever to meet the employer's obligation" and therefore does not constitute a "plan" subject to ERISA. 482 U.S. 1 (1987). Thus, on the one hand, an employer that wishes to avoid ERISA's application may make one-time, lump sum payments of severance triggered by a single event [i.e., termination]; however, often lump-sum payments constitute a draw on employer assets [particularly where the employee is a high level executive] or perhaps, the employer wants leverage to enforce a non-competition provision.

While Fort Halifax Packing Co. constitutes one end of the spectrum, several other court decisions provide parameters as to when, in New York, a severance arrangement will be considered an ERISA plan because the arrangement involves an "ongoing administrative scheme." For example:

- An employer orally advised employees that if they continued to work until the completion of a consolidation transaction, those employees would receive an additional 60 days pay following their last day of work, which they could take either in a lump sum or in bi-weekly installments. The court held that the arrangement was not a plan subject to ERISA. The court reasoned that the arrangement was analogous to Fort Halifax Packing Co. even though payment was not complete until after 60 days following termination. The Court characterized this payment period as short and found that the arrangement did "not require an ongoing administrative program to meet the employer's obligation." James v. Fleet/Northstar Financial Group, Inc., 992 F. 2d 463 (1993).

- An employer announced in a memorandum to senior employees the details of a severance pay arrangement that provided for payments to senior-level employees upon their involuntary discharge. Payments under the arrangement were based upon both the length of time the employee held his position and his prospects for reemployment, but severance payments would be made only if the employee displayed a reasonable and good faith effort to obtain a position commensurate with his former level of responsibility. In addition, the employee would not be eligible for payments under the arrangement if the termination was for either illegal conduct or substantially deficient performance. Under the arrangement, a terminated employee would continue to receive other benefits, and the memorandum contained no provision for termination or amendment of the severance arrangement. The employer neither created nor circulated any documents purporting to amend, modify, or terminate the arrangement. In concluding that the arrangement required an "ongoing administrative scheme" subject to ERISA, the court examined the following three factors:

    - whether the employer's undertaking or obligation requires managerial discretion in its administration,

    - whether a reasonable employee would perceive an ongoing commitment by the employer to provide employee benefits; and

    - whether the employer was required to analyze the circumstances of each employee's termination separately in light of certain criteria.

The court stated that all three factors favored its conclusion and noted that it did not decide which factors are determinative or whether more factors should be considered in deciding if a particular severance arrangement constitutes an "ongoing administrative scheme". Schonholz v. Long Island Jewish Medical Center, 87 F.3d 72 (2d. Cir. 1996).

- An employer eliminated written employment contracts by letting them expire without renewal. The employer then created plans to provide severance benefits for senior executives. Approximately 21 management employees were covered by one of these plans. The plans provided that a covered executive would receive severance payments in an amount based on his previous salary [under the employment contract] if his employment was terminated involuntarily, unless the termination was "for cause." The payments would either be paid periodically in accordance with the employer's regular payroll schedule or, if the employer elected, in a lump sum. The plan provided that employees receiving severance benefits would be subject to certain continuing obligations. In addition, the plan stated that the employer could terminate (or amend) the plan except that termination (or amendment) may not "reduce or adversely affect" the severance benefits of any eligible employee "whose employment terminates within two years of the effective date" of plan termination (or amendment).

  The court held that the arrangement is an ERISA governed "plan" because it embodied "an ongoing commitment." In applying Fort Halifax Packing Co., James and the Schonholz factors, the court noted that benefits under the plan could be paid under a protracted period of time; the plan's termination provision was not absolute; and that the plan embodied significant managerial discretion and a case-by-case analysis to determine whether the employee was terminated "for cause" and/or whether the terminated employee continued to satisfy certain standards of conduct upon which the future receipt of benefits was predicated upon. The court noted that this arrangement presented a somewhat closer call than the arrangement in Schonholz. Tischmann v. ITT/Sheraton Corp., 145 F.3d 561 (2^{nd} Cir.1998).

- An employer maintained a policy manual distributed to employees that stated, in part, employees will "receive appropriate severance pay where applicable." The policy manual provides that if "sufficient cause" exists, an employee can be terminated and will "forfeit all terminal benefits." The court held that the statement in the employer's policy manual constituted a "plan" subject to

ERISA. In reasoning its conclusion, and applying Fort Halifax Packing Co., James and the Schonholz factors, the court noted the following combination of factors: (i) the severance payments were not contingent upon a single event and, to the contrary, were offered without any apparent date restriction and thus could reasonably be seen by employees as an ongoing commitment; (ii) the employer had to make an individual determination as to whether an employee was terminated for sufficient cause; and (iii) the amount of severance was not a fixed amount, and, consequently, the employer would presumably have to determine the amount in each individual case. Kosakow v. New Rochelle Radiology Assocs., P.C., 274 F.3d 706 (2nd Cir. 2001).

- An employer entered into an employment contract with the company's president and CEO that provided a severance package of one year's base salary payable in a lump sum if employment was terminated under certain circumstances. The court held that the employment contract did not constitute an ERISA governed "plan." In applying Fort Halifax Packing Co., Kosakow and Schonholz, the court reasoned: (i) that the arrangement required an insignificant amount of managerial discretion because employment contract contained a fixed set of criteria that triggered severance and the amount of severance could be calculated with simple arithmetic calculations; and (ii) an employee would not reasonably perceive an ongoing commitment because once the employer paid the lump-sum severance, no further obligation exists. Arie Sheer v. Israel Discount Bank of New York**,** 2007 U.S. Dist. LEXIS 16488 (2007).

In examining the facts and circumstances to determine whether an "ongoing administrative scheme" exists, New York courts will therefore examine the following factors:

- the types of payments made under the arrangement (lump sum, period, alternative forms); James v. Fleet/Northstar Financial Group, Inc.

- whether the arrangement requires managerial discretion in its administration; Schonholz v. Long Island Jewish Medical Center.

- whether a reasonable employee would perceive an ongoing commitment by the employer to provide employee benefits; Schonholz v. Long Island Jewish Medical Center. [Whether the employer's right to terminate the plan is absolute. Tischmann v. ITT/Sheraton Corp.]

- whether the employer is required to analyze the circumstances of each employee's termination separately in light of certain criteria. Schonholz v. Long Island Jewish Medical Center.

New York courts have not decided which one of the above factors is determinative in every case, nor have New York courts excluded the possibility that when addressing different situations, other factors may be relevant. Arie Sheer v. Israel Discount Bank of New York.

Employers must also recognize that even *individual* severance arrangements may create ERISA plans. For example, providing severance pursuant to a provision contained in an employment contract may constitute an ERISA plan. Likewise a severance agreement entered into with one employee at termination may also constitute an ERISA governed plan. In this regard, severance arrangements are commonly negotiated when retaining an executive or entering into a corporate transaction such as a merger or acquisition.

B. Does your severance arrangement provide pension or welfare benefits?

Under ERISA, benefits provided under a severance plan may be characterized as a welfare or pension benefit depending on the facts and circumstances. This distinction is of material importance because if the severance payment is considered a pension benefit then, unless the plan qualifies as a top-hat plan [discussed below], the plan will be subject to ERISA's rules regarding participation, vesting, funding and governmental reporting and disclosure. Whereas, if the severance payment is considered a welfare benefit, then the plan is only subject to ERISA's rules requiring governmental reporting and disclosure.[1] An additional exception to governmental reporting and disclosure applies to welfare plans that qualify as top-hat plans [discussed below].

Under U.S. Department of Labor regulations, severance benefits will be considered welfare benefits and not pension benefits if:

- the severance payments are not contingent, directly or indirectly, upon the employee's retiring;

- the total amount of severance paid does not exceed two (2) times the employee's annual compensation during the year immediately preceding the termination of employment; and

- unless the severance is paid in connection with "a limited program of terminations" [as defined by regulation], all severance payments must be made within twenty-four (24) months after the termination of the employee's service.

[1] ERISA's rules governing participation, vesting and funding do not apply to welfare benefits.

C. Top-Hat Plans: Exempt from certain ERISA requirements.

Top-hat plans are unfunded plans that employers maintain primarily for the purpose of providing benefits to a select group of management or highly compensated employees. Top-hat plans may cover a group of employees or just one employee.

Top-hat plans that provide pension benefits are not subject to ERISA's rules regarding participation, vesting and funding. Furthermore, such plans may satisfy ERISA's governmental and reporting requirements by filing a one-time statement with the U.S. Department of Labor (a "top-hat statement") within one-hundred and twenty (120) days of adoption and providing plan documents to the U.S. Department of Labor upon request.

Top-hat plans that provide welfare benefits are exempt from ERISA's governmental reporting and disclosure requirements so long as such plans provide plan documents, upon request, to the U.S. Department of Labor.

Because of the limited 120-day window to avail oneself of the top-hat exemption for pension benefits, each time a new severance arrangement is implemented, employers should seek an opinion from counsel as to whether the severance arrangement is subject to ERISA, whether the arrangement provides a pension or welfare benefit and whether to file a top-hat statement, keeping in mind that individual arrangements may equally be subject to ERISA.

D. Failure to Satisfy ERISA's Requirements.

If your severance arrangement is subject to ERISA but fails to comply, your company and any plan fiduciaries could be subject to various penalties including, but not limited to:

- civil penalties up to $110 per day per violation for failure to provide participants of the severance plan with required documents when requested (including Summary Plan Descriptions etc.);

- civil penalties up to $1,100 per day for failure to file an annual report (i.e., Form 5500); and

- criminal penalties for failure to comply with governmental reporting and disclosure requirements including possible imprisonment and fines of up to $500,000 if the violation is willful.

II. Taxation—the Bane of Your Employment Lawyer: How does Code § 409A impact severance pay and your company's reporting obligations.

A. Hi Employer & Employee, My Name is 409A

Congress enacted Internal Revenue Code ("Code") Section 409A ("Section 409A") as part of the American Jobs Creation Act of 2004 which generally was effective on January 1, 2005. Between 2005 and December 31, 2008, compliance with Section 409A generally required compliance with interim Internal Revenue Service ("IRS") guidance and a reasonable, good faith interpretation of Section 409A. However, effective January 1, 2009, Final Regulations issued by the Treasury Department require strict compliance with the approximate 400 pages of guidance.

Employers need to be aware of Section 409A in structuring employment and severance agreements because violations cause the imposition of significant penalties on the employee. While employers are not directly subject to penalties for violations of Section 409A, many employers decide to pay Section 409A penalties, in part, to keep their employees happy and, in part, because the employer is often the party responsible for drafting the documents that caused the violation. In addition, employers that pay severance with the purpose of attracting an employee or softening the blow of termination are often undermined by the tax penalties associated with arrangements that violate Section 409A. Finally, a violation of Section 409A also imposes additional tax reporting and withholding obligations (including potential withholding penalties) on the employer. Aggregating these additional reporting and withholding obligations for various employees often causes an increased cost to the employer.

B. Section 409A's Application to Separation Pay

Section 409A imposes complex new requirements on nonqualified deferred compensation plans that must be satisfied to avoid immediate income inclusion (on amounts deferred even if it is not yet received), a 20% additional tax penalty and interest on back taxes at a higher-than-standard rate.

Section 409A applies, in relevant part, where an employee has a legally binding right to compensation that is not payable until a later year. An employee does not have a legally binding right to compensation if the employer may unilaterally reduce or eliminate the compensation after the services creating the right have been performed. However, the IRS will scrutinize the facts and circumstances of the arrangement to determine whether the employer's discretion to reduce or eliminate the compensation lacks "substantive significance." In addition, a right to compensation subject to a contingency will still constitute a legally binding right.

Section 409A has special rules applicable to separation pay plans. A separation pay plan is a plan, including a portion of an agreement with one individual, which defers compensation that is not payable under any circumstances unless the employee has a separation from service, whether voluntary or involuntary. Separation pay does not include compensation that the employee could have received without the termination of employment. An arrangement that defers compensation, such as severance, does not escape the application of Section 409A merely because the right to a payment is conditioned upon a separation from service. However, under the Final Regulations, certain types of severance arrangements are specifically exempted from Section 409A.

1. Involuntary Terminations, Terminations For Good Reason and Window Programs.

Severance paid pursuant to an involuntary termination, a termination for good reason or a window program is not subject to Section 409A *to the extent* that the severance pay, or a portion of the severance pay, meets the following requirements:

- the amount of severance pay does not exceed two times the lesser of: (i) the employee's annualized compensation for the calendar year preceding the separation; and (ii) the maximum amount that may be taken into account under the qualified plan compensation limit in effect for the year the employee separates from service; and

- all severance payments must be made no later than December 31 of the second year following the year in which the employee's separation from service occurred. (For example, if an employee separates from service January 27, 2009 all severance must be paid by December 31, 2011.)

The Final Regulations permit the total amount of severance to be divided amongst portions that are subject to Section 409A and portions that are not subject to Section 409A. Thus, if the total amount of severance exceeds the above dollar amount or is paid over a longer period of time than permitted above, but is still paid pursuant to an involuntary termination, a termination for good reason or a window program, only the amount that exceeds the dollar limit or that is paid over the impermissible period of time is subject to Section 409A. Only amounts subject to Section 409A need to comply with its requirements (such as, in part, the six-month delay imposed on payments of severance to certain key employees of publicly traded companies discussed below).

a. Involuntary Termination

An involuntary termination, for purposes of Section 409A, means a severance of the employment relationship due to the employer's independent exercise of the unilateral authority where the employee was willing and able to continue performing services. A termination on prompt of the employee's implicit or explicit request will not constitute an involuntary termination.

An involuntary termination may include the employer's failure to renew an employment agreement at the time such agreement expires provided that the employee was willing and able to execute a new contract with terms and conditions substantially similar to those in the expiring contract and to continue providing such services.

Any documentation characterizing the separation as voluntary or involuntary by the employer and the employee is presumed to properly characterize the nature of the separation. However, ultimately, the IRS will scrutinize the facts and circumstances to determine whether there has been a severance of the employment relationship and whether that severance is involuntary.

b. Termination For Good Reason

Whether a termination of employment is considered to be for good reason is determined based on the facts and circumstances of such termination. For an employee to terminate the employment relationship with good reason, the employer must have taken action that result in a material negative change in the duties the employee performs, the conditions under which the employee provides services or the employee's compensation.

The Final Regulations provide a safe harbor definition of termination for good reason. The safe harbor definition requires that any one or more of the following conditions arise without the consent of the employee and that the employee terminate service within two years after the condition arises:

- A material diminution in the employee's base compensation;
- A material diminution in the employee's authority, duties or responsibilities;
- A material diminution in the authority, duties or responsibilities of the supervisor to whom the employee is required to report, including a requirement that the employee report to a corporate officer or employee instead of reporting directly to the board of directors of a corporation (or other similar governing body with respect to an entity other than a corporation);
- A material diminution in the budget over which the employee retains authority;
- A material change in the geographic location at which the employee must perform the services; or
- Any other action or inaction that constitutes a material breach of an applicable employment agreement by the employer.

In addition, the safe harbor requires that: (i) the amount, time and form of payment upon termination must be substantially identical to the amount, time and form of payment payable under an involuntary termination (to the extent such a right to payment exists); and (ii) the employee must provide notice to the employer of the existence of good reason within ninety (90) days of the initial existence of the condition and provide the employer at least thirty (30) days to remedy the condition.

c. Window Programs

A window program is a program, available for a limited period of time (no longer than 12 months), that the employer establishes to provide severance to employees that terminate service under specified circumstances during that period.

A program will not be considered a window program if an employer establishes a pattern of repeatedly providing severance in similar situations for substantially consecutive, limited periods of time. Whether the recurrence of these programs constitutes a pattern is determined based on the facts and circumstances. Relevant factors to weigh in considering whether a pattern exists is whether severance is provided on account of a specific business event or condition, the degree to which severance relates to the event or condition, and whether the event or condition is temporary or discrete or is a permanent aspect of the employer's business. No one factor is determinative.

2. Collectively Bargained Severance Arrangements

Section 409A does not apply to collectively bargained severance arrangements that provide severance only upon an involuntary termination, termination for good reason or pursuant to a window program agreement so long as:

- the severance arrangement is contained within an agreement that the U.S. Department of Labor determines to be a collective bargaining agreement;
- the severance arrangement is the result of arm's length negotiations between the employer and the employee representatives; and
- the circumstances surrounding the collective bargaining agreement evidence good faith bargaining between adverse parties over the severance arrangement.

In addition, severance arrangements that result from collective bargaining between the union and two or more employers are also free, with some restrictions, to use any *reasonable* definition of what constitutes an involuntary termination or termination for good reason so long as the definition is the subject of arm's length negotiations between adverse parties.

3. Short-Term Deferrals

Section 409A does not apply to severance benefits paid as a one-time lump sum within 2 ½ months of the year in which an involuntary termination or a termination for good reason occurs. The definitions of involuntary termination and termination for good reason must satisfy the requirements of the Final Regulations.

4. Foreign Severance Arrangements

Severance arrangements (including severance paid to employees that voluntarily terminate service) are generally not subject to Section 409A *to the extent* that the laws of a foreign country require that severance be paid and that the severance pay constitutes income taxable in that foreign country. This exception is intended to provide some relief to U.S. citizens that work outside the U.S. and that may receive severance from their foreign employer in the event employment is terminated.

5. Catchall Exception for Limited Severance Pay

In addition, Section 409A contains a catchall exception designed to exclude incidental severance benefits commonly provided upon a termination where the employer and employee may not even realize that Section 409A may have an impact. In this regard, Section 409A does not apply to severance payments that, in the aggregate, do not exceed $16,500 (i.e., the 2011 dollar limitation under Code Section 402(g)).

C. Six-Month Delay For Severance Paid To Key Employees

Severance pay that is subject to Section 409A, among other things, may not be paid to key employees of publicly traded corporations before the date which is six (6) months after the date of separation from service (or, if earlier, the date of death of the key employee).

Key employees generally include: (i) the top fifty officers whose annual compensation is greater than $160,000 (indexed for inflation); or (ii) a one-percent owner of the employer having an annual compensation from the employer of more than $160,000 (indexed for inflation).

The required delay in payment is met if payments that the key employee would otherwise be entitled during the first six months following the date of separation from service are either:

- accumulated and paid on the first day of the seventh month following the date of separation from service, or
- if each payment to which a specified employee is otherwise entitled upon a separation from service is delayed by six months.

An employer may retain discretion to choose which method will be implemented, provided that the employee cannot make a direct or indirect election as to which method will be used.

D. Employer Reporting Obligations Under Section 409A

With respect to an employee's deferral of compensation within the meaning of Section 409A, the Code requires an employer to:

- report to an employee the amount of all deferrals subject to Section 409A on a Form W-2 regardless of whether the deferral of compensation violates Section 409A; and

- treat any amounts currently includible in the employee's income under Section 409A as "wages" and withhold income tax.

1. Reporting Section 409A Deferrals for Employees

An employer is required to report to an employee the total amount of deferred compensation subject to Section 409A in box 12 of Form W-2 using code Y.

However, on December 10, 2008, the IRS issued guidance waiving this requirement so that employers will not be responsible for code Y reporting for Section 409A deferrals for subsequent future calendar years until the IRS issues further guidance.

2. Withholding on Wages Includible in Income under Section 409A

For income tax withholding purposes, an employer must treat any amounts includible in an employee's income under Section 409A as "wages." This means that with respect to any amount includible in the employee's income due to a violation of Section 409A, an employer must:

- report such amounts as wages paid on line 2 of Form 941, Employer's Quarterly Federal Tax Return;

- report such amounts in box 1 of Form W-2 as wages paid to the employee and subject to income tax withholding;

- report such amounts as Section 409A income in box 12 of Form W-2 using code Z; and

- treat such amounts as "supplemental wages" and withhold income tax on that basis (except that the amount to be withheld is not increased on account of the 20% additional tax and interest imposed as a result of violating Section 409A[2]).

E. Section 409A and the Federal Insurance Contributions Act ("FICA")

Section 409A does not affect the imposition of FICA tax on either the employee or employer. FICA tax is therefore imposed on any amount of "wages" paid and received regardless of whether Section 409A is applicable.

FICA tax is generally imposed on "wages" paid under an account balance plan in the later of the year of deferral or the year the employee vests. FICA tax is generally imposed on "wages paid" under nonaccount balance plans in the later of the year of deferral, vesting or when the amount of wages is reasonably ascertainable.

An examination of whether severance pay constitutes "wages" for purposes of the FICA tax is beyond the scope of this memorandum. Although some courts in certain circumstances have held that severance pay is not subject to the FICA tax, as a general rule, severance pay is considered compensation for services rendered and as such, "wages" subject to the FICA tax.

III. Reimbursing Expenses in Connection with Termination: Medical and Outplacement.

Payments, such as the reimbursement of certain expenses or the provision of in-kind benefits, to an employee (or former employee) in connection with the employee's termination may be subject to Section 409A. Although the IRS rejected calls by commentators to exempt broad categories of expense reimbursement arrangements in connection with an employee's termination, the Final Regulations do liberalize the applicable rules.

A. Reimbursement of Medical Benefits

Arrangements that provide nontaxable health coverage are not subject to Section 409A.[3] As such, Section 409A will not apply where an employee receives insured medical benefits post-termination because this benefit is generally nontaxable.

With respect to taxable reimbursements of medical expenses (i.e., payments made directly to the former employee before former employee incurs the medical expenses or benefits provided by a self-funded health plans that discriminates in favor of the highly compensated), the Final Regulations extend the period during such reimbursement may be provided without being subject to Section 409A. An employee may generally receive taxable reimbursements of medical expenses, without being subject to Section 409A, for

[2] Because no income tax is withheld from the amount of the additional 20% tax penalty and interest, employees need to be aware that estimated tax payments may be required to avoid additional penalties for underpayment or late payment of estimated tax.
[3] A right to a nontaxable benefit is not subject to Section 409A.

a period of eighteen (18) months. This exception is administered as if the employee had elected COBRA coverage and paid the applicable premiums. During the COBRA coverage period, generally eighteen (18) months, an employer may provide taxable reimbursements of medical expenses. Employers that wish to provide taxable reimbursements of medical expenses beyond the general eighteen (18) month period must structure the arrangement to comply with Section 409A.

B. Reimbursing Other Expenses

Provided that certain conditions are satisfied, Section 409A does not apply to reimbursement of the following:

- expenses that the employee can deduct under Code Sections 162 and 167 (as business expenses incurred in connection with the performance of services);
- outplacement expenses; and
- moving expenses. (Moving expenses include the reimbursement of all or part of any loss the employee actually incurs due to the sale of a primary residence in connection with a termination.)

These expenses must be incurred and reimbursed before the end of the second calendar year following the year in which employment terminated and the reimbursement payment must be made no later than the end of the third year following the year in which employment terminated. Otherwise, the reimbursement arrangement is subject to Section 409A and must be structured for compliance.

C. Don’t Forget the Catchall Exception

In addition, the catchall exception is also available whereby Section 409A will not apply to severance benefits (including reimbursement arrangements) if total payments do not exceed $16,500 (for 2011).

D. Provision of In-Kind Benefits and Direct Payments by Employer to In-Kind Service Provider

In-kind benefits refers to services provided to or on behalf of an employee, such as financial planning services, retention of an office, or tangible personal or real property made available for use by or on behalf of the employee, such as the use of an aircraft or vehicle. In-kind benefits do not include the transfer of property.

An employee’s entitlement to in-kind benefits from the employer (such as retention of an office or use of an aircraft or vehicle) or an employer’s payment directly to the person providing the goods or services to the employee (such as an employer paying a financial planner to provide services to the employee) are not subject to Section

409A if the provision of such in-kind benefits or direct payment would have been treated as reimbursement arrangements if the employee had paid for such benefits and been reimbursed by the employer. Thus, so long as the provision of the in-kind benefits or the direct payment satisfies the reimbursement arrangement rules such severance benefits will not be subject to Section 409A. Otherwise, the provision of the in-kind benefits and direct payments are subject to Section 409A and must be structured for compliance.

E. Structuring Reimbursement Arrangements and In-Kind Benefits that are Subject to Section 409A

The Final Regulations provide guidance regarding ways to structure an employee's right to taxable reimbursements or in-kind benefits to satisfy Section 409A. To comply with Section 409A, an arrangement that provides for reimbursement of expenses or the provision of in-kind benefits must be in writing and satisfy the following requirements:

- the arrangement must provide an objectively determinable nondiscretionary definition of the expenses eligible for reimbursement or of the in-kind benefits to be provided;

- the arrangement must provide for the reimbursement of expenses incurred or for the provision of in-kind benefits during an objectively and specifically prescribed period (including a period beginning or ending based upon an employee's death);

- the arrangement must provide that the amount of expenses eligible for reimbursement, or in-kind benefits provided, during an employee's taxable year may not affect the expenses eligible for reimbursement, or in-kind benefits provided, in any other taxable year;

    - Taxable reimbursements of medical expenses over a period longer than eighteen (18) months will not be deemed to fail this requirement because the arrangement provides for a limit on the amount of medical expenses that may be reimbursed over some or all of the period in which the reimbursement arrangement remains in effect.

- the reimbursement of any eligible expenses must be made on or before the last day of the employee's taxable year following the taxable year in which the expense was incurred; and

- the right to reimbursement or in-kind benefits may not be subject to liquidation or exchange for another benefit.

For example, a written right to reimbursement:

- of membership fees incurred for each of three specified and consecutive calendar years by a former employee, where the former employee is entitled to reimbursement of the expenses incurred each year without regard to expenses in a different year, and where the former employee cannot exchange the right for cash or any other benefit, *generally will satisfy Section 409A* if the reimbursement payment must be made no later than the end of the calendar year following the year in which the expense is incurred;

- of membership fees of up to $30,000 over three years *does not satisfy Section 409A* because the extent to which the former employee incurred the expense in the first year would affect the amount available for reimbursement in a subsequent year.

This memorandum is not intended to provide legal advice with respect to any particular situation and no decision should be based solely on its content.

If you have any questions concerning this memorandum, please contact:

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jmc/jmc/Pub&Mark/Sem/CNYSales-MarketingExecutives/SeveranceMemorandum