Separation from service under IRC Section 409A

Nonqualified deferred compensation plans are permitted to allow distributions only under limited circumstances. Internal Revenue Code Section 409A (IRC Section 409A) contains six permissible distribution events.[1] The most common of these events is separation from service. Generally, when an employee separates from service, a distribution of benefits begins under a deferred compensation plan.

A separation from service occurs when the facts and circumstances indicate the employee and employer reasonably anticipate no further services will be performed, or the level of bona fide services will drop below certain parameters.[2]

First, the employer determines the average amount of time the employee worked over the past 36 months. Second, the employer projects the amount of service hours that the employee will perform on a permanent basis going forward. The percentage of anticipated service hours over the previous 36-month average will determine whether a presumption that separation from service has occurred.

- If the reasonable expectation is that the employee's anticipated time of permanent services will be 50% or more of the previous 36-month average, the presumption is that the employee *has not* separated from service.
- If the reasonable expectation is that the employee's anticipated time of permanent services will decrease to 20% or less of the previous 36-month average, the presumption is the employee *has* separated from service.

These presumptions may be rebutted by the employer if the employer believes the facts and circumstances warrant a different result.

- If the reasonable expectation is that the employee's anticipated time of permanent services will more than 20%, but less than 50% of the previous 36-month average, no presumption is made. However, a plan document may define what percentage in this range will constitute a separation from service.[2]

If no presumption is made the employer should look to the following factors to determine whether a separation from service has occurred or not:

- Is the employee providing significant services?
- Is the employee considered an employee for other purposes (salary or participation in other benefit plans)?
- How were other employees in similar situations treated?
- Is the employee realistically available to perform services for other companies in the same line of business?[2]

The analysis of whether a separation from service has occurred or not is *not* affected by the continuation of compensation after a reduction of services performed. For example, if a participant terminates services, but continues to earn income after the date services are reduced or eliminated, the determination of whether there is a separation from service will focus solely on the reduction or elimination of service and not on any additional compensation paid.[3]

Examples

Example 1: Future permanent services are 0% of the 36-month average. An employee in a deferred compensation plan will be permanently reducing services to the employer beginning on July 1, 2022. The employee and the employer agree that the employee worked an average of 40 hours per week of the last 36-month period. The employee and employer anticipate beginning on July 1, 2022, the employee will not provide any further services, and no further compensation will be paid. **A separation from service has occurred**.

Example 2: Future permanent services are 50% or more of the 36-month average. An employee in a deferred compensation plan will be permanently reducing services to the employer beginning on July 1, 2022. The employee and the employer agree that the employee worked an average of 40 hours per week over the last 36-month period. On July 1, 2022, the employee and employer reasonably anticipate the employee will provide 32 hours of services (i.e., will work four of five days) per week. Because the employee is providing more than 50% of the average level of services for the previous 36-month period, the presumption is that **a separation from service *has not* occurred**.

Example 3: Future permanent services are less than 20% of the 36-month average. An employee in a deferred compensation plan will be permanently reducing services to the employer beginning on July 1, 2022. The employee and the employer agree that the employee worked an average of 40 hours per week for the last 36-month period. On July 1, 2022, the employee and the employer expect the employee will provide 4 hours of services per week. Because the employee is providing less than 20% of the average level of services for the previous 36-month period, **a separation from service *is* presumed**.

Example 4: Future permanent services are less than 50%, but more than 20% of the 36-month average. An employee in a deferred compensation plan will be permanently reducing services to the employer beginning on July 1, 2022. The employee and the employer agree that the employee worked an average of 40 hours per week over the last 36-month period. The plan document used for this deferred compensation plan does not define a level in which a separation from service occurs in this range. On July 1, 2022, the employee and employer expect the employee will provide 16 hours of services per week. Because the employee is providing more than 20% and less than 50% of the average level of services for the previous 36-months, **no presumption is made as to whether a separation from service has occurred.** Instead, the employer will be required to review other factors to determine whether a separation from service has occurred.

Example 5: Future permanent services are reduced to 0% with a continuance of severance pay. An employee in a deferred compensation plan will be permanently reducing services to the employer beginning on July 1, 2022. The employee and the employer agree that the employee worked an average of 40 hours per week over the last 36-month period. The employee and employer anticipate beginning on July 1, 2022, the employee will not provide any further services, but the employee will receive a severance check until February 1, 2023. A **separation from service will have occurred** on July 1, 2022, when there is an intent of ceasing permanent services.

When a company sells or disposes assets to an unrelated buyer, a participant would generally experience a separation from service from the seller, but the buyer and seller can agree in writing prior to the closing date of the asset purchase transaction to not treat the participants as being separated from service. This is known as the same desk rule. For this rule to apply, the parties must engage in bona fide arm's length negotiations, and all service providers providing services to the seller immediately before and the buyer immediately after the asset purchase must be treated consistently.[4] **It is very important to consult your local counsel on how this rule could be implemented upon an asset purchase transaction.**

Dual status: employee and independent contractor

If a participant provides services as both an employee and an independent contractor, the participant must stop providing services under both statuses for a separation from service to occur. Further, if a participant stops providing services as employee and begins providing services as an independent contractor, or vice versa, a separation from service will not occur until they stop providing services in both capacities.[5]

Example 1: Participant changes status without reduction of services provided. A participant provides services as an employee, having worked an average of 40 hours over the previous 36-month period. If the participant continues to work at the same level of service, but is now compensated as an independent contractor, a separation from service has not occurred until services cease as an independent contractor.

Example 2: Participant changes status with reduction in services provided. A participant provides services as an employee, having worked an average of 40 hours over the previous 36-month period. The participant stops providing services as an employee but will remain available to consult for the company one day a month. The participant would be separated from service because they are below the 20% threshold, and the continuation as a consultant in a limited role does not meet the time-based test.

Dual status: employee and member of board of directors

If an employee is providing services as an employee and as a member of the company's Board of Directors, services performed as a director are generally not considered when determining whether the employee has separated from service, unless the participant is participating in an arrangement where the employee and director arrangements are deemed to be the same.[5]

Example 1: Participant stops proving services as an employee but remains as a board member with employee deferrals only. A participant stops providing services as an employee but continues as a board member. The participant deferred into the plan as an employee. The participant would be separated from service for purposes of the plan because they are no longer providing services as an employee.

Example 2: Participant stops working as an employee but remains as a board member and defers W2 income and board fees. A participant stops providing services as an employee but continues as a board member. The participant deferred base salary as an employee and fees as a director. The participant would be separated from service for purposes of the plan for the portion of the plan associated with service as an employee, because they are no longer providing services as an employee. The participant would not be considered separated for services as a board member.

It's very important to consult your local counsel on how these rules could be implemented for a dual status participant.

Impact of a rehire

The determination of whether a separation from service has occurred is made at a specific point in time based on the facts as of that time. If an employee is subsequently rehired, this rehire does not change the initial determination that a separation from service occurred.[2] See the Applied Knowledge article titled "Deferral timing requirements for rehired employees."

Independent contractors

An independent contractor is considered separated from service at the expiration of their contract, so long as there is a good faith understanding that no further services will be performed, and the contract is not going to be renewed. If there is an expectation that services will continue, that a renewal of the contract may occur, or that the contractor will become an employee, then a separation from service has not occurred.[6]

Impact of leave of absence or furlough on separation from service

Employees who are on military leave, sick leave, or any other bona fide[7] leave of absence are not treated as separated from service if the leave does not exceed six months or longer, or if the employee retains a right to reemployment by statute or contract.[8] If the leave of absence exceeds six months and there is not a right to reemployment, termination is deemed to occur on the first day after the six-month period has elapsed.[8]

Employees on furlough have not meet the definition of separation from service as there is an intent to provide services in the future.

Specified employees

A key employee of a public company, also known as a "specified employee", is not permitted to receive a distribution from their nonqualified plan within the six-month period following separation from service, except if an intervening death occurs and the distribution is allowed by the Plan. See the Applied Knowledge article titled "Nonqualified plan distributions to 'specified employees' of public companies."

There may be more scenarios than addressed above. The question of whether a participant has separated from service is fact-specific, and plan sponsors should consult their local counsel for advice.

[1] IRC Sec. 409A(a)(2)
[2] Treas. Regs. §1.409A-1(h)(1)(ii)
[3] T.D. 9321, 72 Fed. Reg. 19234 (April 17, 2007), Sec. VII(C)(2)(d)
[4] Treas. Regs. §1.409A-1(h)(4); see also T.D. 9321, 72 Fed. Reg. 19234 (April 17, 2007), page 19260
[5] Treas. Regs. §1.409A-1(h)(5)
[6] Treas. Regs. §1.409A-1(h)(2)(i)
[7] A leave of absence is a bona fide leave of absence if there is a reasonable expectation the employee will permanently resume services.
[8] Treas. Regs. §1.409A-1(h)(1)(i)

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