

# The How and When of Separations from Service Under Section 409A

by Eric D. Altholz on September 9, 2022

Readers who regularly work with deferred compensation plans will know that Section 409A of the Internal Revenue Code (“Section 409A”) prescribes six events or times at which deferred compensation may be distributed to participants in a deferred compensation arrangement. The first, and perhaps most frequently used, of these permissible payment events is “separation from service.” While a termination of employment with the service recipient generally will be considered a separation from service, the Treasury Regulations under Section 409A explain that an employee or other service provider may be treated as having separated from service even if he or she continues to provide some services. The Treasury Regulations also contain a special rule that deserves careful attention when an employee or other service provider ceases employment with one member of a controlled group of companies but continues to provide services to another member of the controlled group. With this in mind, we offer a brief refresher regarding some of the key factors that determine whether and when a separation from service has occurred for purposes of Section 409A.

## Separation from service: general concepts

In most cases, a complete termination of employment for any reason will be considered a separation from service under Section 409A. But “termination of employment” and “separation from service” are not synonyms, and care should be taken not to use them interchangeably. The Treasury Regulations under Section 409A state that separation from service occurs when the employer and the employee “reasonably anticipate” that the employee will provide no further services or the level of services provided will permanently be reduced to no more than 20% of the services provided during the preceding 36-month period. (If an employee has not completed 36 months of service, the lookback period would cover the employee’s full period of service.) So the intent of the parties, as evidenced by facts and circumstances, is relevant to determining whether and when a separation from service occurs.

The Treasury Regulations recognize that valuable employees often continue to provide some amount of services either during a brief transition period or on an open-ended basis prior to a complete cessation of services. In these cases, and to provide guidance where the intent of the parties may be evolving, the Treasury Regulations under Section 409A establish some helpful guardrails. As noted above, an employee will be presumed to have separated from service if the level of service provided drops to 20% or less by comparison to the preceding 36-month period. So an employee who moves from full time status to part-time status working just one day a week generally will be considered to

have separated from service as of the effective date of the change, unless the employee and the employer clearly document an intention to treat the reduction in service level as temporary with an expectation that full time service will resume. On the other hand, an employee will be presumed not to have separated from service if the employee continues to provide services at a level of 50% or more of his or her prior level of service. The treatment of an individual who moves from full time status to a work schedule that is more than 20% and less than 50% of the prior level of service must be determined based on the facts and circumstances of the case. (Note that the Treasury Regulations provide that a bona fide leave of absence will not be considered a separation from service regardless of the reduction in the employee's work schedule and services performed during the leave. In applying this rule, however, a leave of absence that extends beyond six months will result in a separation from service, regardless of the intent of the parties, unless there is a statutory or contractual right to return to work.)

Not surprisingly, compensated services provided in any capacity will count for purposes of applying these rules. So if a W-2 employee who purports to terminate employment continues to provide services as an independent contractor (either directly or through an intermediary entity), those services will be treated the same as if the individual continued to provide services as an employee.

Importantly, a separation from service does not occur unless the service provider ceases to provide services to all entities that are considered to be related to the service recipient for purposes of Section 409A. Herein lies a trap for the unwary.

#### Special rule for controlled groups

The entities that comprise a single service recipient are determined under the familiar "controlled group" concepts that apply to tax-qualified and other retirement plans. Under the controlled group rules, all members of a controlled group of companies are considered a single employer for nondiscrimination testing and other purposes. The members of a controlled group of for-profit companies are determined by reference to stock ownership. In the case of a parent-subsidary controlled group, the parent company and all subsidiaries in an unbroken chain of ownership in which each company owns at least 80% of the total voting power or total value of all share classes of the subordinate company will be considered members of the group. The controlled group designation is important for several reasons, including determinations of when a participant in a retirement plan is considered to have experienced a "severance from employment" sufficient to trigger a right to receive a distribution of retirement benefits. Specifically, if an employee of company X who participates in the 401(k) plan maintained by its corporate parent ceases employment at company X and transfers to its sister company Y, the employee will not be considered to have experienced a severance from employment and will not have a right to take a distribution from the 401(k) plan.

The same concepts apply in determining whether a participant in a deferred compensation plan has experienced a separation from service, except that the control relationship among the related entities is generally established by ownership of at least 50% of the total combined voting power or total value of all share classes, rather than at least 80%.<sup>1</sup> This lower threshold for establishing control creates the possibility that an employee who transfers employment within a group of related companies may experience a severance from employment sufficient to receive a distribution of benefits from the employer's 401(k) plan but will not be considered to have separated from service sufficiently to support a distribution from a deferred compensation plan maintained by the same company.

## Final thoughts

This post just scratches the surface of the rules governing separations from service under Section 409A. The Treasury Regulations contemplate a variety of special situations not covered here, including situations in which the service provider is an independent contractor or a member of a board of directors. Given the high stakes involved for both service providers and service recipients, parties to deferred compensation arrangements should affirm their intentions regarding the timing and effect of a complete cessation of service or a reduction in the level of services provided by a service provider. If there is any chance that the facts and circumstances in a given case may be ambiguous, the parties should create the documentation necessary to make their intentions clear.

If you have questions about your company's deferred compensation arrangements, please contact any member of Verrill's Employee Benefits & Executive Compensation Group.



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<sup>1</sup> The Treasury Regulations allow a deferred compensation plan to specify a different percentage between 50% and 80%, or as low as 20% if based on "legitimate business criteria."