Employment Severance Releases: Avoiding Spectacular Tax Problems for Related Separation Pay

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It is a common practice for an employer to require a terminating employee to execute a release of claims in exchange for designated separation pay. Compliance with esoteric tax rules governing deferred compensation is typically far from the minds of the decision makers in that process. The Internal Revenue Code, however, has laid a trap for the unwary: § 409A, while aimed at preventing manipulation of deferred compensation arrangements to artificially delay payment of executive income tax liabilities, has unfortunate and complex interactions with the release/severance process.

409A is broadly applicable to compensation arrangements outside of the qualified plan area. There are a number of exceptions to its application, including a broad exemption for "short-term deferrals"- situations where compensation is paid within 2 and a half months after the year in which the services that give rise to the compensation is paid. While actual payment during that period is a helpful fact, the IRS position is that the arrangement must require that result in order for the short-term deferral exception to be applicable to payments in the severance arena. Many practitioners disagree with the position of the IRS here, but picking a fight over the issue is better avoided if at all possible.

The IRS position is predicated upon the concern that to the extent that a severance payment is contingent upon the terminating employee executing a release, or the expiration of a set period the execution sets in motion, such as the ADEA waiver period, the terminating employee could take advantage of that timing to improperly designate the year of payment. By doing so, the employee could thereby impermissibly control the timing of the income tax liability resulting from the payment. While in the real world, concern about terminating employees manipulating the timing of income tax liabilities seems far-fetched, in IRS-world this concern is real, which creates issues for employers in this context.

There are several alternatives for employers in structuring compliant separation agreements that provide for both the releases and severance payments. The key point is to provide in the severance agreement that the payment will be made on a specified date, or within a period chosen by the employer, rather than at a time controlled by the employee, such as upon his or her execution of the severance agreement (or a certain number of days thereafter).

The referenced approach is fine for agreements now being negotiated or that arise in the future by employers aware of the issue. What about existing agreements that provide for the payment to be made upon the terminated employee's execution of the severance agreement, or the expiration of the ADEA waiver period thereafter? In that case, the IRS has published certain specific procedures in Notices 2010-6 and 2010-80 for resolving non-compliant arrangements without causing a tax disaster for the severing employee. Utilization of those techniques, while burdensome, should eliminate the 20% penalty applicable generally to 409A failures in favor of acceleration of recognition of the relevant income tax applicable to the severance payment in an earlier taxable year.

The adoption of section 409A by Congress has led to many unintended consequences and complexities. The release issue, while adding one more hoop for employers to jump through, can be relatively easily complied with by employers and advisers who are aware of the potential pitfalls of a non-compliant arrangement.

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