

New Rules – Taxation of Separation Pay Under Employment Agreements

The Problem

In order to retain and reward executives, employment agreements often provide for separation pay on an involuntary termination. Until recently, no special income tax rules applied to these arrangements. Income tax was generally payable when the separation pay was actually or constructively received. Recently proposed regulations to new Internal Revenue Code § 409A, however, treat some separation pay arrangements as “non-qualified deferred compensation” and subject them to significant restrictions on elections, forms of payment and timing of distributions. If a separation pay arrangement violates 409A, the penalties on the executive are severe. Income tax on the separation payments is accelerated and, in addition, a 20% excise tax is imposed on the total amount included in income, as well as an interest penalty.

The Solution

In reviewing a current employment agreement or preparing a new one, there are three ways to avoid the penalties for non-compliance with §409A.

1. Design the separation pay arrangement to fall within an exemption to §409A, such as:
 - Short Term Deferral – the separation payment(s) occur within the same taxable year as involuntary termination or within 2 ½ months thereafter.
 - Safe Harbor – the entire amount of separation payment(s) does not exceed two times the employee’s annual compensation or, if less, two times the amount that may be taken into account under tax-qualified plans (\$210,000 for 2005) and all payments are made within two calendar years. *Take Note:* Cannot be used for a “Good Reason” termination.
 - Reimbursable and Other Expenses – Exempt expenses are those that are either excludable from gross income, business deductible, reasonable outplacement, moving, or medical expenses, or do not exceed \$5,000 in the aggregate.
2. Terminate the separation pay arrangement in 2005.
3. Administer the separation pay arrangement in compliance with a good faith interpretation of §409A and amend the arrangement to comply in form no later than December 31, 2006. *Take Note:* Among the various compliance requirements of §409A is the rule that separation pay payments for “key” employees, as defined in the Internal Revenue Code, must be delayed at least six months following the employee’s separation from service.

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