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Taxation of Separation Pay Under Employment Agreements - Part II Termination for "Good Reason" or Resignation

The Problem

To protect executives against arbitrary conduct, employment agreements often provide for separation pay on a termination by the executive for "good reason" or upon a resignation by mutual agreement. This protection has been diminished by §409A of the Internal Revenue Code, which treats such separation pay as deferred compensation, without exceptions, and imposes significant restrictions on benefit distributions, among other things. For example, under one of §409A's distribution rules, separation payments to "specified employees" (generally the top 50 officers who make more than $130,000 in a year) of a company whose stock is publicly traded must be delayed at least six months following separation from service. The penalties for non-compliance with §409A are severe and are borne by the executive.

What alternatives are available to provide immediate continuing income to an executive after a resignation by mutual agreement or a "good reason" termination?

The Solution

1. Executives who are offered the opportunity to resign in lieu of being terminated by the company – a resignation by mutual agreement -- may decide against this, despite the perceived personal embarrassment. Unlike separation pay on a resignation, separation pay on an involuntary termination is exempt from §409A if i) absent an election to otherwise defer the payment to a later period, the separation payment is payable and received within the same taxable year as the termination or within 2 1/2 months thereafter, or ii) the separation payment does not exceed two times the lesser of the executive's annual compensation or the maximum amount that can be taken into account under qualified plans ($220,000 in 2006), and is fully paid by December 31 of the second calendar year following the calendar year of termination. *Caveat*: To the extent the separation pay acts as a substitute for, or a replacement of, amounts that would otherwise be subject to §409A, these exemptions will not apply.

2. Executives may rely less on separation pay for downside protection and demand more in incentive bonus arrangements payable without deferral, or leave part of their separation pay subject to the company's "unfettered" discretion, and thus not subject to §409A *Caveat*: If the company's negative discretion lacks "substantive significance", or the person granted the discretion is controlled by, or related to, the executive, the discretion will be ignored, and the right will be legally binding, thus subject to §409A.

3. The separation pay arrangement may provide that the aggregate amount of the first seven months of installments be paid at the beginning of the seventh month. *Caveat*: Beginning January 1, 2007, such an amendment to a current separation pay arrangement may not be made effective for at least 12 months.

4. Some companies may choose to "gross-up" the executive for the income taxes and penalties incurred. *Caveat:* This may conflict with good corporate governance principles.