INCOME TAX CONCERNS IN CONNECTION WITH SEVERANCE-RELATED RELEASE AGREEMENTS

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It is a common practice for the payment of a severance benefit to be conditioned upon the severed individual's execution of an agreement containing a release of claims against the ex-employer. Where such arrangement does not contain a compliant payment date or period (as described below), the ex-employee may be able to control the timing of the severance payment – and, in particular, the tax year in which the payment is made – based upon when he or she returns the executed release agreement, thereby raising the tax concern.

As discussed in a number of prior Client Alerts, Internal Revenue Code Section 409A provides certain permissible triggers (i.e., separation from service, disability, death, at a specified time or per a fixed payment schedule, certain changes of corporate ownership, certain unforeseeable emergencies) for the payment of "deferred compensation" subject to Section 409A, which may include severance payments. Section 409A generally permits the scheduling of such payments on the trigger date or within a period of not more than 90 days following its occurrence, provided that, if the post-trigger period spans two different tax years of the individual (e.g., separation from service occurs on November 15 and the agreement calls for the payment being made within 90 days thereof), solely the ex-employer (not the ex-employee) may determine whether to make the payment in the earlier or later tax year.

Pursuant to Section 409A and IRS regulatory guidance, various approaches exist for drafting employment/release agreements in compliance with the Section 409A requirements applicable to the timing of severance payment(s). One simple approach would be to provide that the severance benefit will be paid/commence within a time period that is less than or equal to 90 days from the date of termination of employment (e.g., 60, 75 or 90 days, keeping the ADEA periods in mind), provided that the executive first executes the release, and provided further, that should the applicable time period (e.g., 60, 75 or 90 days) cross over into a new tax year of the executive, the payment will be made/commence in the new tax year.

Loeb & Loeb's Employment and Tax attorneys can offer (typically, individually fact-driven) solutions intended to both permit a sensible commercial result as well as one which is Section 409A compliant, both for new and existing arrangements and agreements. In particular, in regard to existing agreements that are not currently Section 409A compliant because they condition severance payments on the execution of a release agreement without specifying a compliant payment date, Section 409A and IRS regulatory guidance provide means of curing the defect. Existing employment or other compensation agreements should be reviewed promptly for this issue. If any of the above concerns are applicable, we recommend that you call your regular Loeb contact as soon as possible for assistance.

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rules governing tax practice, we inform you that any advice contained herein (including any attachments) (1) was not written and is not intended to be used, and cannot be used, for the purpose of avoiding any federal tax penalty that may be imposed on the taxpayer; and (2) may not be used in connection with promoting, marketing or recommending to another person any transaction or matter addressed herein.