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Severance Agreements – Three Tax Traps for the Unwary

Article By:

Severance agreements – especially severance agreements for terminating executives – are ripe with potential tax planning challenges and opportunities. Before you draft your next agreement, beware of the following three traps:

Trap 1: Giving the Employee the Choice Between a Lump Sum Payment and Monthly Installments

In an effort to give employees a choice and more flexibility in their financial planning, some employers give employees the choice between a lump sum severance payment and monthly installments. While this approach seems reasonable, this design raises two potential issues:

- *Constructive Receipt:* If an employer gives an employee the choice between a lump sum payment and a payment of the same value (e.g., one year of compensation) in installments over the course of a period that spans two or more calendar years, then this creates a constructive receipt rule. Simply stated, the IRS will treat the entire payment as having been made in the year that the lump sum payment would have been made and the employer must report the value of the severance on the W-2 for that year, even if the employee elects the installments.
- *Potential 409A Issues:* If the employee had a pre-existing employment or severance agreement that provided a right to the severance benefits in one form, but the form and timing of those payments changes as a result of this election, then this creates an issue under Internal Revenue Code Section 409A (“Section 409A”) unless an exemption applies. Determining whether Section 409A applies to a particular payment is a highly technical and fact specific analysis, so we recommend that you consult your favorite employee benefits/executive compensation lawyer if you have any questions. As a reminder, if Section 409A applies and an issue exists, then the full value of the benefit will be immediately taxable and the employee will be subject to an additional 20% income tax.

Trap 2: Employer-Paid COBRA Benefits

Employers may elect to supplement the cost of COBRA continuation coverage for certain terminating employees. For example, it is fairly typical for employers to provide that the terminating employee will only be responsible for paying the “active employee” rate for all or part of the standard 18-month COBRA period, rather than the 102% COBRA rate. While this seems reasonable, it creates two potential tax issues:

- *Discriminatory Health Coverage:* If the employee receiving this benefit is a “highly compensated individual” and the same benefit is not offered to non-highly compensated individuals, then this creates a discrimination issue. The consequences of this issue depend on the funding status of the health plan. If the plan is fully-insured, then there are currently no tax consequences (until/unless the new regulations go into effect under the Affordable Care Act which would impose a $100/day excise tax on the employer). If the plan is self-insured, then the value of the benefit (generally, the value of the employer-paid portion of the COBRA premiums) is taxable to the employee as W-2 income.

- *Tax Status Depends on Structure:* If the employer pays the insurance company directly (or directly offsets the cost of self-insured COBRA) or requires the employee to submit proof in order to receive reimbursement or payment for the benefit, then the benefit will not be taxable to the employee (except as explained above). If, however, the employer pays the employee an up-front lump sum payment, with the understanding that the money will be used to pay for the COBRA benefit (but with no repayment obligation if the employee uses it for something else), then this will be taxable to the employee as W-2 compensation.

Trap 3: Timing of a Release

If the severance pay is not exempt from Section 409A (as a short-term deferral or involuntary separation pay) and (1) the employee is required to sign a release as a condition to payment *and* (2) the timing of when the employee signs the release will impact the calendar year in which some or all of the severance is paid, then this will create a problem under Section 409A. For example, if the first of 36 installment payments is made as soon as the employee’s release of claims becomes irrevocable, then there is a Section 409A error which will result in immediate taxation of the full value of the severance benefit and an additional 20% income tax on the employee.

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