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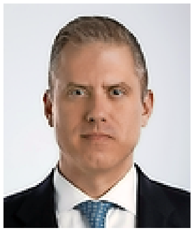
The Long Goodbye: Tax Issues for Executives Transitioning Into Retirement

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It is becoming more and more rare for executives to simply "retire." Rather, companies often structure a longer process to help transition matters and encourage the executive's participation in an orderly manner. (Not-so-hidden secret: law firms deal with this issue too!) This article identifies many of the tax issues companies face when establishing that transition plan.

We discuss below the implications of worker classification, deferred compensation, employee benefits, fringe benefit, and payroll tax issues. Although the issues are discussed separately, it's important to remember how the separate issues below interact with each other. For example, worker classification will have both employee benefits and employment tax implications.

WORKER CLASSIFICATION: EMPLOYEE VS. INDEPENDENT CONTRACTOR

Do the executive and management plan on having the executive remain as a company employee or establishing a "consulting" arrangement? The executive and company management may have negotiated a particular arrangement, but it is up to the tax department to make sure the arrangement makes sense and that the facts support the company's filing positions.

Whether a worker is properly classified for tax purposes as an employee or an independent contractor is dependent on all of the facts and circumstances. [1] Treasury regulations provide the following general statement:

[1] Reg. §31.3121(d)-1 (FICA taxes), Reg. §31.3306(i)-1 (FUTA taxes), Reg. §31.3401(c)-1 (income tax withholding). All section references are to the Internal Revenue Code of 1986, as amended (the "Code"), and the Treasury regulations promulgated thereunder, unless otherwise noted.

> [g]enerally, the relationship of employer and employee exists when the person for whom the services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which the result is accomplished. [2]

[2] Reg. *§31.3401-1(c)*.

A 1987 Revenue Ruling sets forth a 20-factor test to determine whether sufficient control is present to establish an employer-employee relationship under common-law principles. [3] Updated training materials (from 1996) break down evidence of control into the following three categories:

• Behavioral control is indicated by instructions from the employer regarding: when and where to do the work; what tools or equipment to use; which workers to hire or to assist with the work; where to purchase supplies and services; whether work must be performed by a specified individual; or what order or sequence to follow.

• Financial control is indicated by the extent to which the worker has unreimbursed expenses; the extent of the worker's investment; the extent to which the worker makes his or her services available to other clients; how the business pays the worker; and the extent to which the worker can realize a profit or loss.

• Relationship of the parties: how the parties have described the relationship in written agreements; whether the business provides benefits typically provided to employees, such as vacation, sick pay, insurance, or retirement; the permanency of the relationship; and whether the services are key to the regular business of the company. [4]

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[3] Rev. Rul. 87-41, 1987-1 C.B. 296.

[4] “Independent Contractor or Employee? Training Materials,” IRS Training 3320-102 (Rev. 10-96), TPDS 84238I, which were incorporated, in part, into IRM 4.23.5; see, e.g., CCA 199948001 (Dec. 3, 1999) (using the three categories rather than the 20-factor test); PLR 201311002 (Mar. 15, 2013) (confirming continuing validity of the Training Materials); TAM 201014051 (Apr. 9, 2010).

With respect to those situations where an executive switches from an employee to an independent contractor, the analysis of the “relationship of the parties” can touch on a number of factors such as whether the relationship switched without a break in service (demonstrating that the relationship did not change) or if there was a period of time during which the worker did not perform any services (reflecting a new relationship). [5] In addition, if a senior executive switches from an employee to an independent contractor, the company could help its position if it could show that the now-independent contractor is treated similarly to other independent contractors.

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[5] SeeRev. Rul. 87-41; PLR 9345002 (finding no employment relationship where employee had 11-month break).

The difficulty arises when an executive wants to retire but does not want to radically change the relationship with the company. For example, the executive may want to retain the services of the administrative assistant when, in fact, no other outside vendor is provided with such assistance. The executive may also insist on attending department meetings or to be included in strategic planning, actions that are typically inconsistent with those of an independent contractor. In addition, while outside vendors are often provided hoteling office space (cubicles, etc.), they are often not provided a furnished office. Of course, neither a furnished office nor administrative assistance would be fatal to independent contractor status — but executive perquisites can undermine a company's position that a former employee is now an independent contractor.

EMPLOYMENT TAX RISKS OF RECLASSIFICATION

Under standard assessment rules, if the IRS were to successfully reclassify a former executive as an employee, the employment tax consequences [6] for the employer could include: [7] (i) employer liability for underwithheld income taxes (§3403); [8] (ii) employer liability for underwithheld employee FICA taxes (§3101 and §3102(b)); [9] (iii) employer liability for employer FICA taxes (§3111); [10] (iv) employer liability for underwithheld additional Medicare tax; [11] (v) a penalty for the employer share of OASDI (Old Age, Survivors and Disability Insurance) equal to 10% of the required withholding; [12] and (vi) a penalty for the employer share of Medicare tax and additional Medicare tax equal to 10% of the required withholding. [13]

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[6] In addition to employment tax risks, the employer could also face additional liability under its employee benefit plans if such plans did not specifically exclude employees classified by the employer as independent contractors.

[7] The listed items are intended to summarize only the more significant and likely penalties and liabilities relating to withholding. An employer's liability could be reduced under various programs, such as the Classification Settlement Program, or statutory relief provisions, including §3509. The summary above describes an assessment absent any such relief.

[8] The employer would be entitled to abatement for any federal income taxes paid by the executive that can be demonstrated to the IRS through the executive's signing of a Form 4669.

[9] FICA taxes include 7.65% of unreported income up to OASDI base (e.g., $132,900 in 2019) and 1.45% on excess. This is also a “secondary liability” tax, because the taxes are primarily the employee's liability. Reg. §31.6205-1(b)(3).

[10] Employer portion includes 7.65% of unreported income up to OASDI base and 1.45% on excess.

[11] Equal to 0.9% on compensation over $200,000. Reg. §31.3102-4. The employer would be entitled to abatement for any additional

Medicare taxes paid by the executive that can be demonstrated to the IRS through the executive's signing of a Form 4669.

[12] §6656. This failure-to-deposit penalty does not apply where taxes were not withheld (e.g., where income is not reported or where no withholding was collected). SeeRev. Rul. 75-191.

[13] §6656.

EMPLOYEE BENEFITS: WHEN DOES THE EXECUTIVE RETIRE?

Sometimes the simplest questions are the hardest. As described below, whether the executive remains an employee or becomes an independent contractor is not always the deciding factor when determining when the executive is "retired" for employee benefit purposes. A company's best approach to properly timing benefit plan payments triggered by "retirement" is to understand — and document — the scope of the future relationship.

Nonqualified Retirement Plans. If the executive participated in any nonqualified deferred compensation plans after 2004, the company will need to monitor when payment is triggered. Nonqualified benefits accrued after 2004 are governed by §409A and can be paid only upon certain payment events elected by the executive or described in the plan documents. Many of these plans provide for payment following the employee's "separation from service" under §409A. Failure to comply with §409A can result in punitive additional taxes. [14] Thus, establishing when the executive incurs a "separation from service" under §409A is often critical when the executive transitions into retirement.

[14] Under §409A(a)(1)(A)(i), the deferred compensation is immediately includible in income, and, in addition to the standard federal income taxes, §409A(a)(1)(B) imposes an additional 20% tax and a premium interest tax.

An employee "separates from service" with the employer when the employee dies, retires, or otherwise has a termination of employment with the employer based on all the facts and circumstances. [15] The regulations provide a series of presumptions regarding when an individual has incurred a "separation from service" based on the level of services performed. [16] An employee is generally considered to have had a termination of employment on the date after which the employer and employee both reasonably anticipate that the employee would perform no further services, or that the level of bona fide services would decrease to no more than 20% of the average level of bona fide services performed (whether as an employee or as an independent contractor) over the immediately preceding 36-month period. [17] In contrast, if the level of bona fide services is 50% or more of the level previously performed during the 36-month period, the individual is presumed to have not incurred a separation from service. An individual whose level of services falls below 50%, but above 20%, is not subject to any presumption.

[15] Reg. §1.409A-1(h)(1)(i). The relevant facts and circumstances include whether the employee continues to be treated as an employee for other purposes (such as under employee benefit plans), the treatment of other similarly situated employees, and whether the employee is permitted and realistically available to perform services for another service recipient in the same line of business.

[16] Reg. §1.409A-1(h)(i).

[17] Id. The regulations provide that, if certain requirements are met, a plan can designate the level of services (between 20% and 50%) at which a separation from service is deemed to occur.

These presumptions highlight the need for the parties to document their expectations regarding any future consulting or employment relationship. Because the regulations focus on the anticipated level of services, an individual will not incur a separation from service merely by switching from employee to independent contractor status. Although the presumptions noted above are rebuttable — when the parties want the executive to be treated as having a separation from service — it is desirable to ensure an individual's level of bona fide services falls below the 20% threshold to avoid a potential dispute with the IRS. It is unclear how long the level of services must fall below 20% to support the favorable presumption that the employer and employee reasonably anticipated a future level of services below 20%. The regulations are also unclear regarding the period over which services are measured for purposes of determining the presumptions listed above.

It is also worth noting that having the executive incur a prolonged paid leave of absence ("garden leave") but remain an "employee" of the company is not sufficient to delay the executive from incurring a "separation from service." Because the §409A standard focuses on the level of services actually rendered, mere continuation of the employment relationship without actual services will not delay the separation-from-service event for §409A purposes.

Section 401(k) and Pension Plans

Establishing when an executive retires or terminates employment is also often critical for determining whether the employee could elect — or must take — payment under the company's §401(k) and pension plans. For example, an executive may want to be treated as "retiring" to start receiving monthly pension benefits or to lock in the lump sum value (i.e., by taking a full lump sum distribution from the plan). [18] Thus, the company could be asked whether the new arrangement would prevent the executive from receiving a distribution. The tax rules surrounding distributions under 401(k) plans are generally far more liberal. [19] As a result, whether someone has "retired" is often a more pressing issue with respect to pension plans.

[18] Although IRS regulations provide some flexibility regarding "phased retirement," many pension plans still require termination of employment for payments to commence. See Prop. Reg. §1.401(a)-3 regarding rules permitting in-service distributions under a "phased retirement" program.

[19] The regulations provide greater flexibility for profit-sharing plans. For instance, Reg. §1.401-1(b)(1)(ii) generally provides that a profit-sharing plan may provide for distribution upon a "stated age," or severance of employment. Thus, many §401(k) or profit-sharing plans permit in-service distributions upon attainment of age 59½. (See also §72(t) regarding the additional taxes that may apply to in-service distributions prior to attaining age 59½.)

Conversely, an executive who is phasing into retirement may want to delay when "retirement" occurs to further delay receiving minimum required distributions. [20] Federal law generally requires tax-qualified plans to begin minimum payments to participants no later than April 1 of the year following the date the participant reaches age 70½ or, if later, the date the participant "retires." [21] These distributions are called "required minimum distributions" ("RMDs") and are intended to force money out of a tax-qualified retirement plan during the participant's life.

[20] This is especially true if the executive would receive actuarial increases to the retirement benefit when the executive continues to work after normal retirement age.

[21] See§401(a)(9). While the regulations permit a plan to require payment following 70½, regardless of retirement, most plans provide for the "later of" approach.

Whether for purposes of starting payment or for triggering required minimum distributions, the tax rules surrounding tax-qualified plans do not specify when someone "retires" or incurs a "separation from service," or severance from employment. Separate IRS regulations provide that payments can begin only "after retirement" or after a participant incurs a "separation from service"; other provisions applicable to tax-qualified plans utilize the term "severance from employment." [22] Case law is generally vague, providing that "retirement" occurs when an employee actually leaves employment or concludes one's career. [23] A number of cases generally define "retirement" or "separation from service" as when an employee "actually leave[s] employment upon retirement," which occurs when one concludes one's working or professional career. [24] Another case, *Ridenour v. United States*, [25] describes retirement as occurring when an employee discontinues providing services for his employer.

[22] The IRS uses the terms "retirement," "separated from employment," "retires from employment," "separates from service," and "severance from employment" in various regulations related to employee benefit plans. See, e.g., Reg. §1.401(a)-1(b)(1)(i) (requiring that pension plans provide benefits to employees only "after retirement," with an exception for certain participants age 62 and over, even if they have not yet "separated from employment"); Reg. §1.401(a)(9)-2, Q&A-2 (using the term "retires from employment" in establishing required distribution start date); Reg. §1.409A-1(h)(1)(i) (describing when an employee "separates from service"); Reg. §1.411(d)-3(a) (describing a participant's protected accrued benefit in relation to his or her "severance from employment"); see also§402(c)(3)(C)(ii), §402(e)(4)(D) (using an employee's "severance from employment" to establish a qualified plan loan offset amount and an employee's "separation from service" to trigger a lump-sum distribution). The IRS appears to view these terms as having similar meanings, and the slight distinctions between the terms are not significant for our purposes.

[23] *See, e.g., Meredith v. Allsteel, Inc.*, 11 F.3d 1354, 1357-58 (7th Cir.1993) (interpreting the term "retire" under the plan document and ERISA).

[24] Id.

[25] 3 Cl. Ct. 128, 137-38 (1983) (interpreting the term "separation from service" as it relates to a lump-sum distribution upon an employee's promotion to partner at an accounting firm).

For executives who terminate employment and become an independent contractor, the fundamental question is whether the new classification is supportable based on the same worker classification factors and principles described above. In *Reinhardt v. Commissioner*, [26] a tax-qualified plan participant terminated employment and almost immediately thereafter began performing services in the same role as an independent contractor. The Tax Court held that the participant's characterization of his change from employee to independent contractor lacked substance and was a mere "technical change" insufficient to qualify as a separation from service triggering a distribution. [27] IRS guidance addressing whether a separation from service occurred where a worker ended employee status and became an independent contractor also focused on the traditional worker classification factors. [28]

[26] 85 T.C. 511, 525 (1985).

[27] Id. at 520, 525.

[28] SeeRev. Rul. 69-647 (stating that whether the employment relationship ended depended on common law concepts); PLR 8931054 (May 10, 1989) (citing the 20-factor test in Rev. Rul. 87-41 in determining whether the employment relationship ended).

The rules are even murkier in situations where the executive will remain an employee but with significantly reduced hours. As a general matter, there are no rules that would trigger a separation from service for tax-qualified plan purposes upon a reduction in anticipated hours — even a significant reduction — as long as the employee is expected to continue providing services. In this regard, the rules regarding when someone is treated as retiring or incurring a "separation from service" for tax-qualified plan purposes are different than the rules under §409A for nonqualified deferred compensation purposes. For instance, there is — as of now — no presumption in the rules regarding tax-qualified plans that the reduction of anticipated hours below 20% of the employee's historic level would trigger a separation from service.

While the §409A regulations do not apply to tax-qualified plans, it appears the IRS will look to many of the concepts within those regulations for purposes of determining when a separation from service or retirement has occurred. In a 2011 private letter ruling, the IRS addressed a situation where employees terminated employment with the explicit understanding between them and the employer that they will be rehired shortly thereafter. [29] The IRS reviewed, among other guidance, Reg. §1.409A-1(h)(1) and the requirement that, for a "separation from service" to occur under §409A, the employer and employee must reasonably anticipate that no further services would be performed or that the level of services would decrease as described above. The IRS found that, based on the expectation of subsequent rehire and future services, such employees would not be legitimately "retired" and will not incur a separation from service for purposes of the tax-qualified pension plan. The key takeaway from the PLR is that plan sponsors can point to the §409A regulations' reference to the intent of the parties when determining whether an employee has incurred a separation from service for tax-qualified plan purposes.

[29] SeePLR 201147038.

Welfare Plan Issues

The terms of the applicable health and welfare documents should describe whether a transitioning executive remains eligible for the company's medical plan for the active employee group or will become eligible under any retirement medical arrangement, or if the anticipated transition will trigger COBRA under the active plan. For example, the applicable health plan language generally excludes employees categorized as "independent contractors" and may also have language excluding part-time employees. [30] If no longer covered under the active employee plans, the executive should generally be eligible for COBRA. The existing terms of the company's health plan and the requirements imposed by carriers in fully insured plans will often drive the terms of the executive's new arrangement (i.e., independent contractor vs. employee, full-time vs. part-time, etc.). Employers should also carefully assess full-time status for purposes of the Affordable Care Act (ACA) employer mandate.

[30] See IRS Notice 2014-49, *2014-41 I.R.B. 665* (explaining the look-back measurement method); IRS Notice 2012-59, *2012-41 I.R.B. 443* (stating that the ACA does not require coverage of part-time employees).

There are tax traps for the unwary, though. Section 105(h) generally prohibits discrimination in self-insured plans in favor of highly compensated individuals compared to the lower paid workforce. Although the ACA extended similar nondiscrimination rules to certain fully insured plans, the IRS has announced a non-enforcement policy with respect to fully insured plan compliance. [31] These nondiscrimination concerns often arise when companies want to transition an executive into retirement (voluntary or not) without disruption to the executive's health care under the active employee plan. If an arrangement provided to an executive is found discriminatory under §105(h), the value of the actual benefits provided are taxable to the executive. Thus, for example, the company would want to avoid offering an executive the ability to remain on the active plan during a period in which minimal or no services are expected (such as during a garden leave) and only after such period will the executive incur a need for COBRA. Unless lower paid employees are also offered this extended period, such an arrangement could run afoul of the nondiscrimination requirements.

[31] 42 U.S.C. §300gg-16; IRS Notice 2011-1, *2011-2 I.R.B. 259*.

STATE INCOME TAX WITHHOLDING CONSIDERATIONS

It is not uncommon for executives, particularly those who had previously lived and worked in a high-tax jurisdiction such as California or New York, to retire to a state with a lower tax rate or no state income tax. [32] Upon retirement or semi-retirement, the executive is excited to fill out a new state Form W-4 for his or her new state of residence. This can create a myriad of issues for the employer's tax and payroll departments both for future compensation, if the executive is expected to continue to perform services, and for trailing/deferred compensation.

[32] For example, Florida or Texas.

State Income Tax Withholding for Current Services

States with an income tax universally tax the worldwide wage income of state residents (with a tax credit for state income taxes paid to states for services outside of the residency state) and the wages of nonresidents for services “earned” within the state. Therefore, if an executive retires and moves to a non-tax jurisdiction, such as Florida, and continues to perform part-time services for the former employer, the wages for services physically performed in New York will, generally, not be subject to current state income taxes. Unfortunately, New York's “telecommuter” rule complicates the analysis for New York employers. [33]

[33] Similar rules exist in New Jersey, Delaware, and Nebraska.

In TSB-M-06 (May 15, 2006), the New York State Department of Taxation explained its “convenience of the employer” test that is applied to the taxation of nonresident employees. Under that test, if the employee is assigned to an established work location in New York for a New York employer, days worked from the employee's home outside of New York will still be considered New York services. The employee can rebut this presumption only if there is a bona fide business reason for performing the services outside of New York (e.g., duties require that the employee meet clients near his or her home; the employer does not provide the employee with office space; or the employer requires the home office as a condition of employment). Applying this test to the example above, if the Florida retiree works for a New York employer, travels to New York frequently for business, but still performs the bulk of his or her services from his home office in Florida, New York may take the position that 100% of the part-time wages paid to the retiree are subject to New York state income taxation and withholding. As you can imagine, the Florida retiree will not be pleased with this outcome. [34]

[34] As of the writing of this article, the legality of New York's “telecommuting” rule has not been challenged in court.

Taxation of Trailing/Deferred Compensation

As noted above, states with an income tax typically tax nonresidents for wages “earned” within the state. Although the determination varies from state to state, most states take the position that income is “earned” from services performed within a state even if the employee is no longer working or residing within the state at the time the compensation is paid. As a result, employers must determine whether deferred compensation paid to a retiree who moves to another state was “earned” in the prior work state.

Since 1996, Title 4 U.S.C. §114 has prohibited any state from imposing an income tax on the “retirement income” of an individual who is not a resident or domiciliary of such state with respect to payments made after December 31, 1995. The law contains a special definition of “retirement income” that protects many types of income traditionally paid to retirees. This definition extends to some types of termination payments made to executives who leave service before retirement and move out of state or who are residents of one state and work in another state. Specifically, the types of protected payments include:

1. Distributions from Qualified Retirement Plans. The most commonly received type of income protected under the federal law from state source taxation is income attributed to distributions from qualified retirement plans (including pension, profit-sharing, §401(k) plans and ESOP Plans). The federal law also protects distributions from individual retirement accounts (IRAs), §403(a) and §403(b) annuities, simplified employee pensions (SEPs), and §457 and government deferred compensation plans.

2. Nonqualified Deferred Compensation. Nonqualified deferred compensation arrangements are also protected by the federal law, depending upon the type of plan and the benefit distribution schedule. First, all distributions under “excess benefit” (i.e., SERPs), “mirror,” or “wraparound” plans are protected, provided that such plans, programs, or arrangements constitute “nonqualified deferred compensation” (as defined in §3121(v)(2)), and are maintained solely for the purpose of providing retirement benefits in excess of the various limitations placed on qualified retirement plans (such as the §415 li mit on maximum benefits and the annual contribution limits under §401(k) plans). Distributions under any other type of “nonqualified deferred compensation plan” as defined in §3121(v)(2), such as employee deferrals of salary or bonus to be paid after termination of employment, are also protected from state source taxation, provided that the payments are made in a series of “substantially equal periodic payments” (in at least annual installments) over a period of at least 10 years or for the recipient's life or life expectancy (or the joint life or life expectancy of the employee and his other beneficiary).

The “10-year payout” rule was designed to allow a state to apply its own source taxes to nonresidents (whether or not it currently taxes such payments) with respect to deferred compensation in the form of stock options, stock appreciation rights

(SARs), deferred bonuses, vacation pay, and severance pay, as these benefits are typically paid out over a period of less than 10 years. Unfortunately for company tax and payroll departments, the state sourcing rules for stock options and other forms of deferred compensation vary dramatically from state to state. [35]

[35] Thomas Cryan Jr. and Garrett Fenton, Herding Cats: The Muddled State of State Income Tax Withholding for Income Earned by Nonresidents From the Exercise of Stock Options, 58 Pension & Benefits Daily (Mar. 30, 2009).

TAX TREATMENT OF EXECUTIVE RETIREMENT PERKS

Once an Employee Always an Employee

Taxable awards paid to a retiring employee in recognition of his or her prior services as an employee will generally be treated as wages. Section 3121(a) and §3306(b) define the term "wages" for FICA and FUTA purposes, respectively, as all remuneration for employment, with certain limited exceptions. Section 3401(a), relating to federal income tax withholding, contains a similar definition. Reg. §31.3121(a)-1(b), Reg. §31.3306(b)-1(b), and Reg. §31.3401(a)-1(a)(1) provide that the term "wages" means all remuneration for employment unless specifically excepted. Reg. §31.3121(a)-1(i), Reg. §31.3306(b)-1(i), and Reg. §31.3401(a)-1(a)(5) further provide that remuneration for employment, unless specifically excepted, constitutes wages, even though at the time the remuneration is paid the individual is no longer an employee. Similarly, Reg. §1.1402(a)-1(c) provides that gross income from self-employment retains that character even if it is paid in a later taxable year when the individual is no longer performing services. [36] Accordingly, any taxable payments made to a former employee in recognition of prior services as an employee must be treated as wages, subject to withholding and reported on a Form W-2, even though the payment is made at a time when the individual is no longer performing services as an employee.

[36] See *PLR 200244004* (June 19, 2002) (settlement payment to former employee taxable as wages); PLR 9734035 (May 22, 1997) (severance payments to former employees taxable as wages); *PLR 9718001* (Dec. 10, 1996) (referral fees paid to retired employee were earned while retiree was employee and therefore were taxable as wages); PLR 8519058 (Feb. 13, 1985) (options exercised by former employees taxable as wages); PLR 8440019 (June 28, 1984) (options exercised by former employees taxable as wages).

Tax Treatment of Outplacement Benefits

IRS rules are generally very favorable for post-retirement or post-severance educational or outplacement benefits. In Rev. Rul. 96-41, [37] the IRS concluded that persons who terminate service voluntarily can be treated as "retired," under Reg. §1.127-2(h)(1)(i) for purposes of receiving nontaxable educational benefits under §127. Of course, to qualify as nontaxable, the educational benefits would have to be pursuant to a written plan and satisfy the other requirements of §127 (e.g., the plan cannot provide post-retirement educational benefits solely to highly compensated employees). [38]

[37] 1996-2 C.B. 8.

[38] See also Situation (1) of Rev. Rul. 96-41, which posits that educational assistance benefits are provided to former employees who terminate employment voluntarily, as a result of disability, and as a result of layoffs or other involuntary job termination. The IRS concluded that employees can receive tax-exempt benefits in all three types of job termination (voluntary termination, disability terminations, and layoffs), as a result of regulations that cover former employees who are "retired, disabled, or laid off." See also *PLR 86470748* (Aug. 27, 1986), which permitted any former employee to be treated as a "retiree" for purposes of receiving tax-exempt educational assistance benefits.

It is also possible for some forms of education provided to laid-off employees to qualify for the exclusion available for "outplacement services." In Rev. Rul. 92-69, [39] the IRS concluded that outplacement services provided to terminated employees could be excluded as a working condition fringe benefit under §132(d) because the employer derives a benefit that is distinct from the benefit of just providing additional severance (e.g., decrease in the likelihood of employee wrongful termination suits).

[39] 1992-2 C.B. 51.

It is not unusual for retiring executives — particularly those who will continue to perform part-time services for the former employer — to request dedicated office space, secretarial support, or even continued use of the corporate jet. The tax treatment of these perks will depend primarily on whether there is a bona fide business reason for providing the benefit. For example, if the office space and secretarial support is necessary to assist the retired executive in providing continued services for the company, these benefits could be provided as a nontaxable working condition fringe benefit. However, if the executive is using the office and secretarial support for personal reasons or for reasons that do not relate to the company's business, these benefits must be treated as a taxable perk. [40] Similarly, the tax treatment of the executive's continued use of the corporate plane must be reviewed on a flight-by-flight basis. Any flights that are not for bona fide company-related business reasons must be valued under the SIFL rules and treated as taxable wage. [41]

[40] De minimis personal use of the office/secretarial support could be excluded as a de minimis fringe benefit under §132(e).

[41] Reg. §1.61-21(g).

The 'Gold Watch' Exception

It is very common for companies to give a departing executive a retirement gift in recognition of the executive's years of service. Unfortunately, employers are statutorily prohibited from excluding the value of property transferred to an employee as a nontaxable gift. [42] Therefore, the transfer will generally be taxable unless it is considered "de minimis" under §132(e). Many employers have gift and award policies that exempt items of tangible property worth $100 to $250 per item. Arguments supporting this position are that the items listed in Reg. §1.132-6(e)(1) as "de minimis" can be worth that much. These items include: group meals; occasional theater or sporting event tickets; books, flowers, and even something as elaborate as a gold watch given as a retirement award.

[42] See§102(c).

Another possible exclusion would be the "length of service" awards under Prop. Reg. §1.274-8. Unfortunately, there are significant restrictions to these awards and the value would be capped at $1600 for a taxable year.

There is support, however, for exceeding the cap on de minimis or length-of-service awards in the case of a one-time retirement gift. Prop. Reg. §1.274-8 provides that where "an employer provides a gold watch to each employee who completes 25 years of service with the employer the value of the gold watch is excluded from income as a de minimis fringe benefit." The legislative history under §132 also mentions that "traditional awards (such as a gold watch) upon retirement," could qualify as a de minimis fringe benefit. [43] Although it is unlikely that this exception would apply to a high-ticket item such as a new sports car, it could apply to watches, crystal vases, or other items traditionally used to recognize a retiree's years of service.

[43] Jt. Comm. on Tax'n, General Explanation of the Tax Reform Act of 1986 at 37 (JCS-10-87).

CONCLUSION: FOR A 'GOOD' LONG GOODBYE

Tax departments should get involved with their company's Human Resources department as soon as possible to structure an executive's transition into retirement. Tax, more than HR, will bear the anger if the executive, expecting a Form 1099 receives a W-2 instead, which will happen if retirement distributions begin earlier than planned. In many cases, HR may need further education on many of the issues in order to manage an executive's expectations.

Notes

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