



ERISA & Tax Considerations for Severance Benefit Plans

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Agenda

- ✦ Some critical differences between a furlough versus a layoff
- ✦ Application of ERISA to severance plans
- ✦ The “serious consideration” doctrine under ERISA
- ✦ Application of Internal Revenue Code Section 409A to severance plans
- ✦ Best practices for drafting and administering severance plans

Furlough vs Layoff

- ✦ Furlough—Placing an employee in a temporary, non-pay status because of lack of work or lack of revenue to pay the employee
 - > The individual is still an employee of the company and there is an expectation that they will return to their regular job
- ✦ Layoff—This is a termination of employment
 - > No expectation that they will return to work with the same employer

Furlough vs Layoff

- ★ In either case, an employer will need to consider employment law issues (which we will not address in this webinar) such as:
 - if/when a WARN Act notice is required,
 - if/when accrued vacation is to be paid out,
 - possible discrimination issues related to which employees are furloughed or laid off, and
 - for furloughed employees, the possible impact on unemployment benefits

Furlough vs Layoff

- ✦ What benefits will furloughed employees be eligible for during furlough?
 - > How will they pay for those benefits?
 - > Does the applicable plan document allow for furloughed employees to remain covered?
 - > If plans are amended by the employer to allow for coverage of furloughed employees, need to confirm with applicable insurance carrier if that is permitted (such as for an insured health plan, self-funded health plan with stop-loss insurance, disability, life, etc.)
 - > Are the furloughed employees still considered fulltime employees under the ACA rules for the Employer Mandate (pay or play rules)
 - > If the employee has no pay, how does that impact the benefits that are based on pay, such as life insurance, disability pay, etc... Do those benefits need to be amended to reflect this time with no pay?
 - > How is the employee treated for purposes of the 401(k) plan?

Reduced Pay

- ✦ Some employers are not placing employees on a furlough, but rather decreasing pay. Some benefit issues to consider:
 - > Not likely an event that would allow a change to a pre-tax election for the health and welfare plans
 - > How does this impact how benefits are calculated for disability plans and life insurance
 - Are amendments to those plans needed? Will they be permitted by the insurance carrier?

Severance Plans—ERISA Considerations

- ★ ERISA Section 3(1): “employee benefit plan” is defined as “any plan, fund, or program . . . established or maintained by an employer . . . for the purpose of providing for its participants or their beneficiaries . . . any benefit described in section 186(c) of this title”
 - > Severance benefits are among those described in Section 186(c)

ERISA Considerations

- ★ There are some advantages for the employer when the severance plan is an ERISA-covered plan, including, but not limited to, the following:
 - > If the plan complies with ERISA's claims procedure requirements, a court will overturn the employer's decision generally only if the employer acted in an arbitrary and capricious manner
 - > Employee has no right to a jury trial for an ERISA claim
 - > No punitive damages for an ERISA claim

Application of ERISA

- ✦ A key case that analyzes whether a severance plan is an ERISA-covered plan is *Fort Halifax Packing Co. v. Coyne*, decided by the U.S. Supreme Court
- ✦ At issue was whether a Maine statute that required employers to provide their employees with a one-time severance payment established an ERISA plan
- ✦ The Court held that in order for an arrangement to be subject to ERISA, the administration of the arrangement must require “an ongoing administrative program to meet the employer’s obligation”
- ✦ The Court stated that the “requirement of a one-time payment triggered by a single event requires no administrative scheme whatsoever”

Application of ERISA

- ★ Relying on the *Fort Halifax* decision, courts have looked at the following issues to determine the application of ERISA to severance plans:
 - > Does the arrangement require an ongoing administrative scheme for determining eligibility and/or calculating the benefit?
 - For example, in one case, employees received continued health and dental insurance coverage over a six to twelve month period. The court held that the severance arrangement was an ERISA plan, because the administration of the severance plan required the company to make periodic demands on the plan's assets, requiring financial coordination and control throughout the severance pay period. Deutsch v. Kroll Associates

Application of ERISA

- > Does the employer exercise discretion to determine eligibility to receive the severance benefits?
 - For example, discretion was found when a plan required the employer to determine: (1) whether the employee was involuntarily terminated, (2) whether the termination was for cause or not, and (3) whether the employment that the employee found was commensurate with the position from which he was terminated. (Schonholz v. Long Island Jewish Medical Center)
- ★ Most plans are found by courts to require sufficient discretion so that the severance plan is an ERISA-covered plan

Pension Plan or Welfare Plan

- ✦ A severance plan that is subject to ERISA will be classified as either a pension plan or a welfare plan
 - > Welfare plans must satisfy fewer ERISA requirements than pension plans
- ✦ To be a welfare plan, the DOL has said that all of the following requirements must be met:
 - > Severance plan payment is not contingent, directly or indirectly, upon the employee's retirement;
 - > Total amount of the payments to be made does not exceed 2x the employee's annual compensation during the employee's last full year of employment; and
 - > All payments are made within 24 months following the employee's termination

Pension Plan or Welfare Plan

- ✦ A big issue for severance plans is the requirement that the severance plan payment is not contingent, directly or indirectly, upon the employee's retirement
 - > Some DOL Opinion letters look to the definition of "retirement" set forth in the company's defined benefit plan. Other DOL Opinion letters simply look at the age requirement in the plan.
 - > For example, would a plan that contained an eligibility provision that employees must be age 60 with 5 years of service cause the severance plan to be a pension plan?

Pension Plan or Welfare Plan

- ★ The DOL has acknowledged that a severance plan that does not meet all the requirements in the previous slide could still be considered a welfare benefit plan under certain circumstances. (ERISA Opinion Letter 99-01A)
 - > “The preamble to the Federal Register notice adopting regulation section 2510.3-2(b) recognizes that the regulation sets forth conditions under which a severance pay plan will not be deemed to be a pension plan, without excluding the possibility that, in appropriate circumstances, a severance pay plan not meeting the conditions might also be deemed not to be an employee pension benefit plan.”

Welfare Plan vs. Pension Plan

- ★ Welfare plan – ERISA requirements
 - > Reporting and disclosure requirements
 - > Fiduciary responsibilities
 - > Administration and enforcement provisions
- ★ Pension plan – ERISA requirements
 - > Welfare plan requirements listed above
 - > Funding rules –trust requirement and the trust cannot contain a forfeiture provision
 - > Vesting rules
 - > Participation rules

Welfare Plan vs. Pension Plan

- ✦ The issue of welfare plan versus pension plan arises in lawsuits brought by former employees who try to claim that a benefit was “vested.” Some examples:
 - > Employer amended a severance plan to exclude certain employees and then terminated those employees—and did not provide them with severance benefits. Former employees sued. Claimed that the severance plan was a pension plan and they had “vested” in right to benefits.
 - > The plan was to pay benefits over a period of time and the employer ceased paying the benefits because the former employee violated the no-solicitation provision in the severance plan. Former employee sued and claimed that the severance plan was a pension plan and forfeitures were not permitted.

Pension Plan—Top Hat Plan Exemption

- ✦ Although ERISA requires pension benefit plans to adhere to the requirements mentioned in the previous slide, if a plan is considered to be a Top-Hat plan, then ERISA funding, vesting, fiduciary and participation requirements will not apply
- ✦ If the severance agreement is considered to be a pension benefit plan, then it is essential that it fall under the Top-Hat plan exemption

Top-Hat Plan Exemption

- ✦ In order for a plan to be considered a Top-Hat plan, it must be unfunded and maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees
- ✦ This webinar does not discuss this rule in detail

ERISA Requirements

- ✦ If an employer's severance practices constitute an ERISA plan, it must be memorialized in an ERISA-compliant plan document
 - > The plan should clearly state eligibility and benefits
 - > The plan should provide for an amendment procedure. This requirement can protect an employer if it wishes to amend eligibility or benefits available under a severance plan
 - Several courts have found that where an employer handles severance matters on an informal basis, the employer's past practices will provide the basis upon which terminated employees can file a claim or sue for severance benefits that they did not receive

ERISA Requirements

- ✦ Plan must provide all participants who receive a benefit with a summary plan description. Claims and appeals procedure must be memorialized in SPD.
- ✦ Annual Form 5500 must be filed unless there are fewer than 100 participants
 - > The DOL has stated that, for reporting purposes, an employer must count as a participant every employee who would be entitled to benefits if a qualifying termination occurred
 - > Assume that the severance plan states all full-time employees will receive 1 week of pay for every year of service if they are involuntarily terminated. The employer has 500 full-time employees in 2020 and terminates 50. For reporting purposes, the plan has 500 participants—not 50.

Potential Penalties Under ERISA

- ★ If ERISA's requirements are not met, civil and criminal penalties may apply including the following:
 - > Up to \$110/day penalty for failing to furnish a SPD to a participant upon request
 - > Up to \$1,100/day penalty for failing to file annual Form 5500

“Serious Consideration”

- ✦ If an employer is planning to amend its severance plan (or adopt a severance plan), the employer should be aware of the “serious consideration” doctrine
- ✦ It arises out of the ERISA fiduciary duties that are set forth in the statute
- ✦ The duties of care and integrity imposed on an ERISA fiduciary are extremely high
- ✦ Considering the ERISA fiduciary standards set forth in the statute, in *Varity Corp. v. Howe*, the U.S. Supreme Court held that an ERISA fiduciary could not knowingly make misrepresentations to participants about the security of their future benefits

“Serious Consideration”

- ✦ Since *Varsity Corp. v. Howe* was decided, a growing body of case law has addressed the circumstances under which amendments to plan, or the adoption of new plans, must be disclosed to participants
- ✦ Pursuant to various federal court decisions, once an employer gives “serious consideration” to a plan (or plan amendment) that is covered by ERISA, it (in its fiduciary capacity) has an obligation not to make misrepresentations, either negligently or intentionally, to a potential plan participant

“Serious Consideration”

- ★ When “serious consideration” exists is a factual determination
- ★ Many courts consider that serious consideration exists when: (1) a specific proposal, (2) is being discussed for implementation, (3) by senior management with the authority to implement the change (or the plan)

“Serious Consideration”

- ✦ A way to handle this issue is for a specific date be chosen that corresponds to a meeting or action taken by the employer in which a severance plan was under “serious consideration”
- ✦ Once that date is chosen, the employer should consider every employee who both: (1) voluntarily terminated from that date on forward and (2) would have otherwise been eligible for the severance plan
- ✦ Those employees who meet the requirements in #1 and #2 above, should be offered the benefits of the severance plan

Extension of Health Coverage

- ✦ If the severance plan includes extending eligibility for health coverage or paying a portion of the COBRA coverage, this can trigger nondiscrimination issues under Internal Revenue Code Section 105(h) for **self-funded plans**
- ✦ The penalty is that the benefits received by the highly compensated individuals (HCIs) are taxable
 - > HCIs include the top 25% paid in the company
- ✦ This is not an issue for fully insured plans—it is an issue for self-funded plans

Extension of Health Coverage

- ★ To pass the nondiscrimination rules under Code Section 105(h), everyone covered under ALL severance plans should be provided with the same health plan benefits (i.e., company pays for 4 months of COBRA coverage)
- ★ Provisions that are unlikely to work are things such as:
 - > (1) all employees get 4 months of paid COBRA, except that executives get 6 months of paid COBRA coverage, or
 - > (2) COBRA provisions based on years of service (1 month of company-paid COBRA for each year of service)
 - The reason is because it is often the case that the highly compensated individuals are the longer serving employees

Code Section 409A

- ★ Code Section 409A imposes penalties on the employee if payments of “nonqualified deferred compensation” are paid earlier than:
 - > Separation from service
 - > Death
 - > Disability
 - > Specified date or fixed schedule
 - > Change in control
 - > Unforeseeable Emergency
- ★ Very technical regulatory definitions
- ★ Failure to define terms can cause a documentary error due to ambiguous terms

Nonqualified Deferred Compensation

- ★ A deferral of compensation exists when the employee has a legally binding right in one taxable year to compensation payable in a subsequent taxable year
- ★ Whether a plan provides for a deferral of compensation is based on the facts and circumstances at the time the employee obtains the legally binding right to the compensation, or, if later, when the plan is amended to convert a right that does not provide for a deferral of compensation into a right that does

Documentary/Operational Compliance

- ✦ Code Section 409A requires:
 - > Documentary compliance:
 - Time and form of payment
 - Six-month delay for “specified employees” (discussed later)
 - > Operational compliance
- ✦ Code Section 409A requires a plan document for nonqualified deferred compensation
- ✦ Failures
 - > Documentary applies to all participants
 - > Operational applies solely to affected participants

Penalties

- ✦ Failure to comply with Code Section 409A can result in an income tax penalty and a premium interest tax (on top of regular income taxes)
 - > 20% federal tax penalty
 - > 5% California tax penalty
- ✦ Applies to all vested amounts (*i.e.*, no longer subject to a substantial risk of forfeiture)
- ✦ The premium interest tax is the IRS underpayment interest rate plus an additional 1%
 - > Underpayment interest rate is short-term AFR plus 3%
 - > The premium interest rate is calculated based on the underpayment that would have occurred if the amount had been includible in income in the taxable year when first deferred or, if later, when vested

Potential Employer Obligations

- ✦ Gross up provisions in severance agreement
- ✦ Contractual obligations to pay penalties
- ✦ Tax reporting and withholding
- ✦ Costs of operational or documentary corrections
 - > Notice 2008-113 (as amended in Notice 2010-80)
 - > Notice 2010-6

Exemptions Useful for Severance Benefits

- ★ Short-term deferral rule
- ★ Limited separation pay upon an involuntary separation from service or pursuant to a window program
- ★ Certain collectively bargained plans
- ★ Non-taxable benefits
- ★ Certain reimbursement arrangements

Legally Binding Right

- ★ Whether or not a payment is nonqualified deferred compensation is determined when the employee obtains the legally binding right to the payment
 - > State contract law
 - > Plan terms
 - > Facts and circumstances
- ★ Not the same as vesting
- ★ Later amendment of the plan or agreement cannot remove payment or benefit from application of Section 409A

Application to Severance Plans

✦ Eligibility Provisions

- > Automatic eligibility
 - Executive severance plan that provides all senior vice presidents will be entitled to certain severance pay upon involuntary termination without cause
 - Broad-based severance plan that provides minimum severance benefits if an employee is involuntarily terminated without cause (not event limited)
 - Broad-based severance in the event of a reduction of force or position elimination
- > Employer discretion to select participants
 - Employer notification required for participation
- > Window programs

409A Compliant Severance Plan

- ✦ Permissible payment event or date/schedule
 - > Triggered by a separation from service
 - Another payment date that is objectively determinable and nondiscretionary at the time the event occurs
 - > Grace periods
 - Period up to 90 days after payment event
 - A plan may also provide that a payment is to be made during a designated period objectively determinable and nondiscretionary at the time the payment event occurs, but only if the designated period both begins and ends within one taxable year of the service provider or, if later, by the 15th day of the third month after the payment date

Separation from Service

- ✦ Separation from service = termination of employment?
- ✦ Presumption of separation
 - > If services permanently decrease to 20% or less of average services performed over immediately preceding 36-month period, presumed to be a separation
 - > Services as an employee or independent contractor
- ✦ If 50% or more, presumed to be no separation
- ✦ In between 20%-50% -- no presumption
- ✦ “Plan” may adopt its own rule by setting a level of services – greater than 20% but less than 50% of the average level of services provided over preceding 36 months – that will trigger a separation from service

Service Recipient/Employer

- ★ A service recipient under Section 409A includes the employer and all parent or subsidiary companies that would be part of the employers controlled group of companies for purposes of paying US taxes
- ★ Must cease all services with all companies in employer's controlled group

Specified Employees

- ★ Specified employees are employees at publicly traded companies who are
 - > officers with annual compensation greater than \$185,000 (for 2020),
 - > 5% owners, or
 - > 1% owners with annual compensation over \$150,000
- ★ Generally, no more than 50 people will be “specified employees”

Six-Month Delay

- ★ Payments of nonqualified deferred compensation to a specified employee must be delayed for a period of six months (or at death, if earlier)
- ★ Payment on the first day of the seventh month that commences after the date of the separation from service
- ★ This delay is a documentary and operational requirement

Specified Employees

- ✦ Identification of “specified employees” is based on the 12-month period ending on December 31 (or another identification date chosen by the corporation)
- ✦ A persons who is a “specified employee” during that 12-month period is considered a specified employee for the 12-month period commencing on the next April 1 (or sooner, if the plan specifies)
- ✦ As an alternative, employers can apply a six-moth delay to all payments of nonqualified deferred compensation

Short-Term Deferral Exemption

- ✦ A payment is not treated as nonqualified deferred compensation subject to 409A if an employee actually or constructively receives payment of the entire amount by the later of:
 - > 2 ½ months from the end of the employee's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture; or
 - > 2 ½ months from the end of the employer's taxable year in which the amount is no longer subject to a substantial risk of forfeiture
- ✦ The short-term deferral rule does not apply if under the terms of the plan there is a **possibility** of making the payment after the above deadline

Substantial Risk of Forfeiture (SRF)

- ✦ An amount is subject to a SRF only if entitlement to the amount is conditioned on the future performance of substantial services, OR upon the occurrence of a condition that is related to a purpose of the compensation if the possibility of forfeiture is substantial
 - > This is a facts and circumstances determination
 - > With regards to substantial future services, factors include whether the hours required to be performed during the relevant period are substantial in relation to the amount of compensation
 - > A condition related to a purpose of the compensation means it must relate to the employee's performance of services OR the employer's activities or organizational goals

SFR

- ♦ If a payment is subject to the occurrence of an involuntary termination of employment without cause, then the amount is treated as subject to a substantial risk of forfeiture

General Releases

- ✦ In IRS Notice 2010-80 the IRS clarified its position on payment of nonqualified deferred compensation contingent on a general release:
 - > Applies to plans or agreements subject to Section 409A
 - > Two possible payment periods
 - Fixed payment date after termination (i.e., 90-days after termination of employment regardless of when release is signed and irrevocable)
 - Payment within a certain period no longer than 90 days, but if payment period crosses tax years, then the payment must be made in the second tax year

Short-Term Deferral Rule – Common Mistakes

- ✦ *Release Agreements:* If severance payments are contingent on the employee's execution of a general release, the short-term deferral rule may not apply if the agreement does not include a deadline for signing the release
 - > Absent a deadline that meets the parameters of the short-term deferral rule, there is a possibility that the payment could be paid outside the deadlines required by the rule
- ✦ Examples of provisions in a general release that could violate Section 409A include:
 - > Payment will be made within 30 days after the employee's execution of the general release
 - This is too open ended—it is possible that payment will be made after the short-term deferral deadline
 - > Employee must execute the release within 30 days of presentation of the release
 - Again, this is too open ended

Separation Pay Plans

- ★ Severance pay is exempt from Code Section 409A if:
 - > The plan only provides for separation pay upon an involuntary termination or pursuant to a window program; and
 - > Severance pay does not exceed 2x the lesser of:
 - The employee's annualized compensation based on the annual rate of pay for services provided to the employer for the taxable year preceding the separation; or
 - The maximum amount that may be taken into account under a qualified plan under Code Sec. 401(a)(17) (for 2020, \$285,000); and
 - > All payments are made by the end of the second taxable year of the employee following the year in which the separation occurs

Separation Pay Plans

- ✦ Involuntary termination means a separation from service due to the employer's independent exercise of its unilateral authority to terminate the employee, other than due to the employee's implicit or explicit request
 - > Employee must have been willing and able to continue performing services
 - > A "good reason" termination may be treated as an "involuntary termination" if the plan's definition of "good reason" meets the requirements of Code Section 409A

Separation Pay Plans

- ★ Payment for reasons other than involuntary termination (*e.g.*, at retirement, disability or death) will not meet the exemption
- ★ Payments will not be exempt if they exceed the lesser of 2x: (a) the annual base pay for the year prior to year of separation or (b) Code Section 401(a)(17) limitation for the year of separation

Separation Pay Plans – Stacking Exemptions

- ✦ An agreement can be structured to take advantage of both exemptions—the short-term deferral exemption and the involuntary separation exemption
 - > For example, if the severance is paid in installments, all installments that must be paid before March 15th of the year after separation can qualify for the short-term deferral exemption and all installments required to be paid after March 15th and before December 31st of the 2nd year after separation can apply to the involuntary separation exemption
 - > However, to obtain this treatment, the agreement or plan must specifically state that each installment is a separate payment for Section 409A purposes

Window Programs

- ✦ The involuntary severance from employment requirement is not applicable to window programs
 - > The other two requirements (amount and time of payment) must be met
- ✦ A window program means a program established by an employer to provide separation pay in connection with an impending severance
- ✦ The program must be for a limited period of time (typically no longer than 12 months) for participants who terminate during that time
- ✦ Generally this applies to a group RIF, reorganization or closure of a business unit

Non-Taxable Benefits

- ★ Code Section 409A does not apply to a legally binding right to receive a nontaxable benefit
 - > IRS has informally indicated that this exemption can be used if the employer pays for all or a portion of an employee's health benefits for a period of time after the employee's separation of service
 - > This exemption does not apply to employer paid health benefits that are provided on a discriminatory basis under Section 105(h) of the Internal Revenue Code. In that case, the benefit is a taxable benefit subject to Section 409A

Outplacement Services

- ★ Exemption from Code Section 409A for career transition benefits/outplacement services that are provided in-kind or by reimbursement
- ★ All career transition benefits must be provided by the end of the second calendar year after the calendar year in which the employee had a separation from service
- ★ Reimbursements must be made no later than the third year following the year of separation from service

Limited Separation Benefits

- ♦ Separation pay benefits can be treated as exempt from Code Section 409A if the amount of the benefits, in the aggregate, do not exceed the limit under Code Section 402(g) for the year in which the service provider had a separation from service

Substitution

- ★ If an amount is forfeited and then replaced, in whole or in part, with another amount of benefit, that is a substitute
- ★ The new risk of forfeiture will generally be disregarded (unless material consideration exception applies)
- ★ For example, assume a severance plan provides for three years of salary continuation payments on a fixed schedule in compliance with Section 409A. A benefit paid in a lump sum under the short-term deferral exemption cannot be provided instead.

Plan Aggregation

- ✦ For certain requirements under Section 409A, all non-qualified deferred compensation plans of a service recipient that are of the same category are treated as a single plan.
- ✦ Involuntary separation pay or window programs are a category of plans that are treated as a single plan

Issues to Consider for Severance Pay

- ♦ Items to think through when dealing with severance:
 - > Was the severance subject to a Substantial Risk of Forfeiture?
 - > Was the termination of employment a Separation from Service?
 - > Was the termination an Involuntary Separation?
 - > Is the individual a Specified Employee?

Best Practices

- ✦ Determine if plan is subject to ERISA and/or Code Section 409A
 - > Plan document requirements
 - > Summary plan description
- ✦ Whenever possible, try to fit payments and benefits within an exemption from Code Section 409A
- ✦ Use safe harbor provisions
- ✦ For discretionary plans, make eligibility contingent on written notice from employer

Best Practices Continued

♦ Savings clauses

- > Include “separate installment” language in order to stack exemptions
- > Include specified employee requirements even if not yet a public company
- > Include provisions that all terms will be interpreted as necessary for payments to be compliant or exempt from Code Section 409A
 - Can save plan from documentary errors due to ambiguous terms

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