

Severance Plans: What Every Employer Needs to Know

Navigating ERISA and Tax Code Section 409A

October 21, 2021

Samuel J. Baldwin, Esq.

Kenneth F. Ginder, Esq.

Is your severance plan, policy, or practice subject to the Employee Retirement Income Security Act of 1974, as amended (“ERISA”)?

- Many employers maintain informal or formal severance plans, policies, or practices, often without realizing they are subject to ERISA
- A severance policy or practice will generally constitute a “plan” subject to ERISA if:
 1. a reasonable person could ascertain:
 - the existence of intended benefits and intended beneficiaries;
 - the source of financing;
 - a procedure for receiving benefits; and
 2. there is an ongoing administrative scheme (per a 1987 U.S. Supreme Court case, Fort Halifax Packing Co. v. Coyne, addressing severance pay for employees of a Winslow, Maine poultry processing and packing plant)

Is your severance plan, policy, or practice subject to ERISA? (Cont.)

- Characteristics of an ERISA-governed severance plan
 - specific procedures are in place (the policy identifies who is eligible for benefits and contains a benefit formula)
 - an ongoing administrative program
 - the employer enters a number of identical or similar arrangements
 - benefits are paid in a series of payments
- Characteristics suggesting ERISA does not apply
 - benefits are provided on an ad hoc basis
 - no definite procedure exists for providing benefits
 - a one-time payment triggered by a single event

If it is an ERISA-governed plan, is it a pension benefit plan or a welfare benefit plan?

- Pension benefit plans (i) provide retirement income or (ii) result in a deferral of income for a period extending to or beyond the termination of employment.
 - Subject to complex rules for participation, benefits, vesting and funding
- Welfare benefit plans provide benefits in the event of unemployment or certain enumerated benefits, including severance benefits
 - The complex pension plan rules do not apply

ERISA safe harbor

- An ERISA severance plan will be treated as a welfare benefit plan (not as a pension plan) if:
 1. payments are not contingent upon the employee's retiring;
 2. total payments do not exceed twice the employee's annual compensation during the year proceeding termination; and
 3. payments are completed within 24 months of termination (or in the case of terminations in connection with a limited program of terminations (a "window program"), within 24 months after the employee reaches normal retirement age)

What are the consequences of sponsoring an ERISA-governed Severance Plan?

- Formal plan document
 - *Important note:* A severance policy may be treated as an ERISA plan even if the policy is not in writing. For example, an employer with an established practice of providing severance could be treated as having an ERISA plan even if it is not set forth in a written document
- Summary plan description (SPD), summary of material modifications (SMM)
- Form 5500 annual report requirement
- ERISA fiduciary requirements
 - Duty of loyalty (“exclusive purpose”)
 - Duty of care (“duty of prudence”)
 - Duty to follow written terms of plan
 - Diversify assets to avoid large loss
- Exception for “top hat” plans

What are the penalties for failure to comply with ERISA?

- Failure to file Form 5500 - \$2,259 per day
- Failure to provide participants with SPD - \$110 per day
- Breach of fiduciary duty
 - Fiduciaries may be personally liable
 - DOL 20% penalty
- Prohibited transactions
 - Excise taxes and DOL penalties
- Criminal charges for willful violations - **unusual**
 - Maximum criminal penalties for ERISA violations include up to 10 years in jail and fines of up to \$100,000
 - Companies charged with ERISA violations can face criminal fines of up to \$500,000

What are the advantages of an ERISA-covered severance plan?

- ERISA claims procedures
 - Specific procedures must be exhausted before filing suit
 - Set a limitations period for lawsuits
 - Set the forum for lawsuits
- Preemption of state law
 - For example, breach of contract, state wage statutes
 - Many state law claims provide for punitive damages, ERISA does not
 - Generally, lawsuits must be in federal court
- Employer decisions are afforded deference by a court
 - Employer decision will only be overturned if the fiduciary acted “arbitrarily and capriciously” in construing the plan or denying benefits

When may a severance plan be subject to Code Section 409A?

- Severance plans can be a form of deferred compensation subject to Code Section 409A unless an exception applies
- As a rule, deferred compensation arises where there is a legally binding right during a taxable year to compensation that is or may be payable in a later tax year
 - Example 1: employee terminates in November 2021 with a legal right to monthly severance payments over the next six months, December 2021 through May 2022
 - Example 2: employee terminates in November 2021 with a legal right to a lump sum payment by December 31, 2021

Exceptions to Code Section 409A

- Safe Harbor Rule for Severance Plans
- Short-Term Deferral Exception

Section 409A safe harbor for severance plans

- Plan must be either:
 - Based on involuntary termination of employment, or
 - A window program
 - Cannot establish a pattern of providing these over consecutive periods of time
- Benefit must not exceed two times the lesser of:
 - The employee's annual compensation in the year prior to the employee's separation from service, or
 - The annual limit on compensation under Code Section 401(a)(17) for a qualified pension plan (\$290,000 for 2021)
- Payments must be made no later than two years following the calendar year in which the employee was terminated

Section 409A short-term deferral exception

- The rule – all payments are received either:
 - During the taxable year that includes the date the amount is no longer subject to a substantial risk of forfeiture, or
 - No later than the 15th day of the third month following the end of the taxable year that includes the date the amount is no longer subject to a substantial risk of forfeiture – measured from the later of the end of the recipient's taxable year (December 31) or the employer's taxable year
- *What does that mean for a severance plan?*
 - Severance benefit is paid by March 15 of the year after the employee terminates employment
 - If employer does not use a calendar fiscal year, date may be later
 - Must be involuntary termination of employment
- Remember to account for any release of claims that may be required under the severance plan

How can a severance plan comply with Code Section 409A?

- § 409A generally requires:
 - Written plan document
 - Specified payment date, schedule, or event (“separation from service” as defined in the rules)
 - Restrictions on changes to time and form of payment
 - Prohibition on acceleration of payments
 - Restrictions on the ability to electively defer payments

Consequences of not complying with Code Section 409A

- An *operational failure* or a *plan document failure* will have severe consequences for the employee:
 1. *Immediate Inclusion of Income*: all compensation deferred under the plan for the taxable year and all preceding taxable years is includable in gross income for the taxable year (even if the amounts are not actually paid)
 2. *20% Penalty*: the tax shall be increased by an amount equal to 20% of the compensation required to be included in gross income
 3. *Interest-Based Tax*: an interest penalty is imposed equal to the underpayment rate (plus 1%) that would have applied had the deferred compensation been included in gross income in the year first deferred (or the first year there was no substantial risk of forfeiture)

Next steps

- Inventory whether you have any severance policies or practices
- If yes, determine whether they are an ERISA and/or 409A covered plan
 - If it is not clear, it may be prudent to assume ERISA and 409A apply and adopt a document that complies with the safe harbors
- If it is an ERISA or 409A covered plan, implement policies to comply

Questions?

Verrill Employee Benefits & Executive Compensation Group
Blog: <https://www.verrill-law.com/benefits-law-update/>

Kenneth F. Ginder
kginder@verrill-law.com
207-253-4912

Samuel J. Baldwin
sbaldwin@verrill-law.com
207-253-4532

This communication is provided for general information purposes as a service to clients and friends of Verrill Dana, LLP. This communication may not be relied upon by any person as legal advice and does not create an attorney-client relationship. This information may not be used in any marketing or promotional materials without our express permission.