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Primer on Severance Plans Under ERISA and the Tax Code

by Kimberly S. Couch on June 29, 2021

Many employers maintain formal or informal severance policies or practices that they use sporadically. Other employers may implement a severance program for a limited period of time to reduce the number of employees overall or within a work classification or location. All employers should be mindful that these policies, practices, and programs may be subject to requirements under the Employee Retirement Income Security Act of 1974 ("ERISA") and, without careful planning, the rules for deferred compensation under Section 409A of the Internal Revenue Code ("Code").

ERISA Considerations

In general, an employee benefit policy or practice is deemed to be a "plan" subject to ERISA if it provides one of the benefits identified in Section 3 of ERISA and if a reasonable person could ascertain (i) the existence of intended benefits and intended beneficiaries, (ii) the source of financing, and (iii) a procedure for receiving benefits. An employer's practice of providing severance benefits to individual employees may not be a severance plan subject to ERISA if benefits are provided on an ad hoc basis and there is no definite procedure for providing benefits. In its Fort Halifax Packing Co. v. Coyne decision, the U.S. Supreme Court determined that an ERISA severance plan must have an ongoing administrative scheme and held that a one-time severance payment triggered by a single event is not an ERISA plan. In contrast, if the employer has specific procedures in place (for example, the policy identifies who is eligible for benefits and contains a benefits formula), and there is an ongoing administrative program, or if the employer enters into a number of identical or very similar arrangements, the employer's severance policy will be treated as a severance plan that is subject to ERISA.

Safe Harbor Rule for Severance Plans

Under ERISA, a plan, fund, or program that (i) provides retirement income to employees or (ii) results in a deferral of income by employees for a period extending to or beyond the termination of employment generally is treated as a pension plan subject to complex rules for participation, benefits, vesting, and funding. A plan, fund, or program that is established by an employer for purposes of providing benefits in the event of unemployment or benefits described in Section 302(c) of the Labor Management Relations Act of 1947 (which lists severance benefits) is treated as an employee welfare plan under ERISA and is exempt from the more stringent pension plan requirements.

The Department of Labor has created a safe harbor rule for severance plans under which an arrangement providing for the payment of severance benefits on account of

termination of employment will be treated as a severance plan and not a pension plan, provided:

- the payments are not contingent, directly or indirectly, upon the employee's retiring;
- the total amount of the payments does not exceed the equivalent of twice the employee's annual compensation during the year immediately preceding the termination of employment; and
- all payments to the employee are completed (i) in the case of an employee whose service is terminated in connection with a limited program of terminations, within the later of 24 months after the termination of the employee's employment or 24 months after the employee reaches normal retirement age, or (ii) in the case of any other employee, within 24 months after the termination of the employee's employment.

For this purpose, "annual compensation" is defined as the total of all compensation, including wages, salary, and any other benefit of monetary value, whether paid in the form of cash or otherwise that was paid as consideration for the employee's service to the employer during the year (or that would have been paid at the employee's usual rate of compensation if the employee had worked a full year).

A severance policy may be treated as an ERISA plan even if the policy is not in writing. For example, if an employer has established a practice of providing employees who are involuntarily terminated with one week of pay for each year of service, then the practice will be treated as a plan subject to ERISA. In that event, the plan should satisfy ERISA plan requirements including:

- The requirement for a formal plan document;
- Participant disclosure requirements, which may include distribution of a summary plan description, summaries of material modifications, and/or summary annual reports;
- Reporting requirements, which may include filing annual returns (Form 5500s); and
- ERISA fiduciary requirements. [1]

An employer who sponsors an ERISA-covered severance plan but does not comply with ERISA requirements may be subject to taxes and penalties (for example, up to $2,259 per day for failing to file the annual report).

Benefits of an ERISA Severance Plan

Employers may have additional responsibilities when maintaining a severance program subject to ERISA but there are advantages. If ERISA applies to a severance plan, then claims made by a participant under state and common law (such as breach of contract,

state wage statutes, or promissory estoppel) generally are preempted, and the participant's only remedies are under ERISA. Many state statutes provide for punitive damages in claims relating to an employee's employment and benefits. ERISA does not provide for punitive damages and courts have been reluctant to read this type of award into the statute. Further, an employer generally may remove a lawsuit brought in state court to federal court. Finally, if a severance plan (and/or its summary plan description) contains the appropriate language, the plan fiduciary's decisions may be afforded deference by a court of law and will be overturned by a federal court only if the plan fiduciary acted arbitrarily and capriciously in construing the plan or in denying benefits.

Code Section 409A Considerations

In general, if an employee has a legally binding right in one year to receive payment of compensation in another year, there will be a deferral of compensation and the payment may be subject to Section 409A of the Code. In addition, a plan that pays benefits upon termination of employment may be treated as a deferred compensation plan under Section 409A if severance benefits are paid over more than one year. Unless the employer implements a formal deferred compensation plan that specifies the time and form of payment and subjects deferred compensation payments to a substantial risk of forfeiture, the deferred compensation will be taxed in the year that there is a legally binding right to receive it, regardless of when it is actually paid. Under these rules, severance payments made over more than one year may be includable in an employee's gross income in the year in which the employee terminates employment.

Safe Harbor Rule for Severance Plans

Certain bona fide severance arrangements that provide separation pay upon an **involuntary termination of employment** or pursuant to a **window program** are excluded from Code Section 409A. A voluntary severance plan will not be exempt from Section 409A unless it is offered as part of a window program. A window program exists if separation pay is made available for employees who terminate employment within a limited period of time (not to exceed 12 months) under specified circumstances. A severance arrangement will not be treated as a window program if the employer establishes a pattern of providing similar severance pay in similar situations over substantially consecutive periods of time.

In order to be exempt from the deferred compensation rules of Code Section 409A, the severance arrangement must not exceed **two times the lesser of**: (i) 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 (ii) the annual limit on compensation under Code Section 401(a)(17) for a qualified pension plan ($290,000 for 2021). In addition, the payments must be made no later than two years following the

calendar year in which the employee was terminated. This safe harbor rule is not identical to, but is consistent with, the safe harbor for severance plans under ERISA.

In addition, other post-termination benefits provided under a severance plan may be exempt from Section 409A including:

- Reimbursements that may be excluded from the employee's income, such as business reimbursements and moving expenses;
- Reimbursements for medical expenses during the period that the former employee could have elected COBRA continuation coverage; and
- Certain in-kind payments and payments for goods and services.

Unless the post-termination benefits are excludible from the employee's income under the Code, the benefits will be exempt from Section 409A only if the post-termination benefits, in the aggregate, do not exceed the dollar amount under Code Section 402(g)(1)(b) for the year of separation (which is $19,500 for 2021).

Short-Term Deferral Exception

If an employer wants to provide severance payments that exceed amounts permitted under the safe harbor rule for severance plans, the payments may still be exempt from Code Section 409A under the short-term deferral exception. In general, severance payments made to an employee who terminates employment, whether voluntarily or involuntarily, will not be treated as deferred compensation payments subject to Section 409A if all payments are made within 2-1/2 months following the close of the year in which the employee's termination of employment occurs.

Other Considerations

This post provides a high-level summary of ERISA and tax issues that should be addressed when an employer seeks to implement a temporary or permanent severance program. Other issues may include the need to comply with the Age Discrimination in Employment Act ("ADEA") and to obtain ADEA waivers from older employees, and the impact of severance payments on other employee benefits. Tax-exempt and certain governmental employers must structure severance plans to comply with Code Section 457. An employer should consult with legal counsel before implementing a severance program.

Please contact a member of Verrill's Employee Benefits & Executive Compensation Group if you have any questions regarding severance programs.

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[1] There is an exemption from most of these requirements for so-called "top hat" plans that are maintained solely for highly compensated or select management employees. However, other employees may not participate in a top hat plan.

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