Source: Pension & Benefits Daily: News Archive > 2017 > February > 02/15/2017 > Analysis & Perspective > View From McDermott: Considerations in Designing Severance Plans and Arrangements for Tax-Exempt Organizations

View From McDermott: Considerations in Designing Severance Plans and Arrangements for Tax-Exempt Organizations

By Joseph Urwitz and Ashley McCarthy

Joseph Urwitz (jurwitz@mwe.com) is a partner in the law firm of McDermott Will & Emery in Boston. He focuses his practice on a variety of compensation and benefit issues relevant to tax-exempt entities, including retirement, deferred compensation, incentive and severance arrangements, employment and change in control agreements, plan correction procedures and affiliations between tax-exempt entities.

Ashley McCarthy (amccarthy@mwe.com) is an associate in the law firm of McDermott Will & Emery in New York. She focuses her practice on a variety of employee compensation issues, including non-qualified deferred compensation, incentive compensation arrangements maintained by for-profit and tax-exempt entities, and employment and severance arrangements.

The authors thank Nancy Gerrie, Todd Solomon and Mary Samsa, partners in McDermott Will & Emery's Chicago office, for their assistance in preparing this article.

Introduction

There are numerous reasons why organizations exempt from taxation under Internal Revenue Code Section 501(c)(3), as amended (the "Code" and, such organizations, "Tax-Exempt Entities") may offer severance payments to employees who incur involuntary terminations of employment. For example, severance that is conditioned on the departing employee's execution of a release of claims in favor of the Tax-Exempt Entity can reduce the likelihood of costly and burdensome litigation. Similarly, payment of severance may reduce the risk of negative publicity for the Tax-Exempt Entity by diminishing resentment felt by departing employees. Severance may also help retain existing employees by providing them with a measure of economic security that can dissuade them from seeking alternative employment, particularly if they suspect that the Tax-Exempt Entity has encountered budgetary shortfalls and may be implementing near-term workforce reductions. For these and other reasons, many Tax-Exempt Entities have either implemented or are considering implementing severance programs. Tax-Exempt Entities should be aware of unique opportunities and recent IRS regulations that impact the design of severance programs. This article discusses key decisions and planning opportunities for Tax-Exempt Entities to consider when designing and implementing severance plans and individual severance arrangements. Tax-Exempt Entities face a number of legal and regulatory challenges in establishing severance arrangements, particularly with respect to executive-level severance, as discussed in more detail in Part I. Part II discusses the legal parameters around using Code Section 403(b) retirement savings plans to offer severance to employees with lower levels of compensation.

Part I: Bona Fide Severance Plans and Window Programs under the New Proposed Code Section 457(f) Regulations

A. Taxation of Severance under Code Section 457(f)

Code Section 457(f) generally governs the deferral of compensation payable by Tax-Exempt Entities to their employees. Amounts deferred under a severance plan subject to Code Section 457 are generally taxable to the employee on the later of the first date on which there is a legally binding right to the compensation or, if the compensation is subject to a substantial risk of forfeiture, the first date on which the substantial risk of forfeiture lapses. We refer to this as the "Income Inclusion Rule." Amounts are subject to a "substantial risk of forfeiture"—and therefore are not yet included in taxable income—if entitlement to those amounts is "conditioned on the future performance of substantial services." But the "substantial risk of forfeiture" may lapse—and the attendant taxation event may occur—long before the employee actually receives the deferred income.

Fortunately, the IRS released long-awaited regulations under Code Section 457(f) on June 22, 2016 (the "Proposed Regulations") that provide more detail on how Tax-Exempt employers can structure severance programs to avoid the early imposition of tax due to the Income Inclusion Rule.

B. The Bona Fide Severance Pay Plan Exemption

Under the Proposed Regulations, a plan or arrangement qualifies as a "bona fide severance pay plan", and is therefore not subject to the Income Inclusion Rule, if it meets all of the following three requirements (the "Severance Plan Exemption"):

Requirement One: Benefits under the plan are only payable upon an involuntary severance from employment or pursuant to a window program (as detailed below).

Requirement Two: The amount payable does not exceed two times the participant's annualized compensation, based on the annual rate of pay for the calendar year preceding the calendar year in which the participant has a severance from employment with the Tax-Exempt Entity (or the current calendar year if the participant had no compensation for services provided to the Tax-Exempt Entity in the preceding calendar year).

Requirement Three: The entire severance benefit must be paid to the participant no later than the last day of the second calendar year following the calendar year in which the severance from employment occurs, pursuant to a requirement contained in a written plan document.

The Proposed Regulations further define "involuntary severance from employment" (for purposes of meeting *Requirement One* of the Severance Plan Exemption) as "a severance from employment due to the independent exercise of the [Tax-Exempt Entity's] unilateral authority to terminate the participant's services, other than due to the participant's implicit or explicit request, if the participant was willing and able to continue performing services." Whether a severance from employment is involuntary "is based on all the facts and circumstances without regard to any characterization of the reason for the payment by the [Tax-Exempt Entity] or participant."

Additionally, the Proposed Regulations specify that an employee's resignation for "good reason" qualifies as an "involuntary severance from employment," so long as (i) the triggers permitting an employee to resign for "good reason" are pre-specified in writing and meet certain requirements (as described in greater detail below), and (ii) the "primary purpose" of including the "good reason" triggers in the arrangement, or of the actions by the employer that satisfy the "good reason" triggers, is not avoidance of Code Section 457(f).

The Proposed Regulations provide that a resignation for "good reason" will only be treated as an "involuntary severance from employment" if the relevant facts and circumstances demonstrate that the resignation was the result of "unilateral [Tax-Exempt Entity] action" that causes a "material negative change" to the employee's relationship with the Tax-Exempt Entity. The following factors may provide evidence of the required "material negative change": (i) a material reduction in the duties to be performed; (ii) a material negative change in the conditions under which the duties are to be performed; (iii) a material reduction in the compensation to be received for performing such services; (iv) the extent to which the payments upon a resignation for good reason are in the same amount and made at the same time and in the same form as payments that would be made upon an actual involuntary termination by the Tax-Exempt Entity; and (v) whether the employee is required to give the Tax-Exempt Entity notice of the existence of the "good reason" condition and a reasonable opportunity to remedy such condition.

The Proposed Regulations provide a safe harbor definition of "good reason." If a severance plan or arrangement complies with the "safe harbor" definition described in the Proposed Regulations, the plan or arrangement's "good reason" will be deemed to satisfy the involuntary severance from employment condition of *Requirement One*.

On a separate but related note, Tax-Exempt Entities should also bear in mind the private inurement doctrine when crafting severance arrangements for their senior executives. While a detailed discussion of the doctrine is beyond the scope of this article, the general requirement of the doctrine is that severance should not be "excessive." By way of context, a recent national survey of college presidents found that 60% of private universities provide severance to their presidents and, of those that do, over half provided twelve months of severance. However, each Tax-Exempt Entity will need to review the facts and circumstances of its own particular arrangements to ensure it does not violate the private inurement doctrine.

C. The Short-Term Deferral Rule

Code Section 457(f) provides an exemption from immediate taxation for payments that are made shortly after the right to the payment becomes "vested"—that is, when it is no longer subject to a substantial risk of forfeiture. Generally, if a payment is made not later than March 15 of the year following the year of vesting, taxation does not occur until payment occurs, rather than upon vesting. This rule is commonly known as the "short-term deferral rule." For example, an employee might become entitled to a $50,000 annual incentive payment based on her 2017 calendar year performance. If the incentive arrangement provides that she has a right to receive the payment if she is employed on December 31, 2017, she would have vested in the right to the payment on that date and, absent the short-term deferral rule, would have been required to report $50,000 in income in 2017, even if the bonus was not paid until 2018. Because of the short-term deferral rule, however, if she receives her incentive payment on or before March 15, 2018, the incentive payment will not be taxable until paid. While beyond the scope of this article, making the incentive payment after March 15, 2018, could also raise compliance issues under Code Section 409A unless payment timing was carefully structured.

The short-term deferral rule can also apply in the severance context. Specifically, to the extent severance is paid on or before March 15 following the year of employment termination, the amount payable is not limited to the amount described in *Requirement Two* above (i.e., two times the employee's annualized compensation). The Severance Plan Exemption and the short-term deferral rule can be combined to structure severance payments such that a portion of the severance is paid during a period later than March 15 of the year following the year of termination under the Severance Plan Exemption and a portion is paid on or prior to March 15 of the year following the year of vesting under the short-term deferral rule, as illustrated below.

D. Example

Assume a Tax-Exempt Entity is party to an employment agreement with Ms. Smith (the "Smith Employment Agreement"). Pursuant to the Smith Employment Agreement, if the Tax-Exempt Entity terminates Ms. Smith's employment without cause, Ms. Smith is entitled to a severance payment equal to 36 months' continued base salary, payable in equal monthly installments over the three years following her employment termination. Assume further that Ms. Smith received annual compensation equal to her base salary for calendar year 2016. If the Tax-Exempt Entity terminates Ms. Smith's employment without cause on October 31, 2017, the final twelve months' severance (*i.e.*, the amount in excess of two times her 2016 compensation) would be taxable upon her termination if the Severance Plan Exemption were available but not the short-term deferral rule. But using the short-term deferral rule in conjunction with the Severance Plan Exemption allows the full amount of the severance payment to be made without subjecting amounts to tax before payment. Specifically, the Smith Employment Agreement could be designed such that (a) amounts up to two times Ms. Smith's 2016 compensation are paid over the two-year period following her employment termination and (b) amounts which exceed two times her 2016 compensation are paid on or before March 15, 2018. Structuring the Smith Employment Agreement this way results in no taxation before payment, though it does cause the severance to be paid over a shorter period of time (i.e., by October 31, 2019, rather than October 31, 2020).

E. Window Programs

As noted above, the Proposed Regulations provide that, to meet *Requirement One* of the Severance Exemption, a severance arrangement must *either* only provide severance benefits upon an "involuntary severance from employment," *or* be a window program. Window programs are severance programs established by an employer to provide severance pay in connection with a severance from employment (including a voluntary resignation) during a limited period of time (typically no longer than 12 months).

Window programs may provide severance only to individuals whose termination occurs under specified circumstances during the window period or to all individuals whose severance termination occurs during the window period. A program is *not* a window program under the Proposed Regulations if it is part of a pattern of multiple similar programs that, if offered as a single program, would not be a window program. In other words, Tax-Exempt Entities cannot establish a rolling series of supposed window programs to circumvent *Requirement One* of the Severance Exemption. However, if a Tax-Exempt Entity is planning a discrete reduction in force, a well-designed window program would permit the Tax-Exempt Entity to incentivize employees to voluntarily resign by offering them severance payments without subjecting such severance payments to the Income Inclusion Rule.

Part II. Post-Termination Contributions to 403(b) Retirement Plans

Tax-Exempt Entities that sponsor a retirement savings plan under Code Section 403(b) ("403(b) Plan") can use a mechanism for providing post-termination payments to their non-highly compensated employees (for 2017, those with compensation under $120,000 in 2016, subject to adjustment in future years) ("NHCEs") without having to grapple with the Income Inclusion Rule, Severance Plan Exemption, and other rules described above. Pursuant to a sometimes overlooked provision of the Code Section 403(b) regulations, if its 403(b) Plan so allows, a Tax-Exempt Entity may continue to make employer non-elective contributions to the 403(b) Plan on behalf of a former employee through the end of the five taxable years following the taxable year in which the former employee ceases to be an employee. Each annual post-employment non-elective contribution must not exceed the lesser of (i) the dollar amount in Code Section 415(c)(1)(A) (i.e., $54,000 for 2017); or (ii) the former employee's annual includible compensation based on the former employee's average monthly compensation during his or her most recent year of service.

In the case of former part-time employees or former full-time employees who were employed for only part of the most recent year, the former employee's "annual includible compensation" during his or her "most recent year of service" is calculated by aggregating the former employee's most recent periods of service until the former employee's service equals, in the aggregate, one year of service. These non-elective contributions, like all contributions to a 403(b) Plan, would not be includible in the former employee's taxable income until they are distributed to the former employee.

Tax-Exempt Entities are advised to offer such post-termination contributions only to NHCEs. The IRS non-discrimination testing in this area is highly complex and ill-defined, and requires plan sponsors to perform calculations with respect to previous years in which the benefit is offered. Post-termination contributions may even pass non-discrimination testing in one year only to have that year's contributions cause the plan to fail discrimination testing in future years. Note that there is no analogous rule permitting extended post-termination payments under a so-called "401(k) plan" (i.e., a profit-sharing plan with an elective deferral feature). Rules under Code Section 401(k) allow for the deferral of certain post-termination compensation (but not severance pay) during the two-and-a-half-month period following employment termination.

Part III. Conclusion

Tax-Exempt Entities face different challenges and opportunities than do their non-tax-exempt peers in designing severance arrangements. While the Income Inclusion Rule requires careful structuring to avoid immediate income inclusion, the availability of the special 403(b) Plan rule means Tax-Exempt Entities have an additional opportunity to provide tax-deferred severance pay to their NHCEs.

ISSN 2161-8704