SEPARATION AGREEMENTS: BREAKING UP IS HARD TO DO

"The employer-employee bond is sometimes difficult to sever."

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Goodbye: Essential Elements

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III. Is your severance arrangement subject to ERISA?
IV. Does your severance arrangement provide pension or welfare benefits?
V. The top-hat plan exemption from ERISA
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Goodbye: Essential Elements

I. ERISA's Requirements
   - A. File Form 5500 (unless exempted)
   - B. Plan must be in writing and provide detailed claim procedures
   - C. Provide a Summary Plan Description ("SPD")
   - D. Provide Summary Annual Report (unless applicable exemption)
   - E. Stringent Fiduciary Responsibilities

Goodbye: Essential Elements

II. Failure to Satisfy ERISA's Requirements

- civil penalties up to $110 per day per violation for failure to provide participants of the severance plan with required documents when requested (including Summary Plan Descriptions etc.);
- civil penalties up to $1,100 per day for failure to file an annual report (i.e., Form 5500); and
- criminal penalties for failure to comply with governmental reporting and disclosure requirements including possible imprisonment and fines of up to $500,000 if the violation is willful.

Goodbye: Essential Elements

III. Is your severance arrangement subject to ERISA?

- ERISA applies to "any ***plan***…established or maintained by an employer…for the purpose of providing participants" certain benefits.
- Since ERISA does not provide a definition for the term "plan," the U.S. Supreme Court issued guidance in Fort Halifax Packing Co. v. Coyne where it held that a "one-time, lump sum [severance] payment triggered by a single event requires ***no administrative scheme*** whatsoever to meet the employer's obligation" and therefore does not constitute a "plan" subject to ERISA. 482 U.S. 1 (1987).

Goodbye: Essential Elements

New York courts will examine the following factors to determine if an "administrative scheme" exists:

- the types of payments made under the arrangement (lump sum, period, alternative forms);
- whether the arrangement requires managerial discretion in its administration;
- whether a reasonable employee would perceive an ongoing commitment by the employer to provide employee benefits;
- whether the employer's right to terminate the plan is absolute.
- whether the employer is required to analyze the circumstances of each employee's termination separately in light of certain criteria.

Goodbye: Essential Elements

- New York courts have not decided which one of the above factors is determinative in every case, nor have New York courts excluded the possibility that when addressing different situations, other factors may be relevant.

- Employers must also recognize that even *individual* severance arrangements may create ERISA plans.

Goodbye: Essential Elements

IV. Does your severance arrangement provide pension or welfare benefits?

- Under ERISA, benefits provided under a severance plan may be characterized as a welfare or pension benefit depending on the facts
- Distinction is of material importance because if severance payment is a pension benefit then, unless the plan qualifies as a top-hat plan, the plan will be subject to additional ERISA's rules regarding participation, vesting, funding and governmental reporting and disclosure.
- Whereas, if severance is considered a welfare benefit, the plan is only subject to ERISA's rules requiring governmental reporting and disclosure. An additional exception to governmental reporting and disclosure applies to welfare plans that qualify as top-hat plans. ERISA's rules governing participation, vesting and funding do not apply to welfare benefits.

Goodbye: Essential Elements

Under U.S. Department of Labor regulations, severance benefits will be considered welfare benefits and not pension benefits if:

- the severance payments are not contingent, directly or indirectly, upon the employee's retiring;
- the total amount of severance paid does not exceed two (2) times the employee's annual compensation during the year immediately preceding the termination of employment; and
- unless the severance is paid in connection with "a limited program of terminations" [as defined by regulation], all severance payments must be made within twenty-four (24) months after the termination of the employee's service.

Goodbye: Essential Elements

v. Top-Hat Plan Exemption

Top-hat plans are unfunded plans that employers maintain primarily for the purpose of providing benefits to a select group of management or highly compensated employees. Top-hat plans may cover a group of employees or just one employee.

- Top-Hat Pension Plans. Top-hat plans that provide pension benefits are not subject to ERISA's rules regarding participation, vesting and funding. Furthermore, such plans may satisfy ERISA's governmental and reporting requirements by filing a one-time statement with the U.S. Department of Labor (a "top-hat statement") within one-hundred and twenty (120) days of adoption and providing plan documents to the U.S. Department of Labor upon request.

Goodbye: Essential Elements

- Top-Hat Welfare Plans. Top-hat plans that provide welfare benefits are exempt from ERISA's governmental reporting and disclosure requirements so long as such plans provide plan documents, upon request, to the U.S. Department of Labor.

Goodbye: Essential Elements

VI. Advantages of ERISA's Application

- Plans are subject to federal rather than state court jurisdiction'
- Employer and participants may benefit from ERISA preemption
- Benefits are protected from creditors in the event of personal bankruptcy

Severance Releases: A trap for the unwary

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Taxation: How does 409A impact severance pay

A. Hi Employer & Employee, My Name is 409A
   - Congress enacted Internal Revenue Code ("Code") Section 409A ("Section 409A") as part of the American Jobs Creation Act of 2004 which generally was effective on January 1, 2005.
   - Between 2005 and December 31, 2008, compliance with Section 409A generally required compliance with interim Internal Revenue Service ("IRS") guidance and a reasonable, good faith interpretation of Section 409A.
   - Effective January 1, 2009, Final Regulations issued by the Treasury Department require strict compliance with the approximate 400 pages of guidance.

Taxation: How does 409A impact severance pay

B. Section 409A's Application to Separation Pay

- Section 409A imposes complex new requirements on nonqualified deferred compensation plans that must be satisfied to avoid:
  - immediate income inclusion (on amounts deferred even if it is not yet received),
  - a 20% additional tax penalty; and
  - interest on back taxes at a higher-than-standard rate.

- Employers need to be aware of Section 409A in structuring employment and severance agreements because violations cause the imposition of significant penalties on the employee and imposes additional withholding & reporting obligations on the employer.

Taxation: How does 409A impact severance pay

- Section 409A applies, in relevant part, where an employee has a legally binding right to compensation that is not payable until a later year.

- Section 409A has special rules applicable to separation pay plans. A separation pay plan is a plan, including a portion of an agreement with one individual, which defers compensation that is not payable under any circumstances unless the employee has a separation from service, whether voluntary or involuntary.

Taxation: How does 409A impact severance pay

C. Potential Exemptions for Severance Arrangements

- Involuntary Terminations provided certain requirements are met.
- Terminations for Good Reason provided certain requirements are met.
- Termination pursuant to a Window Program provided certain requirements are met.
- Certain Collectively Bargained Severance Arrangements.
- Severance paid within short-term deferral exception.
- Certain foreign severance arrangements.
- Limited amount of severance that does not exceed $16,500.

Taxation: How does 409A impact severance pay

D. Employer Reporting Obligations

With respect to an employee's deferral of compensation within the meaning of Section 409A, the Code requires an employer to:

- report to an employee the amount of all deferrals subject to Section 409A on a Form W-2 regardless of whether the deferral of compensation violates Section 409A; and
- treat any amounts currently includible in the employee's income under Section 409A as "wages" and withhold income tax.

Taxation: How does 409A impact severance pay

Reporting Section 409A Deferrals for Employees

- An employer is required to report to an employee the total amount of deferred compensation subject to Section 409A in box 12 of Form W-2 using code Y.

- However, on December 10, 2008, the IRS issued guidance waiving this requirement so that employers will not be responsible for code Y reporting for Section 409A deferrals in calendar year 2008. In addition, the waiver of this requirement will remain in effect for subsequent future calendar years until the IRS issues further guidance.

Taxation: How does 409A impact severance pay

Withholding on Wages Includible in Income under Section 409A

An employer must treat any amounts includible in an employee's income under Section 409A as "wages" and:

- report such amounts as wages paid on line 2 of Form 941, Employer's Quarterly Federal Tax Return;
- report such amounts in box 1 of Form W-2 as wages paid to the employee and subject to income tax withholding;
- report such amounts as Section 409A income in box 12 of Form W-2 using code Z; and
- treat such amounts as "supplemental wages" and withhold income tax on that basis (except that the amount to be withheld is not increased on account of the 20% additional tax and interest imposed as a result of violating Section 409A).

Reimbursing Expenses in Connection with Termination

- Payments, such as the reimbursement of certain expenses or the provision of in-kind benefits, to an employee (or former employee) in connection with the employee's termination may be subject to Section 409A.

- This includes reimbursement of medical expenses as well as other expenses.

Reimbursing Expenses in Connection with Termination

Reimbursement of Medical Expenses

- Nontaxable Health Coverage. Arrangements that provide nontaxable health coverage are not subject to Section 409A. A right to a nontaxable benefit is not subject to Section 409A.
  - As such, Section 409A will not apply where an employee receives insured medical benefits post-termination because this benefit is generally nontaxable.

Reimbursing Expenses in Connection with Termination

- Taxable Reimbursements of Medical Expenses. Taxable reimbursements include payments made directly to the former employee before former employee incurs the medical expenses or benefits provided by a self-funded health plan that discriminates in favor of the highly compensated.
  - An employee may generally receive taxable reimbursements of medical expenses, without being subject to Section 409A, for a period of eighteen (18) months. This exception is administered as if the employee had elected COBRA coverage and paid the applicable premiums. During the COBRA coverage period, generally eighteen (18) months, an employer may provide taxable reimbursements of medical expenses. Employers that wish to provide taxable reimbursements of medical expenses beyond the general eighteen (18) month period must structure the arrangement to comply with Section 409A.

Reimbursing Expenses in Connection with Termination

Reimbursing Other Expenses

Provided that certain conditions are satisfied, Section 409A does not apply to reimbursement of the following:

- expenses that the employee can deduct under Code Sections 162 and 167 (as business expenses in connection with the performance of services);
- outplacement expenses; and
- moving expenses. (Moving expenses include the reimbursement of all or part of any loss the employee actually incurs due to the sale of a primary residence in connection with a termination.)

- These expenses must be incurred and reimbursed before the end of the second calendar year following the year in which employment terminated and the reimbursement payment must be made no later than the end of the third year following the year in which employment terminated. Otherwise, the reimbursement arrangement is subject to Section 409A and must be structured for compliance.

Separation Agreements

Participant Questions

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