

## **H. SEVERANCE PAY PLANS OF STATE AND LOCAL GOVERNMENT AND TAX-EXEMPT EMPLOYERS**

by  
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### **1. Introduction**

Section 457 plans are nonqualified, unfunded deferred compensation plans established by state and local government and tax-exempt employers. All plans of deferred compensation established by these employers are generally eligible (covered by 457(b)) or ineligible (covered by 457(f)) plans, subject to specific requirements and deferral limitations of section 457 of the Internal Revenue Code of 1986 ("Code"). This article will examine those plans which are not subject to the requirements of section 457, and specifically those plans which are classified as "bona fide severance pay plans" within the meaning of section 457(e)(11). The purpose of this article is to identify the differences between a severance pay plan, which is exempt from section 457, and a section 457 plan providing for the deferral of compensation. By recognizing those factors that characterize each type of plan, it will be easier to identify when a purported severance pay plan is in fact a plan of deferred compensation subject to the requirements of section 457.

### **2. Section 457 of the Code**

Section 457 of Code controls the income tax treatment of elective and nonelective nonqualified deferred compensation plans established by tax-exempt organizations and state or local governmental entities. Section 457 plans are unfunded plans. Unless a Plan is exempt from section 457, (for instance, if it were a bona fide severance pay plan) the Plan must satisfy the requirements of section 457(b) and limit both elective and nonelective deferrals to the lesser of \$7,500 or 33 1/3% of a participant's includible compensation for the year, or the amounts deferred are included in the gross income of a participant for the first taxable year in which there is no substantial risk of forfeiture under section 457(f).

The advantage of having a plan qualify as a "bona fide severance pay plan" excepted from section 457 is that it may provide benefits in excess of the \$7,500 deferral limit for eligible 457(b) plans and the amounts deferred need not be subject to a substantial risk of forfeiture as is otherwise required under 457(f). In fact, the benefits provided often amount to 10 to 20 times the annually permitted deferral under an eligible section 457 plan, or even greater. However, if a

severance pay plan is found to be a deferred compensation plan subject to section 457(f), then all amounts not subject to a substantial risk of forfeiture are currently taxable to the employees, for both income and employment tax purposes.

Section 457 applies to all plans, both elective and nonelective, providing for the deferral of compensation. In Notice 87-13, 1987-1 C.B. 432, Q-and A-26, the Internal Revenue Service ("IRS") addressed the question of which types of plans are subject to section 457:

Section 457 applies to amounts deferred under a deferred compensation plan regardless of whether the plan is in the nature of an individual account or defined contribution plan or defined benefit plan, including a deferred compensation plan that provides benefits in excess of the benefits provided under a qualified plan under section 401(a), a deferred compensation plan that provides benefits in excess of the benefits permitted to be provided under a qualified plan on account of section 415, and a deferred compensation plan that provides benefits only to a select group of executives or other highly compensated employees (e.g. a "top hat" plan). Also, section 457 applies to amounts deferred even though deferred amounts are determined by reference to factors other than the annual compensation of the individual (e.g., years of service, final average salary), uncertain in aggregate amount, and are payable over an indeterminable period (e.g., over the life of the individual).

Thereafter, in Notice 88-8, 1988-1 C.B. 477, the Service sought to further explain its position on the scope of section 457 by clarifying that:

a bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plan maintained by a state or local government or tax-exempt organization will not be subject to the provisions of section 457 for taxable years of employees beginning before the issuance of guidance describing the extent to which these forms of compensation are subject to section 457. The exemption applies to such plans whether they are elective or nonelective.

Finally, in Notice 88-68, 1988-1 C.B. 556, the Service announced that the types of plans described in Notice 88-8, including bona fide severance pay plans, would not be treated as deferred compensation plans subject to section 457 when regulations were issued. The Notice also stated that this rule would apply without

regard to whether such plan is elective or nonelective in nature. The Notice concluded with a comment that "{a} number of issues remain with respect to section 457, including when a vacation leave, sick leave, compensatory time or severance pay plan is bona fide, and not a mere device to provide deferred compensation." (Emphasis added).

### 3. Section 457(e)(11) of the Code

Section 457(e)(11) of the Code, enacted as part of the Tax and Miscellaneous Revenue Act of 1988 ("TAMRA"), effectively superseded the notices discussed above. Section 457(e)(11) provides that "{a}ny bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plan shall be treated as a plan not providing for the deferral of compensation." The legislative history of TAMRA indicates that this section was intended to codify Notice 88-68, but provides no further explanation. The Service has not yet provided any interpretative guidance, either in the form of regulations or otherwise, with respect to Section 457(e)(11).

The position of the Service, however, is that the mere designation of a plan as a "bona fide severance pay plan" under 457(e)(11) is meaningless if the benefit package provided, as well as the spirit of the plan, is more in the nature of a deferred compensation plan. As Notice 88-8 articulated, if a plan is set up as a mere device to provide deferred compensation, then it is not a severance pay plan. An analysis of the differences between these two kinds of plans is necessary in order to determine when a "severance pay plan" is really a plan of deferred compensation.

### 4. What is a Severance Pay Plan?

Although the Service has not published any guidance defining "bona fide severance pay plan" for purposes of section 457, other sections of the Code, the Department of Labor regulations, and the case law do provide some guidance. It should be noted, however, that many of the Code sections, regulations and cases to be discussed determine whether an arrangement is one of deferred compensation and not whether the plan may be characterized as "a bona fide severance pay plan" under section 457(e)(11). Nevertheless, these items provide some indication of how it is possible to differentiate between severance pay plans and plans of deferred compensation.

Generally, the term "severance pay" connotes payment to an employee

because of his or her termination of employment under an unanticipated set of circumstances, rather than compensation that has been unconditionally deferred until termination of employment. Severance plans have as their basic function the payment of benefits on account of a separation from service due to a contingency beyond the control of the employee. For example, employees who are laid off or dismissed due to corporate downsizing or restructuring would be paid these benefits, while those that held their jobs would have no rights to those funds. Thus, these arrangements generally provide payments to employees because employment has been terminated, not simply when employment terminates. Payments regarded as severance may also include payments made to employees who voluntarily terminate employment, most often before attainment of retirement age, as part of a window-type early retirement incentive program.

In contrast, the more common nonqualified deferred compensation arrangement would be structured to postpone the payment of income taxes on compensation for current services until the payment of benefits under the plan, usually when the participant retires, separates from service, dies or becomes disabled. The employee is entitled to these benefits conditioned only by years of service. The employee knows of and can plan on these benefits. Thus, the more common deferred compensation plan has as its central characteristics the accrual of benefits by reason of the passage of time and the payment of these benefits to the participant at his retirement.

#### A. Under ERISA

One of the authorities practitioners rely on when designing their plans as severance pay plans is the Department of Labor regulation describing what a severance pay plan is under the Employee Retirement Income Security Act of 1974 ("ERISA"). Section 3(2)(B) of ERISA authorizes the Secretary of Labor to adopt regulations under which severance pay arrangements will be classified as welfare benefit plans rather than pension plans for purposes of Title I of ERISA. This section further provides that a plan shall nevertheless be treated as a pension plan if it has the principal effect of evading the standards applicable to pension plans. Under section 3(2)(A), a "pension plan" is generally defined as a plan that provides retirement income to employees or results in a deferral of income by employees for periods extending to the time of termination of covered employment or beyond, regardless of the method of calculating the contributions made to the plan, the method of calculating the benefits under the plan or the method of distributing benefits under the plan. Section 3(1) of ERISA defines an "employee welfare benefit plan" generally as a plan maintained for the purpose of

providing medical, surgical, or hospital care or benefits, or benefits in the event of sickness, accident, disability, death or unemployment, or vacation benefits, as well as some other specific benefits.

A comparison of the two ERISA plan definitions highlights the major difference between these two types of plans. A pension plan provides retirement or other deferred income based on the premise that benefits increase with tenure and job longevity, whereas a welfare plan provides a more or less fixed benefit payable only upon the occurrence of a specific, often contingent, event, such as sickness or unemployment.

Section 2510.3-2(b)(1) of the Labor regulations under ERISA provides that an arrangement providing for "severance benefits on account of" termination of employment will not be treated as a pension plan if (i) the payments are not contingent, directly or indirectly, on the employee's retirement, (ii) the total payments do not exceed twice annual compensation, and (iii) the payments are generally completed within two years of termination of employment. Apart from the three specific requirements, the regulation is limited to plans that pay "severance benefits on account of termination of employment..." The one case to address this issue concluded, in fact, that this regulation has no applicability to a plan that unconditionally provides benefits upon termination of employment. See, Lima Surgical Associates, Inc. v. United States 20 Cl. Ct. 674, 686-687 (1990), aff'd, 944 F.2d 885 (Fed. Cir. 1991).

Standard characteristics of plans that unsuccessfully purport to be severance pay plans are provisions that are drafted to comply with the technical requirements of the Department of Labor regulations so that they appear like severance pay arrangements, but otherwise contain all of the structural elements and substantive provisions generally associated with deferred compensation plans subject to section 457. For example, under such a plan, termination of employment may mark the time when the deferred compensation is paid, rather than the event that gives rise to the employer's payment obligation. The plan merely defers compensation to the point in time when the participant terminates employment, whether voluntarily or involuntarily. There is no contingency that is normally associated with severance pay plans. The participants get their money no matter what the reason for terminating employment, even though it may be limited to two times the annual compensation of the participant and be paid out within two years time.

Another way employers try to circumvent the rules is by drafting a plan that

only permits the payment of benefits in the case of "involuntary retirement", but that then defines "involuntary retirement" so broadly that a participant will, in fact, receive the benefits no matter what the reason for leaving. When reviewing severance pay plans, it is important to look beyond the standard definitions given and determine the actual facts and circumstances applying to each individual situation.

Ultimately, any arrangement of a state or local government or tax exempt employer that is clearly equivalent to a nonqualified deferred compensation plan should be subject to section 457.

#### B. Section 404/Section 419/162 Distinction

While state and local governments and tax-exempt employers take no deductions for contributions made to their plans, the Code sections dealing with deductions for taxable employers nevertheless provide yet another distinction in the treatment of severance plans and deferred compensation plans. If a plan is a plan of deferred compensation, then section 404 will govern the timing of the deduction for income tax purposes. If the plan is something other than a deferred compensation plan, such as a severance pay plan or other welfare benefit plan, then section 419 governs when an employer may take a deduction for contributions made to the plan. Thus, an analysis of the characteristics used to distinguish between these kind of plans for deduction purposes can illuminate the differences between a severance pay plan and a plan of deferred compensation, even though no deduction is involved for employers who sponsor section 457 plans.

Section 404 sets out the rules governing the timing of employer deductions under nonqualified deferred compensation arrangements and qualified plans of taxable employers. If a plan is a deferred compensation plan, then payments are deductible under section 404(a)(5) of the Code only "in the taxable year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan." Section 1.404(a)-12(b)(2) of the Income Tax Regulations elaborates that "if unfunded pensions are paid directly to former employees, such payments are includible in their gross income when paid, and accordingly, such amounts are deductible under section 404(a)(5) when paid."

The regulations under section 404 distinguish between welfare benefit plans and deferred compensation plans. Regulation 1.404(a)-1(a)(2) provides that section 404 does not apply to contributions to a plan that is "solely a dismissal

wage or unemployment benefit plan, or a sickness, accident, hospitalization, medical expense, recreation, welfare or similar benefit plan, or a combination thereof." The regulations give an example of such a plan: "{I}f under a plan an employer contributes 5 percent of each employee's compensation per month to a fund out of which employees who are laid off will be paid benefits for temporary periods, but employees who are not laid off have no rights to the funds, such a plan is an unemployment benefit plan...." Reg. 1.404(a)-1(a)(2). The regulations further provide that when a plan has the features of both kinds of plans, the entire plan is evaluated under section 404(a). See Reg. 1.404(a)-1(a)(3).

Section 419(a), as enacted by the Tax Reform Act of 1984, prescribes limitations on deductions for contributions paid or accrued with respect to welfare benefit plans after December 31, 1985, in taxable years of employers ending after that date. See Reg. 1.419-1T Q-and A- 1 and 2. Contributions paid or accrued by an employer to such a fund will generally be deductible only when paid to the fund, subject to certain limitations. Sections 419, 419A. For purposes of the section 419 deduction, a welfare benefit is a benefit other than (1) property transferred in connection with the performance of services, and (2) qualified and nonqualified deferred compensation. See sections 419(e)(1), 419(e)(2). Section 1.419-1T, Q- and A-3 of the Income Tax Regulations provides that "{f}or purposes of this section, the term "welfare benefit" includes any benefit other than a benefit with respect to which the employer's deduction is governed by section 83(h), section 404 (determined without regard to section 404(b)(2)), section 404A, or section 463."

Prior to the enactment of section 419, section 162 governed the timing of deductions for contributions to welfare benefit plans and such deductions were allowed for all the "...ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business...." Under section 1.162-10(a) of the Income Tax Regulations, amounts may nevertheless not be deductible under section 162(a) "if, under any circumstances, they may be used to provide benefits under a stock bonus, pension, annuity, profit-sharing, or other deferred compensation plan of the type referred to in section 404(a)."

The case law in this area, which generally deals with pre-1986 deduction issues under section 162, has determined that so-called severance pay plans providing for payments in all events following termination of employment are deferred compensation plans, rather than dismissal or unemployment benefit plans. See New York Seven-Up Bottling Co. V. Commissioner, 50 T.C. 391 (1968); New York Post Corp. v. Commissioner, 40 T.C. 882 (1963). These cases are important

in that they shed some light on how the courts distinguish between the two kinds of plans, regardless of whether the deduction is now taken pursuant to section 419 rather than section 162.

Most recently, the Seventh Circuit Court of Appeals in Wellons v. Commissioner, T.C. Memo. 1992-704, aff'd 31 F.3d 569, (7th Cir. 1994), reviewed the issue of whether an employer's plan constituted a severance pay plan or a plan of deferred compensation for purposes of the employer's deduction under Section 404(a)(5) of the Code. Under that plan, a participant who terminated employment was entitled to a benefit equalling twenty-one (21) weeks of average weekly compensation for each year of service. The maximum allowable benefit was two times the annual salary of the participant for the year immediately preceding termination, and the benefits were paid under the plan within twenty-four (24) months of the severance. The Seventh Circuit Court, in affirming the Tax Court on this issue, determined that the plan in question was a plan of deferred compensation, even though it had some of the characteristics of a welfare benefit plan. The Court noted that:

On its face, Wellons' plan seems more akin to a pension plan than to a plan providing benefits corresponding to those listed alongside "welfare" benefits in 26 C.F.R. section 1.404(a)-1(a)(2). The instant plan is most akin to an arrangement providing either dismissal wages or unemployment benefits, but even these categories are obviously intended to apply narrowly in limited circumstances, and these plans operate more as insurance in case of a contingent event than as a guarantee of income upon a certain event. Wellons plan, by contrast, covers all employees who leave his employment for whatever reason. Similar to a pension plan, the benefits vest after five years of employment and are commensurate with salary and length of service.

Wellons, supra, at 571-572. Based on the foregoing, the Court determined that the contributions to the plan were governed by section 404(a)(5) and deductible only in the years when benefits were actually paid, disallowing the deductions taken pursuant to section 162. As an aside, it is interesting to note that the Court determined this despite the fact that the plan was set up to comply with the ERISA regulation dealing with severance pay plans under section 2510.3-2(b)(1) of the Labor regulations, as previously discussed.

In reviewing a plan that has the characteristics of both a deferred compensation plan and a welfare benefit plan, it is important to analyze whether

the plan operates more like a retirement plan than not.

### C. Section 501(c)(9) "VEBA" Analysis

Finally, a third analogous area where a distinction is made between severance pay plans and deferred compensation plans is under section 501(c)(9) of the Code, which defines tax exempt voluntary employee beneficiary associations ("VEBAs").

A "VEBA" is a tax-exempt entity created to fund life, sick, accident or other benefits for members, their dependents or designated beneficiaries. Section 501(c)(9). The regulations under this section explain that a VEBA may provide a benefit that "protects against a contingency that interrupts or impairs a member's earning power," including severance benefits described in the Department of Labor regulation, but not a benefit that is "...similar to a pension or annuity payable at the time of mandatory or voluntary retirement...." Reg. 1.501(c)(9)-3(d), (e) and (f). The regulations also pertinently provide that "...a benefit will be considered similar to that provided under a pension, annuity, stock bonus or profit sharing plan if it provides for deferred compensation that becomes payable by reason of the passage of time, rather than as the result of an unanticipated event." Reg. 1.501(c)(9)-3(f).

In Lima Surgical Associates Inc., v. United States, supra, a plan and trust were set up by an employer to provide severance pay to employees of a medical corporation. The Service argued that the plan and trust did not qualify as a "VEBA" under section 501(c)(9) because they failed to meet three of the four mandatory requirements for qualification. In particular, the Court determined that the plan and trust provided retirement benefits rather than the required welfare benefits. The so-called severance payments were computed on the basis of compensation and length of service and were not designed to provide for the replacement of income upon the happening of unforeseen events. Also, the plan was almost identical to the employer's discontinued retirement plan. The Court of Appeals for the Federal Circuit commented that "the taxpayer acknowledges that retirement is one of the several types of terminations that will trigger benefits under the Plan. The trial judge found that one of the important purposes of the Plan is to pay benefits to eligible members upon their retirement. As in a pension or annuity plan, the benefits are computed based on the employee's salary and length of service. The record reflects that the only participant to obtain benefits under the Plan did so upon retirement." See, Lima, 944 F.2d at 889-890. For all these reasons, the Court found that the plan and trust did not qualify as a

tax-exempt VEBA. See also, Canton Police Benevolent Assoc. v. United States, 844 F.2d 1231 (6th Cir. 1988) ("Dividend" paid to members of a VEBA only upon their retirement from police force was a retirement benefit and not a severance benefit, and employer was not entitled to tax-exempt VEBA status.)

The regulations under section 501(c)(9) focus on the conditions under which benefits are payable. Benefits under the VEBA may be paid only if they are triggered by a "contingency" or "unanticipated" event, not if they are simply deferred until termination of employment, as under a deferred compensation plan. We would argue that to fit within the exception under 457(e)(11), a severance pay plan would have to differ meaningfully from a deferred compensation plan in a similar manner.

#### D. Conclusion

As the foregoing discussion illustrates, there is ample guidance to assist in making an analysis of whether a plan is a severance pay plan or one of deferred compensation. This guidance is equally relevant for an analysis of whether a plan is a "bona fide severance pay plan" under section 457(e)(11) of the Code. In the absence of regulations on this issue under section 457, a review of these other sections of the Code, the Department of Labor regulation, and the case law can be used in trying to determine whether a plan is a "bona fide severance pay plan" under section 457.

#### 5. Sample Purported Severance Pay Plan

The following sample plan is typical of a plan that purports to be a severance pay plan, but is actually a plan of deferred compensation. It is representative of certain plans the Service has reviewed or audited. Under the Plan, a participating employee enters into an agreement with the Employer under which a specified amount of severance pay would be credited to the account for each year covered by the Agreement. The amount may be negotiated on an annual basis under a separate agreement, or for all plan years or a stated number of years until a stated level of benefits is reached. The negotiated benefits are reflected in separate bookkeeping accounts maintained by the Employer. Actual contributions are not made to the accounts, rather the balance represents nothing more than an unsecured promise to pay such benefits in the future. The Plan reflects that the Participants have no greater rights to the assets of the Employer than do any other unsecured creditors of the Employer. The Plan year is defined to mean the calendar year or other fiscal year which the employer selects. The Plan is not

intended to be "funded" within the meaning of ERISA.

Under the Plan, severance benefits are limited to two-times compensation (monetary and nonmonetary) for the Participant's final year of service and the benefits are payable in a single sum or in installments over a 24-month period following any termination from employment, including voluntary and involuntary termination, disability, death and retirement. Participation in the Plan is elective, and based on annually negotiated compensation packages. Participants' accounts are credited with earnings as determined by the Employer, and the amounts in the Participant's accounts are not subject to a substantial risk of forfeiture. Finally, participation in the Plan is limited to a "select" group of management or highly compensated employees.

The Service would certainly question the validity of such a plan as a "bona fide" severance pay plan excepted from section 457 under section 457(e)(11). The Service has not issued any ruling which determines that this type of arrangement is "bona fide" under section 457(e)(11), nor are we aware of any other authority where a plan which so closely resembles a nonqualified deferred compensation plan has been determined to be a "bona fide" severance pay plan. Under the Plan, the participants are able to defer a specific amount of compensation by contract before their services are performed and the distribution of the compensation deferred is not conditional on the termination of employment under limited circumstances or subject to a substantial risk of forfeiture. Such a plan is indistinguishable from a typical nonqualified deferred compensation plan and should not be characterized as a "bona fide severance pay plan" under section 457(e)(11), but as a plan of deferred compensation subject to all the requirements of section 457.

Additionally, the Service has reviewed other cases where a "purported" severance pay plan was in fact a plan of deferred compensation. For example, a so-called "severance pay plan" that uses the criteria of New York State Unemployment Law to define "involuntary termination", but that does not require the participants to actually qualify for New York State unemployment benefits and intends to construe the terms of the law liberally in favor of participants, constitutes a plan of deferred compensation. Moreover, a purported "severance pay plan" that provides that all terminations will be deemed "involuntary terminations" unless the employer states otherwise should be presumed to constitute a plan of deferred compensation designed to pay benefits in all events of termination.

## 6. Conclusion

When reviewing a severance pay plan of a state or local government or tax exempt employer, it is important to review whether the plan allows employees to defer portions of their salaries or otherwise provides deferred compensation benefits until such time that the employees separate from service. In particular, take the time to analyze whether the plan permits the deferral of income until retirement, and whether the benefits paid truly result from an unanticipated separation from service, and not merely the passage of time. Look beyond what the plan says and see what it does. If the plan resembles a section 457 plan, question its status as a severance pay plan.