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ERISA ALERT
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Is your severance plan exposing employees to penalties?

Many severance arrangements, including severance arrangements that are included in executive employment agreements, obligate employees to sign a general release in favor of the employer as a condition to receiving any severance payments from the employer upon termination of employment. Because Section 409A of the Internal Revenue Code generally limits the ability of an employer or employee to have discretion over the timing of when deferred compensation can be paid, a possible violation of Section 409A of the Code can arise if the requirement to execute a release in order to receive a severance payment does not sufficiently specify when the release must be executed. For example, in the absence of a time requirement for executing the release, an employee terminated in year 1 could choose to delay signing the release until year 2 in order to have the severance payments made in year 2. Such discretion would be viewed as a violation of Section 409A and would require that the employee recognize income in year 1 and pay penalties and interest.

As the above example illustrates, to avoid adverse tax consequences under Section 409A of the Code, it is essential that any severance arrangements that require an employee to execute a release as a condition to receiving any severance payments specify when the release must be executed and when the severance payment will be made after the release has been executed. The IRS has issued guidance for correcting severance arrangement documentation that does not comply with Section 409A. To fully correct without exposure to penalties, the amendments to the documents must generally be made before the triggering event for the severance payment occurs (i.e., termination of employment). Special transitional relief is available for documentation failures that are corrected by December 31, 2012.

Employers and employees who have severance arrangements are encouraged to review the documentation to confirm that the requirements of Section 409A of the Code are being complied with. Appropriate amendments should be made to correct any deficiencies or ambiguities.

This Alert is one in a series on the topic of ERISA and employee benefits. To read past alerts, please click here. For more information on this Alert of other ERISA matters, please contact:

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