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Severance and Deferred Compensation Consideration for Tax-Exempt Colleges and Universities

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In-house counsel and human resources professionals at tax-exempt colleges and universities often face a variety of challenges when structuring, and determining obligations due under, severance arrangements. There are some key considerations to bear in mind, which are outlined in this article.

IN DEPTH

Considerations When Structuring Severance Arrangements

Negotiating When Severance Is Due: Severance arrangements often provide payment only on an employee termination by the employer without “Cause” (*e.g.*, employee’s failure to follow directions from superiors, commission of a crime involving dishonesty or fraud,) or by the employee for “Good Reason” (*e.g.*, material salary reductions, relocation requirements). These terms are often among the most heavily negotiated in employment and severance agreements.

Deciding What Severance Benefits to Give: Severance generally includes cash payments based on a multiple of salary (*e.g.*, 12 months’ base salary). But severance may also consist of other payments or perquisites, such as an employer subsidy for COBRA coverage premiums. Executive-level benefits can be quite varied, and may include post-termination limited employment, tuition benefits for the employee’s dependents, and continued use of an office, library, gymnasium or other facility. An institution might consider spreading severance pay over more than one calendar year to avoid reporting a large number in a particular year (see “**Reporting**” below).

Restrictive Covenants: Especially at senior levels, severance is often conditioned on signing a release of claims and compliance with post-termination obligations. These releases often include restrictive covenants, including obligations not to compete, not to solicit other employees, to maintain the confidentiality of non-public information and not to disparage the employer. Release agreements require the employee to surrender the right to bring certain employment related claims against the institution.

Excise Tax Considerations: The Tax Cuts and Jobs Act of 2017 implemented two excise taxes on private universities. The first imposes a 21% excise tax on covered institutions on amounts paid to “covered employees” in excess of $1 million in any calendar year. The second is a 21% excise tax on payments to covered individuals in excess of three times their average compensation over the five years preceding the year of termination which are “contingent” on their separation from service. Carefully structuring severance arrangements in advance can mitigate or eliminate these excise taxes.

Tenure: Because universities generally cannot terminate tenured faculty members except for adequate cause or under extraordinary circumstances because of financial exigencies, universities often offer voluntary retirement incentive programs. For example, the university might offer tenured faculty two years’ pay, retiree medical coverage, and continued use of an office and campus facilities on turning age 68 but have the offer expire or reduce at age 70. A voluntary early retirement program would generally be in lieu of, and not addition to, other severance payments, and program documents should reflect that.

Considerations When Severance Is Due

Determining Which Documents Provide for Severance: Determine which arrangements provide for payments upon termination of employment and how those arrangements fit together. Review any relevant documents (*e.g.*, the employee’s individual offer letter, employment agreement and/or severance agreement, and any amendments). Next, locate and review any broad-based severance plans or policies. Finally, ensure that there are not any severance commitments being made to the terminated employee orally or by email. Employment termination is also a distribution event under tax-qualified retirement plans (and often non-qualified retirement plans), so those should be examined as well to determine whether benefits may be distributable.

Reporting: Private institutions generally must file an annual report on IRS Form 990, which requires institutions to report tax-year compensation for a number of individuals, including current officers, directors and trustees. States often have similar reporting requirements. Severance pay is included in the compensation disclosed, and, in order to avoid negative press, institutions often try to avoid reporting a large severance figure in a single year.

While this article provides an overview of severance and deferred compensation considerations for tax-exempt colleges and universities, we highly recommend consulting with legal and tax professionals before implementing severance arrangements, and again when severance and/or deferred compensation obligations are due.

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