

## In This Issue

*In this third issue of the McGraw Wentworth Benefit Advisor for 1999, we will focus on benefit offerings for separated employees. We have found that a little planning and careful negotiating with providers can make the difference in the successful execution of a severance agreement.*

*This issue will include a review of the following:*

★ *the variables involved in offering severance pay arrangements*

★ *the extension of welfare benefits under formal and informal severance plans*

*We welcome your comments and suggestions regarding this issue of our technical bulletin. For more information on this Benefit Advisor, please contact your Account Manager or visit the McGraw Wentworth interactive web site at [www.mcgrawwentworth.com](http://www.mcgrawwentworth.com).*

## “There Will Be A Few Changes”

### BENEFITS FOR SEPARATED EMPLOYEES

The involuntary separation of an employee, manager or executive can be a shock to both the individual and the organization. Outside of the Fortune 500, formal severance pay plans are rare, and so these separations often involve individually negotiated severance agreements.

*“Joel’s last day will be Friday. We have agreed to continue his pay for three months, to continue his medical and dental coverage for six months, and to allow him to continue to pay for his optional life insurance until he has found a new job. We also agreed that he will be eligible for the Profit Sharing Plan contribution at the end of the year.”*

*“Can we do that ? ”*

Before answering the question, we thought a brief review of the variables involved in offering severance pay arrangements might be helpful. We have found that a little planning and careful negotiating with providers can make the difference between a “yes” and a “no” answer.

### BACKGROUND

To provide for a smooth transition and to avoid legal disputes, many companies offer severance pay arrangements to involuntarily terminated employees. In

addition to cash compensation, an employer might offer other benefits to terminated employees, such as health care and life

insurance coverage, the payment of accrued vacation time, and outplacement assistance. A signed release form in which the employee gives up any potential rights to sue the employer in exchange for receiving the benefits frequently accompanies severance and early retirement benefit packages.

The term “severance pay” has no technical tax definition but generally refers to a payment to a former employee in connection with termination of employment. Severance arrangements are



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sometimes simply **informal** employer pay practices such as ad hoc payments for an isolated termination, but can also be **formal**, ERISA-governed, plans that have specific administrative requirements. The Bureau of Labor Statistics 1997 survey indicates that only 37% of employees are covered by **formal** severance pay plans. Most other employers negotiate **informal** severance pay arrangements as events occur.

## SEVERANCE PAY PLANS

### Formal

A formal severance pay plan looks much like any other ERISA-covered welfare benefit plan and operates under similar rules. The plan should be in writing, make appropriate filings, and comply with ERISA's fiduciary standards. To avoid being deemed a pension plan, severance pay plans must limit benefits to no more than twice the employee's prior annual compensation and complete all payments within 24 months of the termination.

Even without a written summary plan description (SPD) or plan document, severance pay arrangements can still constitute an ERISA-covered plan. Some courts have determined that a formal plan exists if established administrative procedures, past practices, or specific circumstances imply the existence of (1) intended benefits, (2) intended beneficiaries, (3) a source of financing, and (4) a procedure to apply for and collect benefits. Most standard em-

ployment agreements, such as personal service agreements, do not create ERISA-covered plans. However, the applicability of ERISA does not depend on the number of employees covered and courts have ruled that some individual agreements do constitute formal severance pay plans.



### Informal

Informal severance pay plans don't exist as a company policy; they are established as needed. When a situation such as a plant closing or executive termination occurs, a company extends or negotiates a "one-time" offer to the affected employee(s). By definition, there is no plan documentation except for the contract agreements and waiver notices drafted at the time of the event. The offer has no specific boundaries, but typically follows the pattern of formal severance pay plans and includes cash compensation outplacement services, and extensions of coverage under benefit plans.

### Formal vs. Informal

From a legal perspective, the arrangements are quite different.

A formal severance pay plan operates under ERISA's basic preemption rules to the extent that state laws "relate to" the plan. ERISA provides the exclusive remedies to participants and

preempts state causes of action for benefits. An informal severance plan does not operate under ERISA's pre-

emption of state contract enforcement for claims related to severance payments.

From a tax perspective, a severance arrangement's status as a formal plan has no effect on the tax treatment of severance benefits payable. Whether formal or informal, severance pay is generally considered taxable compensation to the recipient and a tax deductible ordinary and necessary business expense to the company. Severance benefits provided through the company group benefit plans are generally not taxable compensation to the recipient and are tax deductible to the company. However, extensions of benefits under self-funded plans could constitute impermissible discrimination under Internal Revenue

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## NOTABLE THOUGHTS

**DON'T BE AFRAID TO TAKE A BIG STEP IF ONE IS INDICATED;  
YOU CAN'T CROSS A CHASM IN TWO SMALL JUMPS.**

**DAVID LLOYD GEORGE**

Code section 105(h). When this occurs, the value of the discriminatory coverage becomes taxable wages to the ex-employee.

From a qualified retirement plan perspective, a severance arrangement's status as a formal plan has no effect because participation in qualified retirement plans must cease at the date of termination. Any extension of retirement benefits must either be done through a non-qualified retirement arrangement or through payment of additional taxable income.

Benefit extensions are permissible for welfare benefit plans, but there are significant differences between extending coverage through formal and informal severance pay plans.

## EXTENDING WELFARE BENEFITS

### Formal Plans

When a formal severance pay plan exists, many group benefit plan contracts can be modified in advance to allow for extended coverage. If a formal severance pay plan calls for a one week extension of health benefits for each year of service, the defined extension can be added to the eligibility and termination sections in a welfare plan SPD. For insured plan arrangements, the carrier underwriting the risk will typically want to review the specific severance pay document and may want to adjust premiums to reflect risk. Under self-funded

plan arrangements, stop loss insurance providers must be notified of the provisions and care must be taken to ensure that the extension does not constitute impermissible discrimination under IRC Section 105(h).

Severance extensions can typically be added to group medical, dental, vision, EAP, life insurance and optional life insurance plans - both insured and self-funded.

However, due to the specific contract language and high risk of claims, extensions are not typically available for group short term and

long term disability benefits. If a severance pay plan calls for extension of disability coverage, individual disability contracts could be underwritten that allow for continuation of coverage after separation of employment.

### Informal Plans

By their variable nature, informal severance pay arrangements cannot be pre-negotiated into group benefit plan contracts, therefore, post-agreement special arrangements must be made. In some situations, carriers/providers will agree to specific "one-time" extensions of coverage. In many situations, statutory extensions of coverage and existing contractual extensions will be available to provide benefits. Finally, if health evidence can be provided, the departing em-

ployee can enroll for individual coverage. If the individual has sufficient "credible coverage" as provided in the Health Insurance Portability and Accountability Act (HIPAA), health evidence requirements will be waived.

Specific "one-time" extensions can sometimes be negotiated for medical, dental, vision, EAP, and life insurance. Self-funded health plan arrangements offer

the most flexibility, but stop loss insurers must be notified and Section 105(h) discrimination rules will apply. Insured

short and long term disability plans are the least flexible and carriers generally will not extend coverage. There are no guarantees that "one-time" extensions will be available under any plan.

In most cases, informal severance pay benefits are provided through statutory benefit extensions (e.g., COBRA) and continuation or conversion options found in the existing group benefit plan contracts. COBRA typically allows group medical, dental, and vision coverage to be continued. Group life insurance contracts frequently include conversion privileges that can be exercised under a severance arrangement. Group optional life plans often include portability features that allow coverage to continue after termination.

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When using COBRA, be sure that a standard COBRA notice is provided and that the separated employee elects coverage. The company can pay COBRA premium for a period of time and, if time remains, the ex-employee may continue payments. Even under COBRA, self-funded arrangements may still run afoul of Section 105(h) discrimination rules if the ex-employee was highly compensated. Importantly, the length of the COBRA continuation period is not affected by the company payments and will be limited to the statutory duration (e.g., the 18-, 29- or 36-months).



For group life conversions, the company can agree to pay the conversion policy premium for the period specified in the severance pay arrangement with the ex-employee continuing payments after that time. Be

careful to understand the type of conversion available under your group life contract because some conversion options require payment of higher cost whole life premiums. Under group optional life plans, the better contracts allow for ex-employees to continue coverage at the same

rates paid prior to termination, while other contracts call for a higher premium or do not allow for continuation after termination. If available, the company can agree to pay premiums for a period of time, with the former employee continuing payments after that time.

Advance planning for informal agreements will avoid many problems. To be safe, the duration of the severance offer should not exceed the available COBRA extension period unless you have a quality health plan conversion option. Negotiate with your carrier for a group life

conversion option, preferably using low cost term insurance, and for a group optional life portability feature. If disability is a concern, as it often is for executives, consider implementing individual contracts that can be extended after the termination. Most importantly, make sure the person negotiating the severance agreement understands what is available.

### CAN WE DO THAT ?

*So, can we deliver on the promises made to Joel in our opening?*

*Yes.*

Extend Joel's COBRA coverage and have the company pay his medical and dental premium for the six month period. He can continue COBRA coverage for another 12 months by self-paying after the six months expire. Make arrangements to have his optional life changed to an individually billed (portable) arrangement and have him send the bill to the company until he finds that new job. Finally, calculate his profit sharing payment and provide it as a taxable income bonus payment with a tax gross up, if needed, to make him whole.

We hope that you find this information helpful. We provide it as a general guide and to share our experience with these situations. We always recommend that you consult your tax and legal counsel for specific advice about handling severance pay arrangements and the extension of benefit plan coverage.

Our technical bulletins are written and produced by the McGraw Wentworth staff and are intended to inform our clients and friends on general information relating to employee benefit plans. They are not intended to provide either legal or tax advice. Consult your legal counsel or tax advisor in matters that directly affect your benefit plans.

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