

Severance Plans: The Promise and the Savings

by **Philip Parker**

Plan sponsors overlooking their severance plans are missing opportunities for cost savings they could achieve by eliminating inefficiencies and maximizing plan design. This article reviews the history of severance plans, explains how supplemental unemployment benefit (SUB) plans work, provides plan sponsors with questions they should ask when reexamining their severance offerings, and suggests options for plan sponsors to consider in terms of optimizing their severance plan's cost control and certainty, tax savings and appropriate cost sharing with employees. A case study illustrates how one Fortune 500 company reduced its overall severance spend while improving benefits for terminated employees in need of assistance.

Recent economic crises have led employers to examine their employee benefit plans to look for efficiencies, cost control and certainty, tax savings, and appropriate cost sharing with employees. We think it's time to examine the benefit amounts, payment form, tax consequences and reasons for sponsoring a severance plan.

HISTORY

There are two types of severance plans. The traditional plan, funded through an employer's general assets or from a trust fund, evolved from the U.S. labor code in the 19th century. During the Civil War, a severance equal to three months of pay was given to soldiers upon discharge. This led to extending severance payments to workers in many situations. By the end of World War II, new legislation resulted in a proliferation of employer-sponsored severance plans.

Supplemental unemployment benefit (SUB) plans were introduced in 1955. These plans were often used

in union negotiations to guarantee wages during periods of unemployment. SUB plans provided additional payments by the company over and above state unemployment benefits and were not subject to Federal Insurance Contributions Act (FICA) taxes (that is, Social Security and Medicare payroll taxes). The use of SUB plans has spread across industries as they allow employers to realize significant savings while still providing a 100% replacement of base pay during the employee's period of severance.

HOW DOES A SUB PLAN WORK?

A SUB plan works in many ways like state unemployment benefits:

- Employees are required to register and be eligible for state unemployment in order to receive benefits from the SUB plan.
- Each week, terminated employees must verify that they are still unemployed and are still physically capable and available for work as defined by their state unemployment agency. This is often done via a website or phone number connecting terminated employees with an interactive voice response system or service center.

TABLE I**EXAMPLE OF SUB PLAN'S TAX ADVANTAGE OVER A TRADITIONAL SEVERANCE PLAN**

	Employer Payment		Employee Benefit	
	SUB Plan	Severance Plan	SUB Plan	Severance Plan
Weekly benefit before taxes	\$1,000.00	\$1,000.00	\$1,000.00	\$1,000.00
FICA (Social Security and Medicare) taxes	\$0.00	\$76.50	\$0.00	\$76.50
Total	\$1,000.00	\$1,076.50	\$1,000.00	\$923.50
Weeks	26	26	26	26
Total	\$26,000.00	\$27,989.00	\$26,000.00	\$24,011.00
Advantage due to SUB plan	\$1,989.00	N/A	\$1,989.00	N/A
Employees laid off	500	500	500	500
Advantage due to SUB plan	\$994,500	N/A	\$994,500	N/A

- Payments must be made on a weekly or payroll-by-payroll frequency based upon the weekly amount of SUB plan benefit that the terminated employee is to receive.
- During the period of unemployment, SUB plan benefits are not subject to FICA taxes. This saves the employer and the employee up to 7.65% in taxes. Of note here is that severance payments made from a traditional severance plan are subject to FICA taxes.
- If the terminated employee becomes reemployed, future payments, if any, become subject to FICA taxes. Special rules apply if the terminated employee becomes disabled or dies.
- Payments are based upon base pay and exclude overtime or bonus from the pay used in calculating the SUB plan benefit.
- Payments from a SUB plan for most states can be paid concurrent with the terminated employee receiving his or her state unemployment benefit.

TAX ADVANTAGES OF A SUB PLAN

The elimination of FICA (Social Security and Medicare) taxes can be a financial boon to the employer and the employee. Consider the following, assuming one employee is laid off and his benefit is \$1,000 a week for 26 weeks: If the employee verifies his unemployment status each week and does not find a job within the 26-week period, he would receive \$26,000 over the period of his SUB plan payments. If the same payments were made from a traditional severance plan, assuming a FICA rate of

6.25% and Medicare tax rate of 1.40%, he would receive \$24,011. That's \$1,989 less than he would have seen under the traditional severance plan. The employer pays \$1,989 less in taxes as well. Therefore, by using a SUB plan, the employer has lowered its severance spending while simultaneously increasing the benefit paid to the employee.

Table I illustrates this concept for a layoff of 500 people. This simple example, when applied to a layoff of 500 employees in a year, produces nearly \$1 million in savings for the plan sponsor and provides nearly \$1 million more in payments to the terminated employees. From a purely financial perspective, the use of a SUB plan is a win-win for the plan sponsor and the severed employees. It should be noted that employees who find employment prior to the end of their severance period have less savings due to the tax advantages of the SUB plan that are realized. Any payments made after they are reemployed become subject to FICA taxes. Employers will realize approximately 80% of the potential FICA savings due to a shortened period of severance due to reemployment.

PURPOSE OF A SEVERANCE PLAN

When plan sponsors are asked: "Why do you even have a severance plan?" typical responses range from "I don't know" to "We want to help our former employees until they are employed again." These answers indicate that plan sponsors haven't taken a hard look at their severance plan. In reviewing their severance benefits, employers need to examine the benefit as they would any other benefit they are providing employees:

- Does this benefit help with recruitment and retention?
- Do employees know about, understand and appreciate the benefit?
- Are the benefits equitable across our employee base?
- Is this plan design providing the appropriate level of benefit?
- Is the cost of providing this benefit appropriate?
- Are we administering this benefit in a cost-efficient manner?
- What are the risks inherent with providing this benefit?
- Are the legislative requirements being followed through a documented set of procedures?
- Are we taking advantage of any tax laws that may apply to this benefit?

When these questions are applied to a severance plan, the answers often vary by industry. For example, severance plans are quite common throughout the United States and therefore are a benefit that is expected by employees from prospective and current employers. SUB plans are less frequent but are commonplace in certain industries.

In the next two sections, we'll examine two of these questions specifically.

IS THE SEVERANCE PLAN DESIGN PROVIDING THE APPROPRIATE LEVEL OF BENEFIT?

What is the appropriate level of benefit that a severance plan should provide? To answer that question, a plan sponsor needs to determine its reasons for having a severance plan in the first place. Is it to assist employees in bridging the gap from termination to reemployment? Is it an effort to reduce or eliminate the feeling of guilt that employers often feel for having laid off employees?

What severance benefits are plan sponsors typically providing to their employees? From my experience, the typical plan provides a multiplier that is applied to years of service that determines the duration of the severance period. For example, one to two weeks per year of service is a typical plan design. An employee who is terminated with 15 years of service would receive a benefit for their final pay rate for 15 to 30 weeks. For purposes of our analysis, let us assume the employee works in the state of New York and has a final base pay rate of \$1,000 per week.

Combined with state unemployment, another employer-paid benefit, the severance plan provides a benefit that is 40% greater than base pay (Table II). This is an example of "double-dipping" that employ-

TABLE II
EXAMPLE OF SEVERANCE BENEFIT
DOUBLE-DIPPING

	SUB Plan
Plan weekly benefit after FICA taxes	\$1,000
Weekly state unemployment benefit	\$405
Total weekly benefit	\$1,405
Weekly base pay while employed	\$1,000
Percentage of pay replaced during severance period	140%

Note: Assumes employee in state of New York with final base pay rate of \$1,000 per week.

ers deal with in other benefits. If we look at a comparable type of benefit, disability benefits, we find that employers have recognized that their disability benefit, combined with state disability benefits, would provide a benefit larger than anticipated. To deal with the double-dipping in disability benefits, a vast majority of employers offset their disability benefit by that provided by state disability. For example, if the disability benefit is designed to replace 50% of pay during disability and the state disability benefit replaces 10% of pay, the employer bifurcates the benefit so that the employee receives 40% from the employer and 10% from the state disability. The result is that the employee still receives his promised 50% disability benefit.

Employers with severance plans are starting to examine the double-dipping issue and taking the same approach. The promised benefit, 100% of base pay, is being paid from two sources: the plan and state unemployment. Taking this approach, the participant in our example would receive \$595 from the SUB plan and \$405 from New York State unemployment, which adds up to the promised replacement pay of \$1,000. By coordinating the payment with state unemployment, the plan sponsor has a savings of 40% on its severance spending for this terminated employee.

Why aren't more plan sponsors taking this approach? Essentially, the historical practice of employees' double-dipping makes the change to the coordinated benefit approach appear to employees as a takeaway. While it's true that, if applied to an employee already in pay status, this would be a takeaway, as a plan design change applied to future benefits it's a return to the original intent of the plan

TABLE III**EXAMPLE OF DIFFERENT APPROACHES EMPLOYERS CAN TAKE IN DESIGNING SEVERANCE BENEFIT DURATION**

	Continuing for Full Duration	Reducing to 50% at Reemployment	Stopping at Reemployment
Scheduled weeks duration	20	20	20
Weeks unemployed	15	15	15
Weekly benefit	\$1,000	\$1,000	\$1,000
Benefit after employment	\$1,000	\$500	\$0
Total payments while unemployed	\$15,000	\$15,000	\$15,000
Amount paid while working for another company	\$5,000	\$2,500	\$0
Decrease in severance spend	\$0	\$2,500	\$5,000
Decrease as a percentage of severance spend	0%	12%	25%

(which is to provide 100% of pay during the promised period of payment). Implementation of this change is most successful when accompanied by strong communications explaining the two sources of promised payments.

Another aspect of severance to consider is the duration of the severance benefit. If a terminated employee secures other employment prior to the end of his severance period, this usually means he is being paid by the plan sponsor while working for another company. For a plan sponsor, that could be a significant expense. Plan sponsors have dealt with this issue using a SUB plan: Since state unemployment stops at reemployment, plan sponsors have taken this approach as well by stopping, or reducing, the benefit when the employee becomes employed. Table III shows approaches employers can take in designing severance benefit duration.

The adjustment of the severance payment at the time of reemployment may also be viewed as a take-away if it is not the current plan design. A well-designed communication plan is critical in explaining this plan design change to current employees.

The total savings from the elimination of FICA taxes, integrating with state unemployment and reducing, or stopping, payments at reemployment typically result in a 35% to 55% reduction in severance spending. Severed employees continue to receive 100% of their base pay during their period of severance, while the employer sees a significant amount of savings by converting to a SUB plan and changing its benefit plan design. It is important to note that em-

ployers need not adopt all of these plan changes; many employers change to SUB plans just for the tax savings and continue to allow double-dipping by terminated employees receiving severance benefits and state unemployment benefits simultaneously, or continuing benefits once a terminated employee is reemployed.

ARE THE SEVERANCE BENEFITS EQUITABLE ACROSS OUR EMPLOYEE BASE?

Let's assume, for the sake of example, that an employer's severance plan formula is the same for all employees throughout an organization, and that the average severance payment is \$1,000 per week. If state unemployment benefits are not taken into account in the severance plan's formula, then the employees are receiving a total benefit that is greater than 100% of base pay. How much greater depends on which state they are employed in. Figure 1 shows that employees in different states can receive dramatically different benefits, which creates inequity throughout a multistate organization.

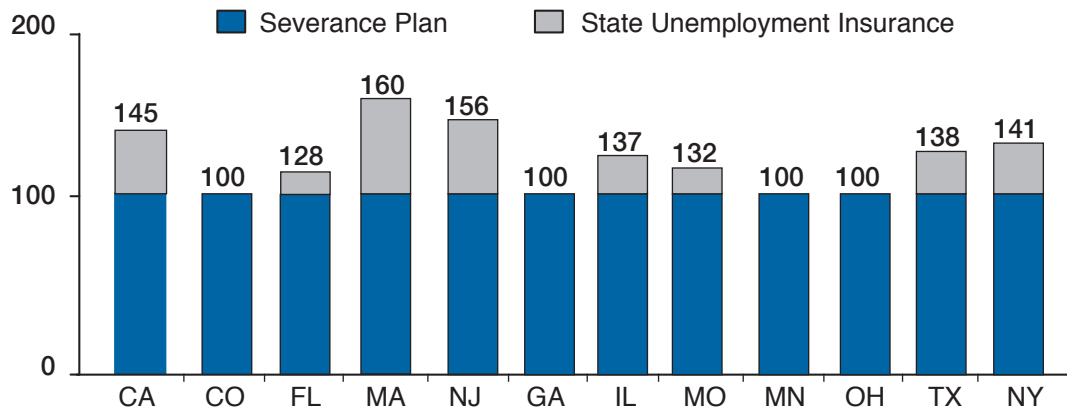
By reducing the benefit payable from the plan by state unemployment, the plan sponsor ensures that employees across the organization are receiving equitable benefits.

ADMINISTRATION OF SUB PLANS

In order to adopt an SUB plan, a plan sponsor

FIGURE 1

HOW TOTAL SEVERANCE PAYMENTS CAN EXCEED BASE PAY WITHOUT ADJUSTMENT FOR STATE UNEMPLOYMENT BENEFITS



needs expertise in plan design, regulations and administration. SUB plans are Employee Retirement Income Security Act plans and require plan documents, summary plan descriptions and approval and filing in various states. Each state has its own rules regarding the application of SUB plans and integration with state unemployment.

Communications require personalized packets educating the terminated employees on the SUB plan requirements for that individual. In addition, kits that include step-by-step instructions for employees are needed to simplify the plan administration. Employees need a method to report their employment status on a weekly basis. A service center to assist employees with questions, resolve reporting errors and reach out to employees who fail to report their employment status is essential to administering the plan.

As with all benefit plans, data must be clean and automated to ensure it is reported correctly. Employment status monitoring and payroll feeds need to be 100% right so that severance payroll is accurate.

USE OF THE SAVINGS IN SEVERANCE SPENDING

Table IV shows the large annual savings in severance spending employers realize by updating their severance plan.

Employers can use these saving in many ways:

- Improve employee health care benefits, or re-

duce the annual increase in cost sharing with employees

- Improve company cash flow
- Improve 401(k) matches and other employee benefits for active employees.

The following case study is an example of a creative use of the savings generated from converting to an SUB plan and changing the plan design to pay 100% of base pay from all sources during the period of unemployment.

CASE STUDY: FORTUNE 500 COMPANY

By using an outsourced SUB plan design and administration solution for SUB plans, a Fortune 500 company was able to maintain its traditional formula for determining the number of weeks of base pay to be paid as severance while also reducing costs.

- SUB plan payments were exempt from FICA taxes (both employee and employer Social Security and Medicare taxes).
- Payments were integrated with state unemployment insurance benefits so that terminated workers would receive full base pay replacement between the two sources of income.
- If a terminated worker found new employment prior to the end of his severance period, 50% of the remaining weeks would be paid as a lump sum.

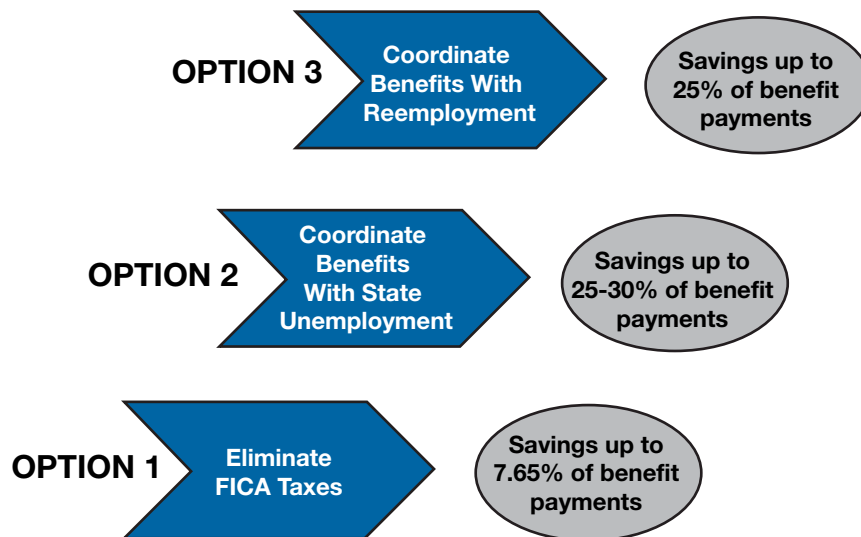
While these common design changes reduced the

TABLE IV**RECENT SAVINGS REALIZED BY EMPLOYERS UPDATING THEIR SEVERANCE PLAN**

	Approximate Number of Reductions in Force (RIFs)	FICA Savings	State Unemployment Integration	New Employment Coordination	Total Savings
Client 1 <i>Half year</i>	1,400	\$ 691,000	N/A	N/A	\$ 691,000
Client 2	1,800	\$ 907,000	\$3,264,000	\$653,000	\$4,824,000
Client 3	1,600	\$ 664,000	\$3,381,000	\$942,000	\$4,987,000
Client 4	200	\$ 267,000	\$ 701,000	\$ 86,000	\$1,054,000
Client 5	1,400	\$1,134,000	\$5,639,000	\$420,000	\$7,193,000

FIGURE 2**IMPACTS OF SEVERANCE PLAN REDESIGN**

Severance plan redesign can deliver cost savings at three levels, depending upon the company's objectives:



overall cost of severance benefits, the company wanted to provide a more meaningful benefit to those employees whose severance period was not long enough to allow them to find employment. Using the savings achieved from the plan redesign, the company was able to provide a four-week extension of benefits to any terminated employee who was still unemployed at the end of his severance period. This supplement directed the company's severance dollars to those former employees who were in need of assistance, while not providing windfalls to those who were able to secure employment more quickly.

The company realized substantial savings in the costs associated with its overall severance program. After the first 24 months, it saw a reduction in severance cost of approximately \$3.5 million, or 30% when compared with the cost of its prior severance program. Of the \$3.5 million saved, \$1.2 million was used to extend the severance period for those former employees in need.

CONCLUSION

Plan sponsors have several options to consider when reviewing their severance plan that can elimi-

nate double-dipping of benefits (overpayment) and FICA taxes, and generate significant savings for the plan sponsor (Figure 2).

Option 1: Eliminate FICA taxes for severance payments through a SUB plan and trust. This option increases after-tax benefits for workers and reduces tax liabilities for employers.

Potential savings: up to 7.65%. Savings will depend on when in the calendar-year displacements occur (e.g., at the end of the calendar year, more highly compensated employees will have already reached the OASDI wage base, making additional savings limited for the employee and the employer).

Option 2: Coordinate severance payments with state unemployment benefits, maintaining 100% income replacement for former employees. This option offers the additional advantage of creating a more equitable benefit across the entire workforce, since different states provide different levels of benefits to unemployed workers.

Potential savings: up to 25-30%. The degree of savings will depend on the distribution of states in which the displaced employees reside.

Option 3: Implement a new employment feature whereby severance payments stop when a displaced worker finds new employment.

Potential savings: up to 25%, based on national averages. Local conditions may vary.

The economy has resulted in employers examining their benefit plans to look for efficiencies, cost control and certainty, tax savings and appropriate cost

sharing with employees. In order to achieve these goals, the past few decades have seen significant changes in retirement plans and health and welfare benefits. Employers should also examine other benefits, such as severance, to ensure that these programs are meeting their needs on a tax-advantaged basis.

Now is the time to maximize severance benefit plans for efficiencies, cost control and certainty, tax savings and appropriate cost sharing. ◀

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