

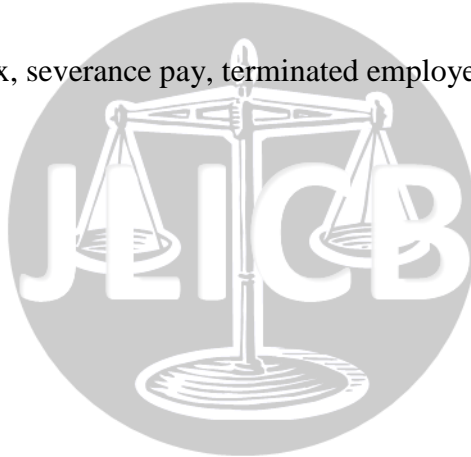
Soften the blow by providing tax-free fringe benefits to terminated employees

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ABSTRACT

When “laid-off” or induced to take “early retirement,” a former employee faces serious concerns about finances. Employers may wish to assist these terminated employees by making severance payments. However, the employer’s after-tax cost of providing severance pay typically exceeds after-tax benefit received by the former employee. Fortunately, an alternative approach can yield superior after-tax consequences to both parties. This approach involves the continuation of certain qualifying employee fringe benefits to the former employee for a period of time after termination. This article identifies the most significant of these fringe benefits and explains the income tax and FICA tax consequences to both the employer and the former employee.

Keywords: fringe benefit, tax, severance pay, terminated employees, COBRA



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INTRODUCTION

The lingering recession has forced many employers to reduce the size of their workforce, whether by attrition or by layoffs. Seen primarily as affecting blue collar workers, “downsizing” is increasingly affecting middle management and those in the executive suite. Regardless of job description, terminating or encouraging the “early retirement” of employees is unpleasant for both the employer and former employee and can damage the morale of the remaining employees. Generous severance packages can be palliative, but economically infeasible, for most small businesses. Fortunately, a more affordable, tax-favored, alternative exists. For a relatively modest cost, the employer can continue providing certain types of fringe benefits to the terminated employee. This article will provide an overview of these fringe benefits and explain the income tax and FICA tax consequences to both the employer and the former employee.

BACKGROUND

Wage continuation or severance pay is one way to soften the blow of job termination. Through either a lump sum payment or a series of payments after the final paycheck, the employer provides a temporary source of funds to give the former employee time to secure other employment or to transition into retirement. From the employer’s perspective, these payments represent a sizable cash outflow that undermines the goal of reducing payroll costs during difficult economic times. Fortunately for the employer, these payments are deductible by the employer,¹ reducing the employer’s after-tax cost. On the other hand, severance pay is taxable compensation to the employee.² Moreover, such payments are “wages” subject to FICA taxes on both the employer and former employee.³ Consequently, as illustrated in Example 1, the “take-home pay” provided to the employee for living expenses is reduced significantly.

Example 1

ABC Company reluctantly terminates Eddie Employee. Since Eddie has been a reliable employee, ABC gives Eddie a severance payment of \$5,000.

Effect on the Employer: If ABC Company is in the 30% income tax bracket, this deductible severance payment will generate \$1,500 of income tax savings for ABC Company. On the other hand, this \$5,000 payment is considered “wages” for purposes of the FICA tax. This results in a tax cost to ABC Company of \$382.50, or 7.65% of the \$5,000 payment. In turn, this FICA tax payment of \$382.50 is deductible on ABC Company’s income tax return, yielding a tax savings of \$114.75 [30% of \$382.50].

¹ IRC §162(a)(1).

² IRC §61(a)(1) and Treas. Reg. §1.61-2(a)(1).

³ IRC §3121(a).

As a result, ABC Company’s after-tax cost of this severance payment would be \$3,767.75, determined as follows:

Severance payment	\$5,000.00	
Less: Income tax savings	<u>(1,500.00)</u>	\$3,500.00
Plus: Employer’s share of FICA tax	382.50	
Net of income tax savings	<u>(114.75)</u>	<u>267.75</u>
After-tax cost of severance payment		<u>\$3,767.75</u>

Effect on the Employee:

Continuing this example, assume that Eddie Employee is in the 15% income tax bracket. The severance payment would be subject to both income tax and FICA tax. Eddie’s income tax liability on this payment would be \$750, or 15% of \$5,000, and his FICA tax liability would be \$382.50, or 7.65% of the \$5,000 payment. Thus, Eddie’s “take-home pay” from this severance payment would amount to \$3,867.50, determined as follows:

Severance payment	\$5,000.00	
Less: Income tax liability	<u>(750.00)</u>	\$4,250.00
Less: Employee’s share of FICA tax		<u>(382.50)</u>
After-tax cash inflow from severance payment		<u>\$3,867.50</u>

Consequently, ABC Company ultimately pays \$3,767.75 to provide Eddie Employee with \$3,867.50 for post-employment living expenses.

As an alternative to making severance payments, an employer can continue to provide certain employee fringe benefits to terminated employees. As with severance pay, the employer can deduct the cost of providing the fringe benefits. However, many of these employee fringe benefits are excluded from the gross income of former employee. Thus, fringe benefits continuation can provide valuable, tax-free, financial assistance to former employees with smaller before-tax and after-tax cash outflows to the employer, as shown in Example 2.

Example 2

As in Example 1, ABC Company terminates Eddie Employee. However, instead of giving Eddie a severance payment of \$5,000, ABC Company uses the \$5,000 to continue providing Eddie with qualifying employee fringe benefits, such as health insurance coverage, for the next four months.

Effect on the Employer: If ABC Company is in the 30% income tax bracket, the payment of Eddie’s insurance premiums totaling \$5,000 will generate \$1,500 of income tax savings for ABC Company. This is the same result as for a \$5,000 severance payment. On the other hand, these premium payments are not subject to FICA tax.

As a result, ABC Company’s after-tax cost of the insurance premium payments would be \$3,500.00, determined as follows:

Insurance premium payments	\$5,000.00
Less: Income tax savings	<u>(1,500.00)</u>
After-tax cost of insurance premiums	<u>\$3,500.00</u>

Effect on the Employee: Continuing this example, assume that Eddie Employee is in the 15% income tax bracket. In contrast to the severance payment, the insurance premiums paid by ABC Company for Eddie would not be subject to either income tax or FICA tax. Thus, Eddie receives \$5,000.00 of health insurance premiums tax-free. In other words, ABC Company ultimately pays \$3,500.00 to provide Eddie Employee with \$5,000.00 worth of health insurance coverage. Compared with the severance payment, ABC Company has a lower after-tax cash outflow and Eddie Employee receives a much higher after-tax benefit when health insurance coverage is continued.

TAX-FAVORED FRINGE BENEFITS AVAILABLE TO TERMINATED EMPLOYEES

Although fringe benefits continuation can yield after-tax results that are far superior to severance payments, it is important to note that only certain types of fringe benefits can be provided tax-free to former employees. Specifically, an employer can provide health insurance coverage, group term life insurance coverage, job placement assistance, and education assistance to former employees in a manner yielding tax benefits to both parties.

Health Insurance Coverage

Employer-provided health insurance is one of the most important parts of an employee’s compensation. It is so important that the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) generally requires employers to offer continuing health insurance coverage to former employees, their spouses, and dependents⁴ for up to 18 months after termination.⁵ This is an important safety net for many, but the COBRA mandate does not apply to employers with fewer than 20 employees.⁶ Even though small businesses may not be required to offer COBRA continuation coverage, nothing prevents such an employer from continuing to provide this fringe benefit to former employees.

If an employer continues to pay a portion of a former employee’s health insurance premiums, these payments are deductible as compensation for prior service under IRC §162(a)(1). The former employee also receives a tax benefit. IRC §106(a) provides that premium payments made on behalf of the former employee are excluded from the gross income. This tax-free treatment applies whether the separation from service was caused by termination,⁷ death,⁸ disability, or retirement of the former employee. Similarly, any insurance payments

⁴ Notice 2010-38. Dependents include children under age 27.

⁵ 42 U.S.C. §300gg-41 and IRC §4980B(f)(2)(B)(i)(I).

⁶ IRC §4980B(d)(1).

⁷ PLR 9612008 and Rev. Rul. 85-121

⁸ Rev. Rul. 82-196

made for medical care of the former employee, spouse, and dependents also are excluded from gross income.⁹ Finally, it should be noted that employer-paid medical insurance premiums are not subject to FICA taxes.¹⁰

Life Insurance Coverage

In addition to health insurance, terminated employees are concerned about keeping their life insurance coverage. This is especially true of those who are in poor health and, thus, are unable to obtain a replacement policy. If an employer chooses to provide any type of life insurance coverage to an employee after termination, the premiums will be deductible by the employer. In contrast, these premiums generally are taxable to the former employee. However, if the coverage is for group term life insurance, the premiums paid for the first \$50,000 of coverage is excluded from the employee's gross income.¹¹ For purposes of this exclusion, the term "employee" includes former employees.¹² Moreover, if the terminated employee is disabled, then the exclusion applies to all premiums paid for group term life insurance, even if the policy coverage exceeds \$50,000.¹³

If the employer continues to provide taxable group term life insurance coverage (i.e., coverage in excess of \$50,000) to a former employee, the taxable portion of the premiums will be subject to FICA taxes. This presents an interesting dilemma for the employer. In the typical employment situation, the employer withholds the employee's share of FICA taxes from the employee's paycheck and deposits, via the Electronic Federal Tax Payment System, these taxes with the Treasury Department¹⁴ on behalf of the employee. However, the terminated employee no longer receives a paycheck. In such cases, the employer is relieved of the obligation to withhold either for federal income taxes¹⁵ or the employee's share of FICA taxes.¹⁶ Instead, the employer will provide the former employee with a Form W-2 that discloses the portion of the life insurance premiums that is subject to income tax and the amount of FICA tax that the employee owes on the excess premiums. Using this information, the former employee will include the FICA tax on the Form 1040 and pay this tax directly to the Treasury.¹⁷

Job Placement Assistance

After securing health insurance and life insurance coverage while "between jobs," the soon-to-be-terminated employee is most interested in securing new employment. Here, too, the employer may be in a position to help. However, for employer-provided job placement assistance to be tax-free to the employee, the assistance must be provided before termination.

⁹ IRC §105(b)

¹⁰ IRC §3121(a)(2)(B)

¹¹ IRC §79(a)

¹² IRC §79(e)

¹³ IRC §79(b)(1)

¹⁴ Publication 15, Employer's Tax Guide (2012), p. 23.

¹⁵ IRC §3401(a)(14).

¹⁶ IRC §3102(d).

¹⁷ IRC §3102(d)(1)(C).

In Revenue Ruling 92-69,¹⁸ the IRS addressed the tax treatment of employer-provided outplacement services in several hypothetical situations. Situation 1 involved a company that was preparing to lay off 300 employees pursuant to a one-time reduction in force. This company hired an outplacement firm to assist these employees to obtain employment elsewhere. In Situation 2, the company routinely provided outplacement services for terminated employees. One of the terminated employees, an executive, was unable to find a comparable position in the local job market. The company assisted this employee's national job search by providing, not only job counseling, but also the use of a private office and a secretarial staff. In both scenarios, the Service ruled that the job placement assistance qualified as a tax-free "working condition fringe benefit."¹⁹

By characterizing these placement services as "working condition fringes," the Commissioner opened the possibility of tax-free treatment, but simultaneously imposed two restrictions. First, unlike the exclusions for employer-provided health and group term life insurance which included former employees, the regulations limit the working condition fringe benefit exclusion to "current employees."²⁰ Thus, such services must be provided prior to the employee's termination date. Second, the ruling noted that, to be a working condition fringe, the outplacement services must provide the employer with a substantial benefit. At first blush, this requirement may seem draconian. However, the ruling suggested that job placement assistance programs could benefit the employer since such programs would help to maintain employee morale, to project a positive corporate image, or to avoid wrongful termination litigation.

Education Assistance Programs

In addition to helping an employee obtain new employment, an employer also can help employees to improve their career prospects by offering an education assistance program. As with the previously discussed fringe benefits, the amounts paid by the employer for an employee's education expenses will be a deductible business expense of the employer. The employee also enjoys tax benefits from these programs. These education assistance payments will be excluded from the employee's gross income, up to \$5,250 each calendar year.²¹

To qualify for the exclusion, several requirements must be satisfied. First, the education assistance program must be "a separate written plan of an employer for the exclusive benefit of his employees."²² Next, the education assistance program cannot discriminate in favor of "highly compensated employees" or their dependents.²³ Finally, the education assistance will not be tax-free if it is provided in lieu of other compensation, such as a corresponding salary reduction.²⁴

If these requirements are met, the other features of education assistance programs are quite generous. The definition of "educational assistance" includes not only tuition and fees, but

¹⁸ 1992-2 CB 51.

¹⁹ IRC §132(a)(3) and (d).

²⁰ Treas. Reg. §1.132-1(b)(2).

²¹ IRC §127(a)(1) and (2).

²² IRC §127(b)(1).

²³ IRC §127(b)(2).

²⁴ IRC §127(b)(4).

also books, supplies and equipment.²⁵ On the other hand, employer payments for tools and supplies (other than textbooks) or for meals, lodging, or transportation will not qualify for the exclusion. Perhaps more surprising, the regulations define “employee,” for purposes of this exclusion, as including self-employed individuals²⁶ and retired, disabled, and laid-off employees.²⁷

CONCLUSION

Terminating good employees during difficult economic times is emotionally painful for both the employer and employee. In addition to inflicting financial hardship of the furloughed employee, the firings may cause the employer to suffer from bad publicity, decreased morale among the remaining employees, and possibly wrongful termination suits. Fortunately, it is possible to alleviate some of the suffering by providing tax-favored employee benefits to those who have been terminated or are about to be terminated. For a summary of these employee benefits and their tax consequences, as contrasted with severance payments, see Figure 1.

Since these fringe benefits are deductible by the employer, the employer’s after-tax cost of providing these services is reduced, possibly making these programs financially feasible. Unlike other types of severance payments, these fringe benefits will be tax-free to the former employee. Considering the combined tax benefits, choosing to provide certain employee fringe benefits to terminated employees may be an affordable way to make the best of a bad situation.

REFERENCES

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Treasury Regulations, Title 26 Code of Federal Regulations

²⁵ IRC §127(c)(1)(A).

²⁶ Treas. Reg. §1.127-2(h)(1)(iii).

²⁷ Treas. Reg. §1.127-2(h)(1)(i).

Figure 1
Comparison of the tax treatment of severance pay and fringe benefits provided to terminated employees

Fringe benefit	Income Tax Consequences		Subject to FICA taxes?
	Employer	Former Employee	
Severance pay	Deductible	Included	Yes
Health insurance premiums	Deductible	Excluded	No
Life insurance premiums	Deductible	<ul style="list-style-type: none"> Excluded for first \$50,000 of group, term life insurance coverage Included for group term life insurance coverage in excess of \$50,000 Included for other types of life insurance policies 	<ul style="list-style-type: none"> Premiums for first \$50,000 of group, term life insurance coverage are <u>not</u> subject to FICA taxes. Premiums for coverage in excess of \$50,000 are <u>subject</u> to FICA taxes
Job placement assistance	Deductible	<ul style="list-style-type: none"> Excluded if assistance is <u>provided prior</u> to termination Included if assistance is <u>provided after</u> termination 	<ul style="list-style-type: none"> Not subject to FICA taxes if assistance is <u>provided prior</u> to termination Subject to FICA taxes if assistance is <u>provided after</u> termination
Education assistance	Deductible	<ul style="list-style-type: none"> Excluded up to \$5,250 Assistance in excess of \$5,250 included in gross income. 	<ul style="list-style-type: none"> First \$5,250 of education assistance is not subject to FICA taxes Assistance in excess of \$5,250 is subject to FICA taxes