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BRIDGE TO NEW EMPLOYMENT

Rethinking Severance

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Severance plans may be a sore subject, but looking at alternatives can mean getting more for less.

A company's compensation and benefits plan plays a key role in attracting and retaining skilled employees. Designed successfully, these plans allow a company to compete in the job market for top talent. Yet like any other competitive endeavor, competing at the top levels of employee attraction and retention requires human resources teams to perform at the highest level with agility and finesse in executing their strategies.

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If the goal of your company's severance plan is to provide a bridge to new employment and to maximize the value of your overall compensation and benefits programs, it is important to be aware of the different options available for issuing severance in the case of a reduction in force.

Every year advancing employees expect higher pay and enhanced benefits, yet the edict from upper management to human resources is often to reduce, streamline and consolidate costs. In other words, human resources must skillfully do more with less.

Accordingly, a great deal of consideration goes into the annual matters of calculating raises, determining how to retain outstanding performers, evaluating whether current benefits are sufficient for the employee population, and appraising how the company could provide greater benefits without increasing its costs.

But what about the employees whom the company determines not to retain?

On a regular basis, whether because of new technology and automation, site closures, mergers or other reasons, a number of workers are unavoidably released from their job duties. Contrary to the amount of consideration given to annual compensation and benefits, little consideration is given to these laid-off employees beyond calculating their severance allotment based on a generic formula.

From a bird's-eye view, developing strategies for this group seems to have little to do with the pool of workers whom the company strives to attract and retain. It is therefore easy to overlook the fact that severance payments likely come from the same pool of funds as the overall compensation and benefits budget. As a significant piece of the larger picture, it is surprising that severance is commonly overlooked during annual benefit evaluation conversations.

Neglecting to review severance as part of the whole compensation and benefits strategy is like doing a vehicle inspection without checking the brakes. Avoidance may seem like a safe strategy for a sore subject, but not examining the full benefits of severance programs has the potential to result in greater organization liability, unnecessary spending and inefficiently utilized employee benefits dollars.

Rethinking Severance

The purpose of severance as initially devised was to provide assistance to separated employees during the time it took them to find new employment. In much of today's corporate environment, severance has morphed into something entirely different. Nowadays, severance usually is distributed as a fixed amount based on level and tenure — regardless of whether the released employee already has a new job lined up.

Another possibility exists, however. If the goal of your company's severance plan is to provide a bridge to new employment and to maximize the value of your overall

compensation and benefits programs, it is important to be aware of the different options available for issuing severance in the case of a reduction in force.

Unlike health-care and 401(k) benefit plans, severance and separation benefit plans typically are treated as confidential information, making it difficult to identify industry standards or to perform accurate benchmarking. Without comparison information widely available, many HR executives remain unaware of alternative structures for paying separation benefits. Therefore, the first step to rethinking severance is to become familiar with severance alternatives:

1 | The first and most widely known method for paying separation benefits is lump-sum severance. Lump-sum severance is fully taxable and is made in one large payment with no consideration to whether the employee has a new job lined up or to when the employee becomes re-employed. This method is the costliest to the company and has the most impact on cash flow.

2 | Another way separation payments are made is through salary continuation, in which employees will continue to receive their regular wages for a predetermined amount of time after their employment with the company ends. Salary continuation payments also are fully taxable but are less draining on a company's cash flow. Typically, these payments will continue even after the employee has gained new employment, resulting in a period during which the employee receives double wages. Some companies choose to incorporate cost savings during salary continuation by requiring released employees to file for state unemployment benefits and offset their severance wages by the amount they receive from state unemployment. This does allow for significant savings for the company while maintaining the same level of take-home pay for the employee, but it is important to realize that fewer than half of the states allow released employees to collect company-paid severance and state unemployment benefits concurrently. This causes significant inequity between employees in different states. This also can be quite an administrative burden for an already stretched HR team.

3 | An alternative, less widely known method of paying separation benefits is through a Supplemental Unemployment Benefits (SUB) Plan, a type of separation benefits plan sanctioned by the IRS. Under a SUB Plan, the IRS reclassifies separation payments from wages to benefits, making the payment and receipt of these separation benefits exempt from employment taxes. Unlike traditional severance payments, all 50 states allow released employees to collect state unemployment benefits and company-sponsored SUB payments concurrently. Additionally, since SUB payments are tied to state unemployment benefits, when an individual gains new employment, both the state unemployment benefit and the company-sponsored SUB benefit stop. In this way, SUB payments serve as a bridge to a separated individual's next employment opportunity, and SUB fulfills the original purpose of separation pay.

EXAMPLE: An employee with a weekly base pay of $1,000 is laid off and is eligible for 12 weeks of separation benefit. The employee applies for state unemployment compensation benefits and is eligible to receive $616 per week in state unemployment benefits. Therefore, the SUB payable is $384 per week.

Comparison of employee benefit over 12 weeks:

Employee takes home $918 more under a SUB Plan than under a severance plan

Severance Plan		SUB Plan	
$1,000 *x 12 weeks*	$12,000	**$616 State UI benefit** *x 12 weeks*	$7,392
FICA taxes *7.65%*	($918)	**$384 SUB benefit** *x 12 weeks*	$4,608
		FICA taxes	$0
Total Benefit=	**$11,082**	**Total Benefit=**	**$12,000**

Comparison of employer costs over 12 weeks:

Employer saves $8,634 by using a SUB Plan rather than a severance plan

Salary Continuation Plan		SUB Plan	
$1,000 *x 12 weeks*	$12,000	**$384 SUB benefit** *x 12 weeks*	$4,608
FICA taxes *(7.65%)*	$918	**FICA taxes** *(7.65%)*	$0
FUTA, SUTA *(2.7%)*	$324	**FUTA, SUTA** *(2.7%)*	$0
Cost to Employer=	**$13,242**	**Cost to Employer=**	**$4,608**

The most important aspect of a company's severance plan is that it **fit the company's culture.**

SUB Plans are highly flexible in their design and can be designed either to offer a more generous benefit to the released employee or to maximize savings to the company. SUB Plan design options include:

4 | A re-employment bonus (typically 30% to 50% of the remaining benefit) may be paid if an individual becomes re-employed before the benefit period expires. This incents individuals to return to work while allowing the company to obtain meaningful duration savings.

5 | The extended plan uses savings achieved during the benefit period to provide additional assistance to individuals who remain unemployed beyond the initial benefit period.

6 | Under a flat benefit structure, an employer may pay a standard benefit amount to each separated employee, regardless of the actual amount of state unemployment benefit he or she receives. (For example, each employee receives SUB pay of $200 a week during his or her benefit period.)

Typically, organizations that implement a SUB Plan see cost savings of 30% to 50% compared to the cost of traditional lump-sum severance or salary continuation. In many cases, this can translate into saving millions of dollars. Achieving savings of this magnitude can empower human resources to enhance other critical benefits and help to maximize the value of a company's overall compensation and benefits strategy.

Because of the relatively high administrative burden associated with SUB Plans, companies that choose this option typically engage a third-party administrator to track state regulations, state unemployment claims and employment status of participants, as well as to calculate ongoing benefit payments. The cost of using a third-party administrator is a small fraction of the savings achieved through use of a SUB Plan.

What Is the Right Structure for My Company?

The most important aspect of a company's severance plan is that it fit the company's culture. For instance, if your organization subscribes to an entitlement culture, paying out a lump-sum windfall in amounts correlating to job level might make a lot of sense. Alternatively, within a finite compensation and benefits budget, this kind of windfall to an employee walking out the door may very well cost retained employees their raises, bonuses or a health-care enhancement. Organizations with a cost-containment culture and pervading commitment to the bottom line likely would benefit from a more practical and economical severance plan design such as a Supplemental Unemployment Benefits Plan.

Regardless of how a company chooses to design its severance plan, it is essential that separation benefits be given legitimate thought and attention as an important component of the company's compensation and benefits program.

By making sure that each component of a company's compensation and benefits program is properly evaluated, examined and thoughtfully crafted, HR professionals have the opportunity to successfully compete for top talent and provide real value to their organization's strong, retained workforce. Quite likely, evaluation of a legacy severance program may yield new opportunities.

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