



5 Things Employers Should Know About COBRA and Severance Agreements as Layoffs Loom

Insights

3.15.24

As we edge into the second quarter of 2024, we continue to see a steady stream of layoff announcements — and employers are still feeling the fallout of pandemic-related hiring frenzies, unpredictable economic conditions, and outsourcing. Although some industries have been hit harder than others, most employers have this in common: COBRA is typically offered to employees as part of their severance packages. But COBRA rules are complex, which highlights the importance of considering potential compliance issues when offering COBRA subsidies to departing employees — especially your highly-compensated employees. Are your practices compliant and up to date? Here's a brief background on COBRA and five things to keep in mind when crafting your severance agreements.

First, Let's Review a Few COBRA Basics

Most employers are well-acquainted with COBRA rules. This is a federal law requiring employers with 20 or more employees that offer group healthcare benefits to give employees the opportunity to elect continuing coverage if they've lost benefits because of a "qualifying event," including a reduction in hours, voluntary termination, or layoff. You may also know that states have similar laws — often referred to as "mini-COBRA" — for smaller companies. Here are some key questions and answers to refresh your knowledge of COBRA basics:

How long does COBRA last?

If elected, COBRA coverage continues for 18 or 36 months after the date of the loss of coverage, depending on the beneficiary and the type of event causing the loss of health plan coverage. Let's look at some examples:

- If the employee loses coverage because of a reduction in hours or termination of employment (whether voluntary or involuntary), coverage continues for the employee and any covered dependents for 18 months.
- If the employee became entitled to Medicare less than 18 months before their reduction in hours or termination, then the employee's spouse and dependents may be entitled to the longer of:
- 36 months of COBRA coverage *after the date the employee became Medicare-eligible*. For example, if an employee becomes eligible for Medicare six months before they are terminated

from employment, then the employee's spouse and dependents are entitled to 30 months of continuing coverage (36 months minus six months); or

- 18 months (29 months if a disability extension applies, as discussed below) *beginning on the date of the employee's termination of employment or reduction of hours.*
- The employee's spouse may elect COBRA continuation coverage for up to 36 months (for both the spouse and any dependents) if coverage is lost because of the employee's death or a divorce.

Can COBRA be extended?

If an employee, their spouse, and/or their dependents are entitled to a maximum of 18 months of COBRA, they may be entitled to an extension if they become disabled or if there is a second qualifying event.

For example, if one member of the employee's family is disabled (and meets certain requirements), then all family members may be entitled to an 11-month extension, resulting in a maximum period of 29 months of continuation coverage. The health plan may charge a premium of up to 150% of the coverage's cost if this extension occurs.

On the other hand, if an employee's spouse and dependents already have COBRA coverage, and then experience a second qualifying event (such as the employee's death or a dependent child ceasing to be eligible for coverage as a dependent under the health plan), then they may be entitled to an additional 18 months of continuing coverage (for a total of 36 months).

Can a COBRA coverage period be shortened?

COBRA continuation coverage typically begins on the qualifying event date and ends at the maximum period. However, in certain instances, the period of COBRA coverage can be shortened if:

- An individual does not pay their COBRA premiums timely;
- The employer ceases to maintain any group health benefits;
- An individual obtains group health insurance with another employer; or
- An individual becomes entitled to Medicare benefits after making a COBRA election.

Don't Forget About COBRA When Crafting Severance Agreements

When employees lose their jobs and are offered severance, it's common for employers to pay all or a portion of the COBRA premiums for a few months on a pre-tax basis (although not required by law).

This gives employees additional time to consider their health insurance options while absorbing some of COBRA's financial impact (after all, individuals may have to contribute up to 102% of their monthly premiums while on continuation coverage).

Although this seems straightforward, some potential employer and employee traps exist. Here are five things to keep in mind about COBRA when crafting your severance agreements:

1. *Can you provide more than 18 months of COBRA coverage to a terminating employee?*

A group health plan may provide longer periods of COBRA coverage than the law requires. However, such a decision should not be made lightly. Before offering a terminating employee more than the required 18 months of COBRA continuation coverage, you should consider the following:

- Review the applicable state mini-COBRA laws to see if these provide additional coverage after federal COBRA coverage has been exhausted. This may satisfy the employer's desire to provide a longer coverage period.
- Check with the plan's insurance (if fully insured) or stop-loss carrier (if self-insured) to confirm that any extension period would be covered. If not, you may be on the hook to self-insure any health expenses incurred after the 18-month period, potentially at a significant cost.
- In a severance agreement, you should consider specifying:
 - When any COBRA subsidy begins;
 - When the COBRA subsidy will end (or the duration of the provided subsidy);
 - Any eligibility conditions to receive the subsidy (such as the employee timely electing COBRA and paying any premiums);
 - To which type of coverage the subsidy applies (such as employee-only versus family coverage);
 - Whether the subsidy runs concurrently with COBRA continuation coverage (otherwise, an employee may mistakenly believe that the COBRA continuation coverage begins after the subsidy ends); and
- Any factors that would cause the COBRA subsidy to cease.

You should note that the severance agreement does not take the place of the required COBRA notices. Those notices should be timely sent to the employee in addition to any severance agreement.

2. *Can employees pay for their COBRA premiums out of their severance payments on a pre-tax basis?*

Employers can choose how COBRA subsidies are paid. In some circumstances, employees can pay for their COBRA premiums from their severance payments on a pre-tax basis. To do this, you should consider the following:

- Your Section 125 cafeteria plan must permit these pre-tax payments.
- The employee should affirmatively elect in writing to reduce their severance payments to pay for their COBRA coverage.

- If permitted, these pre-tax payments should not continue beyond the end of the plan year in which the qualifying event occurred, such as the employee's termination or reduction of hours.
- This payment process should be extended to all employees, not just highly compensated employees. Failure to do so could be considered discriminatory under the Internal Revenue Code (IRC).
- In the severance agreement, the employer should specify how the COBRA subsidy is paid, and the employee should understand that the payment method chosen directly impacts the subsidy's taxation.

3. Is providing COBRA subsidies to highly compensated employees discriminatory?

When providing COBRA subsidies, employers must understand their options. These options often depend on whether your group health plan is insured or self-insured.

For example, self-insured or level-funded plans may encounter discrimination issues under IRC Section 105(h) if subsidies (or disproportionate subsidies) were provided to highly compensated employees and not to other employees. In other words, employers cannot offer COBRA subsidies only to executives and not to other employees. Additionally, employers cannot provide richer and/or longer COBRA subsidies to executives without providing the same to other employees. *Again, this only applies if the plan is self-insured or level-funded.*

Highly compensated employees (HCEs) are those employees who meet either of the following criteria:

- Ownership Test: An employee is considered an HCE if they own more than 5% of the company sponsoring the group health plan at any time during the current or previous plan year, regardless of their compensation. Even if an HCE's ownership falls below 5%, they will still be considered an HCE until the end of the plan year following the year they held 5% ownership at any time during the previous year.
- Compensation Test: An employee is considered an HCE if they were paid more than a set amount of compensation determined annually by the Internal Revenue Service (IRS). For example, this set amount was \$150,000 in 2023 and \$155,000 in 2024. You may limit your HCE count to the top 20% of highly paid employees — but if you opt for this limitation, you'll need to state it in your group health plan document. This compensation test does not eliminate any HCEs from the ownership determination.

To avoid any non-discrimination compliance issues, self-insured employers who offer COBRA subsidies should:

- Administer subsidies on a consistent, equitable basis;

- Provide COBRA subsidies on an after-tax basis by imputing income to the employee (equal to the value of the COBRA subsidy) or require the employee to pay for their COBRA continuation coverage on an after-tax basis; and
- Pay the employee a taxable cash payment to cover any COBRA premium costs. Employees can then decide when and where they'd like to purchase health insurance – whether through the employer's group health plan or through an individual policy, such as those found on the Affordable Care Act (ACA) marketplaces. Here, employers can even choose to "gross up" these cash payments to cover any taxes on these amounts.

Employers should understand that the Affordable Care Act added similar non-discrimination rules for fully insured group health plans. However, the IRS has stated that fully insured group health plans do not need to comply with these ACA rules until the IRS issues further guidance. To date, no further guidance has been issued. As such, fully insured employers are not subject to these non-discrimination rules.

4. How does COBRA continuation coverage interact with ACA marketplace or a new employer's group health plan?

Generally, the employee's termination of employment and the exhaustion of COBRA continuation coverage (for example, at the end of 18 months) create a special enrollment right, allowing the terminated employee to enroll in the ACA marketplace or a new employer's group health plan. This means the employee can enroll in either type of coverage outside of the standard open enrollment period.

However, when receiving a COBRA subsidy, employees should understand that terminating COBRA coverage just because their subsidy ended does not create a special enrollment right allowing them to enroll in other coverage.

For example, let's say that an employer provides a 3-month COBRA subsidy on an after-tax basis to all terminating employees. One former employee is hired by a new employer within 6 weeks of their termination date. If the employee decides to stay on COBRA coverage to take advantage of the remaining 6 weeks of employer subsidy, as opposed to enrolling in their new employer's plan upon hire, then the cessation of the COBRA subsidy does not trigger a special enrollment right.

In this case, this employee would have to wait until they fully exhaust their 18 months of COBRA continuation coverage to enroll in either the marketplace or on a new employer's group health plan. Alternatively, they could wait until open enrollment for the marketplace or a new employer's plan to make the switch.

5. Do deferred compensation rules apply to COBRA subsidies?

Finally, IRC Section 409A, which applies to deferred compensation, applies to the reimbursement or payment of subsidized COBRA payments unless an exception applies. Notably, Section 409A does

not apply to:

- Medical reimbursement arrangements that are excluded from income under IRC Sections 105 or 106. Any discriminatory payments provided under a self-insured or level-funded group health plan do not fall under this exception.
- Reimbursements for post-termination medical coverage, but only to the extent that these arrangements provide coverage during the COBRA continuation coverage period (typically 18 months). Any subsidized COBRA payments extending beyond the maximum COBRA period must comply with Section 409A.

If the employer decides to provide the employee with taxable cash compensation to cover any COBRA or other health insurance costs, the employer may want to structure these payments to fit within an exception to Section 409A, such as the short-term deferral exception (stating that all payments must be made no later than March 15 of the year following the employee's separation).

On the other hand, the employer may alternatively want these payments to comply with Section 409A by making them on a fixed date or pursuant to a fixed schedule.

To fully understand the impact of Section 409A on COBRA subsidies, it's best to consult with an employee benefits attorney, as this analysis can often be complex.

Conclusion

If you have questions about offering COBRA subsidies to terminated employees, feel free to reach out to your Fisher Phillips attorney, the author of this Insight, or any attorney in our [Employee Benefits and Tax Practice Group](#) or on our [Reductions in Force \(RIFs\) Team](#). We will continue to provide tips, guidance, and updates on employee benefits and other workplace law topics, so make sure you are subscribed to [Fisher Phillips' Insight System](#) to get the most up-to-date information directly to your inbox.

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Jennifer S. Kiesewetter
Partner
615.488.2905
Email

Service Focus

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