

# Employee Benefit Plan Review

## Ask the Expert

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### REDUCTIONS IN FORCE: COBRA AND INTERNAL REVENUE CODE CONSIDERATIONS

**Q** My company is planning a reduction in force. We are contemplating a severance arrangement that includes subsidies for health insurance premiums for impacted employees. Are there any COBRA or Internal Revenue Code considerations we should be aware of?

**A** Employers frequently seek to pay all or a portion of an employee's health insurance premiums for a specified period of time as part of a severance arrangement.

As an initial matter, the terms of a health insurance plan or insurance policy may permit a former employee to participate in the employer's health insurance plan as though they were an active employee for a period of time. The period of time is generally equivalent to the length of time that the former employee is receiving severance pay. However, where this option is not available under the terms of the health insurance plan or is otherwise insufficient to meet the terms of the severance arrangement, the employer may wish to provide a former employee with a subsidy for COBRA coverage for a period of time.

If the health insurance plan is self-insured and the subsidy is not broadly offered, employers need to consider whether the arrangement could be considered discriminatory under the Internal Revenue Code (Code). For example,

providing subsidized coverage to a top executive on terms and conditions more favorable than those offered to other employees (e.g., providing a greater subsidy or providing a subsidy for a longer period of time as compared to other employees) could run afoul of the nondiscrimination rules of Section 105(h) of the Code.

One approach to avoid Section 105(h) nondiscrimination issues is to provide subsidized coverage on an after-tax basis by imputing income equal to the value of the premium subsidy and/or requiring the employee to pay their share of the premium on an after-tax basis. Another alternative is to provide the employee with a taxable cash compensation payment to cover the premium costs. The employee could then decide whether to purchase COBRA through the employer's plan or purchase an individual policy. Employers may further "gross up" such amounts for taxes payable by the employee.

Note that the Affordable Care Act added a nondiscrimination rule for fully insured health plans, which is similar to the Section 105(h) nondiscrimination rule that applies to self-insured health plans. However, the Internal Revenue Service (IRS) has stated that insured health plans need not comply with the nondiscrimination rule until the IRS issues further guidance. To date, the IRS has not issued further guidance.

Beyond the nondiscrimination issues, employers should ensure that the terms of the severance arrangement are clear. If the terms of

the severance benefits are ambiguous, for example, an employer may find itself at odds with a former employee regarding the COBRA continuation coverage. Questions may arise regarding when the COBRA continuation coverage period begins and ends. If an employer intends for the COBRA continuation period to run concurrently with the subsidized coverage from the date of the qualifying event, the severance documentation should make this clear, and COBRA notices should be sent accordingly. Otherwise, the employee may mistakenly believe and argue that the COBRA continuation coverage begins when the subsidy ends.

In addition, where an employer agrees to pay for all or part of the cost of COBRA coverage, the severance documentation should be clear that the obligation to pay is subject to the employee's timely election of and eligibility for COBRA coverage. The terms of the severance arrangement should also specify for which plans the COBRA subsidy applies and whether the subsidy applies to employee-only or family coverage.

To the extent that an employer may wish to provide COBRA coverage for greater than 18 months, the employer should consider working with its health insurance plan service providers and vendors. In the case of a fully insured plan, the employer should discuss with the insurer whether the insurer will provide coverage beyond the mandated 18-month period. In the case of a self-insured plan, the employer

should discuss with its stop-loss insurer whether COBRA coverage beyond the mandated 18-month period is covered under the stop-loss policy. If an insurance or stop-loss carrier does not cover the extension period, and an employee has a catastrophic medical event after the 18th month of COBRA coverage, the employer may need to self-insure those expenses at potentially a high cost to the company. As a result, an employer should clearly understand the potential risks and costs before providing insurance longer than the mandated 18-month period.

Finally, absent an exception, severance arrangements that include the reimbursement or payment of subsidized COBRA coverage are subject to Section 409A of the Code, which applies to deferred compensation. Importantly, Section 409A does not apply to the following types of medical reimbursement arrangements: medical reimbursement arrangements that provide benefits or reimbursements that are excluded from income under Sections 105 and 106 of the Code; or reimbursements for post-termination medical coverage, but only to the extent that such arrangements provide coverage during the COBRA continuation coverage period (generally 18 months). Notably, self-funded health plans that provide discriminatory benefits do not fit within the exception for medical reimbursement arrangements or reimbursements under Sections 105 and 106 of the Code.

Additionally, subsidized COBRA coverage extending beyond the COBRA continuation period (generally 18 months) must also comply with Section 409A of the Code. To the extent that an employer provides a former employee with taxable cash compensation (for example, to avoid the nondiscrimination rules described above), the employer may need to structure the payments to fit within an exception from Section 409A of the Code, such as the short-term deferral exception (in general, all payments made by March 15 of the year after separation) or separation pay exceptions. Another alternative may be to structure the payments to comply with Section 409A of the Code by making the payments on a fixed date or pursuant to a fixed schedule. 🌟

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