New COBRA Rules: Practical Considerations

The stimulus bill enacted in February provides a temporary, government-subsidized reduction in COBRA premiums for employees involuntarily terminated during the period from September 1, 2008 through December 31, 2009. The new bill does not directly impose financial burdens on employers, but does impose a number of new obligations on them, and raises several interesting questions with respect to severance agreements with executives. This Client Alert discusses the principal obligations and issues raised by the new provision.

Background

Under the statute, any employee terminated within the covered period who is eligible for, or elected, declined, or lost COBRA continuation coverage on or after September 1, 2008, must be given a new sixty-day period to elect such coverage and/or to receive the subsidy. If he does so, the subsidized coverage will begin on March 1, 2009, and the employee will be responsible for only 35% of the premium he was paying. The employer is responsible for paying the remaining 65% up-front, which it recovers through a credit to its payroll taxes. In practice, therefore, the credit will be available only after (i) collection of a former employee's portion of the premium and (ii) the employer's payment of the rest of the COBRA premium.

The subsidy phases out for an employee whose adjusted gross income exceeds $125,000 ($250,000 for joint filers) in the year he would receive the subsidy. Any employee whose income exceeds $145,000/$290,000 and who receives the subsidy is required to include the value of the subsidy in his taxable income in such year (subject to a phase-out for adjusted gross income from $125,000 to $145,000/$250,000 to $290,000). Subsidized coverage lasts for nine months or until the date on which the employee is eligible to be covered by another employer's plan, if earlier.

Notices

An employer's initial obligation is to notify every terminated employee of the subsidy, including those terminated on or after September 1, 2008. This retroactive effect will require employers to review and collate all terminations since that date and to verify the reason for termination. The Department of Labor is to provide a form of notice this month, but until it does, an employer can create and distribute a notice of its own (which may be either a separate notice or an addition to its existing COBRA notice).

If an employer disputes an employee's claim to have been involuntarily terminated, the employee may appeal the denial to the Department of Labor. Inasmuch as the government generally will bear the cost of the subsidy, employers may have little or no incentive to contest such claims. Nevertheless, an employer who is not willing to accept a claim it considers false needs to be aware of this potential burden.

Potential Experience Costs

The subsidy may carry with it hidden costs. This is because those employees who elect COBRA generally have substantially higher claims than active employees or those who decline coverage. Thus, if the subsidy results in a significant number of former employees electing COBRA who would not otherwise have done so, the employer's claims experience may be adversely affected. This could, of course, be reflected in higher future costs. This possibility may be mitigated by the generally high cost of COBRA coverage. In a period of great economic uncertainty, even the 35% cost may be too much for some employees to bear.

Employers also need to be aware that, under the current COBRA rules, if an employer purchased the assets of another company, the selling company ceases doing business, and the employer continues to operate the purchased business without substantial change, the employer will be deemed a successor employer. It therefore will be required to offer COBRA coverage to those employees of the selling company who do not continue on with the employer, as well as those employees of the selling company who were on COBRA through the selling company, and — based upon the stimulus bill — to former employees of the selling company whose employment terminated on or after September 1, 2008. A buyer thus runs the risk of covering individuals (the post-September 1, 2008 terminated employees) whom it never employed and who, as noted above, could impact its claims.

Existing Severance Arrangements

Since September 1, 2008, many employers undoubtedly have negotiated severance arrangements with employees in which the employer agreed to pay a portion of the employee's COBRA premium. The statute in effect penalizes employers who did so. For example, assume that an employer agreed last October to pay 75% of an employee's $1,000 per month COBRA premium. Under the IRS's interpretation of the bill, the employee's premium obligation is deemed to be $250 (not $1,000). This amount would be reduced to $87.50 (35% of $250) by the subsidy, and the employer would be entitled to a payroll credit for $162.50, but would still be responsible for $750 per month. Conversely, if the employee had been paying the full $1,000 premium, the subsidy would reduce his cost to $350 and the government would pick up the remaining $650, a gain of $750 for the employer.

It is not completely clear that such agreements can be revised to take advantage of the subsidy. If they can, the employer presumably would need to make the employee economically neutral by agreeing to pay the additional premium the employee would have to pay (*i.e.*, $350 rather than $87.50 in the above example). Normally, the employer could pay the employee's share of the premium or reimburse him for it, and the payment would not constitute taxable income. In such case, the former employee would be cash-neutral while the employer would have gained $400. It is not clear, however, that, if such reimbursement were made, the IRS would not consider the employee's premium to be $0, in which case the subsidy would not be available. Moreover, if the $350 instead constitutes taxable income, the employee undoubtedly will want to be grossed-up for the additional tax, reducing the employer's gain.

One group of employees for whom such agreements are relatively common are senior executives. Dealing with the issue for such employees, however, may be ameliorated in many cases by the income limitation for use of the subsidy (*i.e.*, severance payments to such executives often exceed the $145,000/$290,000 income cap).

Another potential problem that can arise in connection with a senior officer's termination is the proper characterization of the termination, as the statute does not define an "involuntary" termination. It is relatively common for employers to agree to publicly announce that an executive has resigned to, for example, "pursue other opportunities," when in fact he has been asked to leave. If such an executive were to elect the subsidy, the employer would need to decide whether the prior characterization of a voluntary resignation binds it to deny the claim. This potential problem also may be substantially alleviated by the income cap, which will make the subsidy unavailable to many high-paid executives. The Treasury Department has indicated that it will issue guidance to assist employers in determining what constitutes an "involuntary" termination, but until such guidance is forthcoming, questions remain.

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