CORIENT

UNDERSTANDING SEVERANCE PACKAGES

Being dismissed from your job is never easy. Whether it comes after a year, a decade or a whole career, it's a change that can have ripple effects across your physical, emotional, and financial well-being. Routines are upended, relationships are disrupted, and if work is a big part of your identity, your self-image might falter. Will your next step be a job in the same field? Will it be a new career path? Is it time to embark on an entrepreneurial project? Or should you perhaps consider retirement?

As you ponder the future, there are five key issues that might need your immediate attention:

1. Severance and deferred compensation
2. 401(k) retirement plans
3. Stock award and investment portfolios
4. Life, health and disability insurance
5. Pension plans

This report is designed to enhance your understanding of severance packages and help clarify your decision-making in this challenging time.

1. Severance and Deferred Compensation

Severance and deferred compensation can present financial planning challenges and opportunities. Ideally, you'll make the most of any windfall while minimizing the potential for a large tax liability.

How Severance Packages Work

Severance is commonly paid in a lump sum a few weeks after your separation date but can also extend over a period of several weeks or months. Payment is subject to ordinary income tax, and typically, you can't defer any of the payment to your 401(k) or deferred compensation accounts since the payment is made following your separation date.

Taxes will be withheld, as well as applicable state, FICA and Medicare tax. Since this severance payment could bump you into a higher tax bracket, it's important to think about whether the standard 22% federal withholding tax is enough. You might need to set aside extra cash from your payment to cover the full tax.

If you don't need to use all of your severance payment for living expenses, we often find that such a severance "windfall" presents a good opportunity to tackle other goals, like debt payments, college savings or replenishing an emergency fund.

Deferred Compensation

If you were eligible for a deferred compensation plan, you may have used it to defer a large amount of your annual base salary and bonus each year. If you've accumulated significant assets this way, you'll now want to understand the timing of distributions. Since this is a non-qualified retirement plan, assets can't be rolled over to an IRA. Instead, they're distributed to you.

Distributions from the plan will start within a specified period after your separation date and are made based on the schedule you selected each year during the enrollment period. Typical distribution options are to receive a lump sum or payments over a particular period. Since distributions are taxed as ordinary income, you could lose over 40% of your withdrawal to taxes, depending on the distribution amount and your other income sources in the year of distribution.

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> could help reduce your level of taxation.

Potential ways to avoid having deferred compensation taxed at the highest bracket include accelerating or deferring other income to a future year, which could help reduce your level of taxation. If possible, consider grouping tax deductions into the year when you receive a large distribution.

Also think about creating a donor-advised fund to help minimize tax while supporting your preferred charitable causes. Through this strategy, you may gift assets—even several years' worth—to the donor-advised fund and immediately receive the corresponding tax deduction, while deferring any gifting to the charity until a later date that's appropriate for you. It's like getting an advance tax break on your future charitable giving.

If your deferred compensation balance will remain in its plan for several years, be sure to coordinate your investment allocation with your other investments and overall financial plan so that everything remains aligned with your risk tolerance and goals.

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2. 401(k) Retirement Plans

If you're leaving a job that provides a 401(k) retirement plan, you might consider some steps both before and after your final day on the job to maximize the value you can ultimately realize from the plan.

Before You Leave

A 401(k) plan tax-efficiently builds wealth for retirement and is often supplemented by matching employer contributions. Once your separation date is confirmed, it's generally best to fund the maximum allowable amount to your 401(k) plan before that date. It's a great retirement savings opportunity that will soon be lost, so we suggest you take advantage while you can, as long as it makes sense for your financial circumstances.

If a paycheck adjustment is needed before year-end that will reduce your take-home pay, remember that you'll be receiving a severance payment shortly after separation, which can offset part of this impact.

Some 401(k) plans provide the option of contributing on a traditional pre-tax basis or to a post-tax Roth 401(k). If all your contributions aren't already being made on a pre-tax basis, switching any remaining contributions to traditional pre-tax can help you reduce your taxable income for the year.

What to do with Your 401(k)

After leaving your company, you have a few options regarding your 401(k) plan. First, it might be possible to leave your account in the company plan as it is. Plan terms may vary, so please consult with your company to determine which options are available to you.

If you can keep your plan at the company, it'll remain invested in whatever investments you've chosen and will continue growing on a tax-deferred or tax-free basis, depending on whether your contributions were pre-tax or Roth. You may also continue accessing your account on the 401(k) website. You won't be required to withdraw funds from your account until you reach age 73, when the IRS requires that distributions begin.

If you're between the ages of 55 and 59 ½, consider whether you might need to withdraw from you 401(k) plan before age 60. Generally, withdrawals from a retirement account before age 59 ½ are subject to a 10% early withdrawal penalty. However, a special rule allows penalty-free withdrawals from your 401(k) prior to age 59 ½ if you're at least age 55 during the calendar year that you separate from employment service. As such, it might make sense to leave some or all of your 401(k) assets in the 401(k) plan, just in case you need to withdraw some funds before age 60.

> The components of your 401(k) deposits will determine what type of account the money should be rolled over to, while avoiding taxes.

A second option is to roll over your 401(k) into another company's 401(k) plan, or to an IRA and/or Roth IRA. The components of your 401(k) deposits will determine what type of account the money should be rolled over to, while avoiding taxes. Consider rolling over pre-tax dollars to a traditional IRA, with the check made payable to the IRA custodian. Any Roth 401(k) dollars should be rolled to the custodian of the Roth IRA.

Lastly, if you have an after-tax account where you made after-tax contributions over the years, you may want to consider rolling these contributions into your Roth IRA. It's a unique strategy that many high-income earners can take advantage of, where funding a Roth IRA might not have been possible in the past due to IRS income limits. The after-tax contributions may also be deposited into your personal checking or brokerage account.

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3. Stock Awards and Investment Portfolios

Stock awards offer the potential for significant capital gains as well as the risk of tax liabilities and having an over-concentrated portfolio. Here are some considerations to balance these risks and rewards.

Managing Your Stock Awards

Many companies offer long-term incentive awards to key employees. Such awards often consist of stock options, restricted stock and/or performance-based restricted stock. For some people, stock awards represent one of the largest assets on their personal balance sheet. Therefore, it's wise to create a strategy to carefully unwind these stock positions once you've learned your role at work is being eliminated.

The awards have vesting schedules that may be accelerated based on the criteria in your severance package, and some awards may expire worthless. To maximize after-tax value, it's important to account for this in your financial plan and understand the cash flow and tax implications of your stock strategy.

When restricted stock or performance-based stock awards are released, the award's fair market value is taxed at ordinary income tax rates and reported on your pay stub. For tax purposes, your holding period begins once the shares are released to you. Consequently, selling shares immediately after release can result in negligible capital gains tax.

If you sell within 12 months, any gain is taxed at short-term capital gains rates, which are the same as ordinary income tax rates. Waiting 12 months to sell after shares are released means any gain will be taxed at long-term capital gains rates (federal and potentially state).

Finally, we believe it's important to understand the impact of additional released company stock on your portfolio's concentration in that stock. If you're entering retirement, we recommend limiting concentration in a single stock to no more than 15% of your overall investment portfolio in order to keep yourself adequately diversified.

Maintain an Appropriate Investment Portfolio

We believe a well-constructed investment portfolio is key to long-term financial success and should reflect any stock awards you may receive. Your portfolio is critical to building and preserving wealth and should be designed to fit your cash flow needs, time horizon, risk tolerance and tax objectives. We believe that successful investing requires a long-term perspective and disciplined approach that avoids short-term emotional mistakes.

> A comprehensive strategic asset allocation should form the foundation of any portfolio.

We believe a comprehensive strategic asset allocation should form the foundation of any portfolio. At your workplace, most of your investment assets might be concentrated in the company 401(k) plan, with limited investment choices. After your separation date, it will be crucial to work with a qualified wealth advisor who can help you restructure your affairs.

For example, you may roll your retirement assets into an IRA with many investment choices to help achieve an optimal asset allocation. While having this flexibility is nice, it can be a big task to sift through all the possibilities and arrive at a suitable portfolio. A wealth advisor can help you narrow your options and align your choices with your stage of life, desired mix of investments, cash flow planning, and tax minimization opportunities.

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4. Life, Health and Disability Insurance

For many of us, insurance protection is closely tied to our employer. Here are some factors to consider that can help you maintain the coverage you need at a reasonable cost as you transition out of your job.

Focus on Maintaining Coverage

Insurance planning is a vital component of a comprehensive and well-designed financial plan. It's important to consult with an expert in the field to devise an insurance program that best suits your specific needs and objectives. Since it's quite common for employees to have much of their life, disability and health insurance coverage through their company group plans, we believe you should understand what your departure from the company could mean for your insurance coverage.

Regarding health insurance, determine whether you're eligible for a company retiree health plan. Also, evaluate the merits of electing COBRA for a period of time following your separation date—until you find another job or become eligible for an alternative medical plan (such as Medicare or an individual plan). If you elect COBRA, you and your qualified dependents will have the option of continued health benefits coverage in the event that you lose your job. Remember that once your employer-sponsored benefits end, you'll generally have 60 days to enroll in COBRA.

Having adequate insurance helps you stay prepared in case you or any of your eligible family members encounter unexpected health care needs. We understand that health insurance can be a sensitive and stressful topic, so we're committed to supporting you and ensuring you have the optimal strategy in place, in order to avoid any major gaps in your health care coverage.

Insurance Strategies to Consider

For life insurance, evaluate how much coverage you should maintain, and for how long. Also compare the cost to convert your group coverage to an individual policy versus getting a new policy elsewhere. Typically, you may convert your group policy to an individual policy with no evidence of insurability required, which may be an advantage. However, also bear in mind that group life insurance policies are often more expensive than private policies as you get older, so it may be worthwhile to shop around for a private policy.

When it comes to disability insurance, your coverage often ends on your workplace separation date. Individual private coverage can be expensive and difficult to qualify for, so if you plan to keep working, you may want to be mindful of the group disability coverage offered by a future employer.

> If you hold funds in the company's Health Savings Account (HSA), your account can stay there.

If you hold funds in the company's Health Savings Account (HSA), your account can stay there. Don't worry; you won't forfeit these funds when you leave the company. Please note that if you haven't made your full annual contribution to the HSA via payroll deductions by your separation date, you're still permitted to make any remaining contributions from your personal funds. You can claim a tax deduction for these HSA contributions on your tax return as late as April 15 of the following year after separation.

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5. Pension Plans

Pension plans are an increasingly rare and valuable employment perks. If you are leaving your job with pension plan assets, here are some strategies to help you maximize the benefits.

Your Pension Benefits

A company-sponsored pension plan is a convenient and effective way to save for your retirement years. Such plans are often funded by the employer but sometimes also allow for employee funding. In those cases, if an employee is willing to make additional contributions (typically up to a given percentage of their base salary), the employer will match some or all of the contributions to help the plan's assets grow faster.

While pension benefits are becoming less common, some companies continue to offer them. In most cases, you can take your pension benefit with you when you leave the company or defer receiving pension benefits until a later date. Before you transition out of your company, it's helpful to calculate an estimate of your benefit amount using different benefit start dates and keep them for your records.

Options to Consider

In addition to choosing when to begin receiving pension benefits, you'll need to decide on a payment option. Your options often include an annuity payable only for your lifetime—which is typically the highest payment amount—or payments based on both your life and the life of a surviving spouse or beneficiary.

Deciding what percentage of your payment a surviving spouse or beneficiary receives will impact your pension benefit amount. For example, a retiree may have a Single Life Only Annuity option that pays a monthly benefit of $2,000 for the duration of their life. Alternatively, the Qualified Joint and Survivor Annuity payment option lasts for the retiree's life and the duration of a spouse's life. However, the monthly benefit amount may be reduced to $1,850, with a surviving spouse receiving $925 per month.

Finally, some pension plans provide the option to take a lump sum. If this is appropriate for you, you can generally roll the amount into an IRA to avoid income taxes when the lump sum pension pays out.

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Regarding when and how to receive your pension benefits, we believe it's important to know where your income will come from over the next several years and to understand what your cash flow needs may be. You'll want to consider income sources like other work earnings, Social Security, and investment portfolio withdrawals in order to identify potential gaps in your income needs and how your pension benefit may help fill them.

Your decision should also consider other factors, such as your age, health, lifestyle, future work income and how soon you'll need to start living off your investment portfolio. We build projections to help clients analyze what their income and expenses could be in retirement, where they might generate additional income and how their pension income fits into their bigger retirement picture.

Conclusion

You Don't Have to Take the Next Step Alone

Severance packages can be highly complex, involving a number of decisions around cash flow, taxes, investments, insurance, and financial planning—all with implications for today and tomorrow. You may recognize aspects of your situation where professional guidance could increase your comfort level with how to proceed.

Corient Wealth Advisors are part of professional teams that understand severance packages and how they intersect with the full spectrum of your wealth management needs. We are ready to take the next step with you.

Corient At-a-Glance

Corient is one of the largest integrated fee-only RIAs in the United States. Our partnership model was designed to foster professional collaboration and a relentless focus on client excellence. As fiduciaries, we put our clients first and at the center of everything we do. And as a firm, we focus on exceeding expectations, simplifying lives and establishing lasting legacies.