

Chapter 69 – Termination Plans, Early Retirement Incentives, and Severance Payments

Authoritative Sources

[FAR 31.205-6\(g\)](#), Severance Pay

[FAR 31.205-6\(j\)\(6\)](#), Early Retirement Incentive

[FAR 31.205-6\(l\)](#), Compensation Incidental to Business Acquisitions

This chapter addresses the following topics:

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69-1 Termination Plans, Early Retirement Incentives, and Severance Payments

A termination plan sets out the criteria used by a contractor to terminate its employees and determines the termination compensation to be paid to those employees.

A special termination plan uses different criteria than the contractor's normal established criteria or provides different benefits than its normal established benefits. Special termination plans are used for unusual circumstances such as the requirement to make mass terminations or a goal to make significant reductions in the company's

work force. In such situations, employers have found it advantageous to provide incentives for employees who "volunteer" to be terminated. The employer can design these plans to limit the employees eligible for termination as well as steer employees who would be the best choices from the employer's viewpoint toward "volunteering."

Early retirement incentive payments are payments made pursuant to a plan offered exclusively to employees eligible to retire under a pension plan. The purpose of such plans is to induce eligible employees to make an election to retire early and receive immediate pension benefits. Early retirement incentives are sometimes included within a termination plan. If included in a termination plan, the early retirement incentive policy and procedures must meet the same requirements as if it were a separate plan. (For further discussion of early retirement incentive payments, see Chapter 53, Pension Costs.) Under FAR 31.205-6(j)(6) the present value of the total early retirement incentives given to an employee in excess of the employee's annual salary for the last contractor fiscal year completed prior to the employee's retirement is unallowable.

Severance pay, also commonly referred to as dismissal wages, is defined in FAR 31.205-6(g) as a payment, in addition to regular salaries and wages, to workers whose employment is being involuntarily terminated. If a contractor makes a severance pay plan available to its employees regardless of their retirement eligibility, the payments from that severance plan are allowable if they are reasonable and in accordance with FAR 31.205-6(g). The payments made under a severance pay plan to employees who, coincidentally, are also eligible for pension benefits should not be reclassified and treated as early retirement incentive payments subject to FAR 31.205-6(j)(6).

The auditor should closely review the reasonableness of special termination plans that offer both severance-type benefits and early-retirement-incentive-type benefits to the same employee. A well designed special termination plan usually does not need to offer both of these benefits to the same employee to achieve its goals to reduce levels of employment. Usually, if both types of benefits are included in the plan, the employee can choose one of them, but not both. However, the actual determination of allowability must be made considering the reasonableness of the entire termination plan (see 69-7).

69-2 Severance Pay Benefits

Contractors usually have a severance pay policy that pays employees a set number of weeks' pay based upon years of service. However, some contractors may provide additional termination benefits, such as medical care, education, and relocation expenses in order to reduce hardship to employees terminated as the result of a mass work force reduction process. These additional benefits also represent severance pay. The allowability of the total severance pay is subject to the reasonableness criteria contained in paragraph (b) of FAR 31.205-6, Compensation for personal services. Note that FAR 31.205-6(b) requires the contractor to demonstrate reasonableness of compensation items. It specifies factors to be considered in determining reasonableness, including the compensation practices of other firms in the same industry as well as the practices of firms engaged in non-Government work.

69-3 Payments for Involuntary versus Voluntary Terminations

FAR 31.205-6(g) provides that severance pay is a payment, in addition to regular salaries and wages, to workers whose employment is being involuntarily terminated. This provision can be applied to both of the following situations. First, "involuntarily terminated" can refer to situations where the employee has no option of staying with the company. Secondly, "involuntarily terminated" can refer to situations where the contractor has an established goal for a reduction in work force. Whether or not any specific employee is given an option to stay is irrelevant, provided that the contractor has an established goal. The contractor's commitment to a work force reduction may be evidenced by providing assurance to the Government that the terminated employees will not be replaced; i.e., their jobs have been abolished in order to reach the established goal. Reductions in the work force made under this second situation are often accomplished under special termination plans and may produce higher termination costs than would the contractor's previously established termination benefits. The higher costs are allowable if reasonable (see 69-7). Payments made for involuntary terminations are allowable subject to the provisions contained in FAR 31.205-6, while payments made for voluntary terminations are unallowable.

69-4 Normal and Abnormal Severance Pay

FAR 31.205-6(g)(2) classifies severance pay as either normal or abnormal. Either is allowable only to the extent that in each case it is required by:

- (1) law;
- (2) employer-employee agreement;
- (3) an established policy that constitutes, in effect, an implied agreement on the contractor's part; or
- (4) the circumstances of the particular employment.

Normal severance pay should be allocated to all work performed in the contractor's plant. When the contractor provides for accrual of pay for normal severances, such method will be acceptable if the amount of the accrual is reasonable in light of payments actually made for normal severances over a representative past period and if the amounts accrued are allocated to all work performed in the contractor's plant.

Abnormal or mass severance pay is considered by FAR 31.205-6(g)(2)(iii) to be of such a conjectural nature that measurement of costs by means of an accrual will not achieve equity to both parties. Accruals for abnormal or mass severance pay are not allowable. However, when specific payments occur, allowability will be considered on a case-by-case basis. Severance paid under the terms of a special termination plan is generally abnormal severance.

69-5 Severance Pay When There is a Replacement Contractor

Severance payments made to employees who are to be employed by a replacement contractor are not allowable. For this purpose, employment by a replacement contractor occurs when continuity of employment with credit for prior length of service is preserved under substantially equal conditions of employment, or continued employment by the contractor at another facility, subsidiary, affiliate, or parent company of the contractor.

69-6 Severance Paid in Addition to Early or Normal Retirement Benefits

Prior to October 3, 1988, FAR 31.205-6(g)(2)(i) provided that severance payments, or amounts paid in lieu of, are not allowable when paid to employees in addition to early or normal pension payments.

The prohibition of payment of both severance and pension benefits was deleted by Federal Acquisition Circular 84-39 effective October 3, 1988. The FAR now permits the payment of otherwise allowable severance and pension benefits concurrently, as well as sequentially, i.e., in the latter case, the contractor may delay payment of pension benefits until after the period for which severance pay is provided. In the circumstances where the contractor provides payment of both severance and pension benefits to the same employee, the auditor needs to closely review the plan to determine if the total plan costs are reasonable.

69-7 Reasonableness of Special Termination Plan Costs

Contractors may offer special termination plans, which provide enhanced benefits, to achieve a work force reduction goal by inducing voluntary employee terminations. The rationale behind offering an enhanced severance payment, or an early retirement incentive, should be that the contractor will achieve lower overall costs which will offset the higher termination costs of the special plans. The costs of such plans could include loss of key personnel, higher severance costs (e.g., increased severance benefits for each employee class when compared to the normal plan and higher severance costs resulting from senior workers volunteering to terminate), and higher pension costs resulting from primarily the early retirement incentives. The primary cost reductions of such plans generally are lower overall compensation of the remaining employees, as well as reductions in recruiting and training needs in the near-term. For example, by inducing older employees to retire, the contractor retains younger, fully trained employees who will not need to be replaced for a longer period of time and who are likely to be paid less than the terminated workers.

The contractor should be able to support a special termination plan with sufficient information to make a determination that the additional costs incurred by the special plan are offset by associated additional reductions in other costs. Both FAR

31.205-6(b)(1) and 31.201-3 require a contractor to demonstrate that its plan is reasonable.

In assessing the reasonableness of a plan, the auditor should consider the value of intangible benefits associated with employee morale and the contractor's reputation as an employer. However, there is no presumption that the Government will allow the costs of such intangible benefits. If justification for a special plan is based on the value of intangibles, it would be an appropriate subject for an advance agreement with the Government before the cost is incurred. (See FAR 31.109 for further discussion of advance agreements.) If the cost/benefit analysis includes intangible benefits and no advance agreement was executed, the auditor should discuss this matter with the contracting officer. If it is decided that the intangible items should be included in the cost/benefit analysis, the auditor should evaluate the reasonableness of the values assigned to those items. The auditor should question any unreasonable costs associated with the plan.

69-8 Golden Parachute Plans

A "golden parachute" is a termination agreement which provides for the payment of extremely lucrative financial benefits, usually to a limited number of key executives. The termination or severance payments granted under the "golden parachute" arrangement are normally well in excess of normal severance payments. Such payments are paid only in the event the employee leaves the company following an actual or anticipated corporate merger or a transfer of control over the company. A common motivation for instituting a "golden parachute" plan is to discourage a hostile takeover by making the costs of a takeover prohibitively expensive.

The costs of "golden parachutes" were made expressly unallowable in FAR 31.205-6(l)(1) effective April 4, 1988. Costs of "golden parachutes" are not reasonable, do not benefit the Government, and constitute costs incidental to reorganization because such agreements become operative only with the actual or anticipated corporate takeover. Accordingly, the auditor should also question costs of "golden parachutes" claimed by the contractor for contracts awarded prior to April 4, 1988 based on the cost principle provisions for reasonableness (FAR 31.201-3 and 31.205-6), allocability (the benefits received requirement at FAR 31.201-4), and organization costs (FAR 31.205-27). For costs of "golden parachutes" included in any billing, claim, or proposal submitted by the contractor for contracts awarded on or after April 4, 1988, the auditor should cite FAR 31.205-6(l)(1) as a basis for disallowing such costs. See also Chapter 8, Business Combination Costs.

69-9 Severance Pay to Foreign Nationals

Effective March 29, 1989, service contracts to be performed outside the United States included the clause at FAR 52.237-8. The clause limits severance paid to foreign nationals performing services outside the United States to the amount typically paid to employees providing similar services within the United States. Effective February 19, 1993, this coverage was removed from FAR 31.205-6, 37.110, and 52.237-8, for non-

DoD contracts. This coverage was included in DFARS 231.205-6, effective October 30, 1992, for DoD contracts.

Effective December 21, 1990, the clause at FAR 52.237-8 was revised to make such severance payments totally unallowable for terminations of employment resulting from requests of the host foreign government to close or curtail the employing activity. This prohibition of severance payments only applies to terminations of agreements between the United States and the host country entered into after November 28, 1989. Effective February 19, 1993, this coverage was removed from FAR 31.205-6, 37.110, and 52.237-8, for non-DoD contracts. This coverage was included in DFARS 231.205-6, effective October 30, 1992, for DoD contracts.

The Defense Appropriations Act of 1992 (Section 346) allows DoD to waive the limitations on allowability of severance payments to foreign nationals for contracts for the operations of overseas military banking services.

69-10 Severance Pay Policies for Paid Absence Under the Worker Adjustment and Retraining Notification (WARN) Act

The Worker Adjustment and Retraining Notification Act (WARN), sometimes called the Federal Plant Closure Law, 29 U.S.C. 2101, applies to employers with 100 or more full-time employees or to employers with 100 or more employees who in the aggregate work at least 4,000 hours per week (exclusive of overtime). The Act requires that employees be provided with a 60-day advance notice when a plant is to be closed or there is to be a mass layoff. A plant closure is defined as a permanent or temporary shutdown of a single site of employment, one or more facilities, or an operating unit, where 50 or more employees (excluding part-time employees) lose their jobs. A mass layoff is defined as a reduction in force which is not a plant closing but which results in at least 33 percent of the work force (with a minimum of 50 employees) or 500 employees being terminated (excluding part-time employees).

The WARN Act allows employers to give notice to employees less than 60 days in advance when a business circumstance is such that it is not reasonably foreseeable at the time that the 60 day notice would have been required. In order to be not reasonably foreseeable, the event must be caused by a sudden, dramatic, and unexpected action or condition outside the employer's control.

A contract termination may result in a plant closure under the Act if it causes the shutdown of at least one site, facility, or operating unit. Shutdown of an operating unit will occur when there is the discontinuance of an entire product line or the extinction of an organizationally distinct operation or function. The critical factor in determining what constitutes an operating unit will be the organizational or operational structure of the contractor. The circumstances of each contract termination should be reviewed and evaluated to determine if the contract termination resulted in a plant closure under the Act.

Where a contract termination results in a plant closure, and the contractor has exercised reasonable and prudent efforts in providing timely notification of the plant closing, costs incurred to comply with the WARN Act are generally considered allowable and reasonable business expenses under FAR 31.201-2 and 31.201-3.

Where the termination does not meet the provisions of the WARN Act, the auditor should determine if the contractor's actions were reasonable. For example, if the contractor terminates less employees than the minimum required for application of the WARN Act, any payments made for unproductive effort should generally be questioned as not meeting the test of payments for work accomplished in the current year. However, such payments would be allowable to the extent that the contractor can demonstrate that, given the circumstances at the time, it was reasonable to give the WARN Act notices and make the associated payments to the affected employees.

In some instances, contractors may place WARN Act status employees who are in sensitive positions on paid absence because of fear that those employees, if allowed to work during the 60-day period, might use their positions to harm the contractor's assets or records in retaliation for losing their jobs. There is no existing regulation or policy which specifically prohibits payments for such paid absence. The paid absence during the 60-day notice period could be considered additional severance pay. However, the contractor may claim the costs as some other category of cost associated with the reduction in force. FAR 31.205-6(b) requires that the contractor demonstrate reasonableness of compensation items and FAR 31.201-3 requires the contractor demonstrate the reasonableness of all costs claimed. Therefore, it is incumbent upon the contractor to demonstrate why it believes the employees are a high risk and should not be working during the notice period. The contractor must also explain why these employees cannot be reassigned to perform nonsensitive work elsewhere in the plant and what the contractor's policy and procedures are in this situation. Without acceptable justification from the contractor, any claimed costs for paid absence during the 60-day notice period would be considered unreasonable and should be questioned.