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Supplemental Unemployment Benefits

Although the U.S. Supreme Court disagreed with *Quality Stores* and held that regular severance payments are subject to Federal Insurance Contributions Act ("FICA"), there is an older type of separation pay plan that the IRS agrees is exempt from FICA. Establishing a supplemental unemployment compensation benefits ("SUB") plan to pay separation benefits may be advantageous for employers and their former employees. This article describes a typical SUB plan and explains how paying separation benefits pursuant to the plan may produce employment tax savings and other advantages.

Overview

A SUB plan enables an employer to provide periodic post-separation benefits to former employees without subjecting the benefits to FICA or Federal Unemployment Tax Act ("FUTA") taxes, and in most cases, State Unemployment Insurance ("SUI") taxes.¹ The FICA and FUTA exceptions for SUB pay may result in savings to employers with significant work force layoffs and reductions. Employers may also find additional savings by reducing SUB pay to reflect the fact that employees will not pay FICA taxes on benefits provided by a SUB plan.

SUB pay is tied to unemployment benefits, and thus may only be provided to unemployed individuals who are eligible for and receiving state unemployment insurance benefit payments. Employers may provide separate post-separation benefits to individuals who are subsequently re-employed with the same employer or elsewhere, but the payments cannot be considered SUB pay. Payments provided to re-employed individuals should be considered severance pay that is subject to FICA, FUTA, and SUI taxes. For maximum flexibility and savings, employers can provide SUB pay

¹ SUB plans are not permitted in all states, and some states may require the establishment of a trust as part of the SUB plans design. KPMG can assist in determining the specific requirements of each state.

to individuals while they are unemployed and severance benefits to those individuals if and when they become re-employed.

Recipients of SUB pay must be involuntarily separated from service due to a reduction in workforce; discontinuance of a specific function, plant, or operation; or other similar condition. The individual's separation from service may be temporary or permanent, and SUB pay may even be provided to individuals who may eventually be rehired by the original employer (i.e., the employer providing the SUB pay). SUB pay is not typically provided for executive terminations or single employee terminations (although single employee involuntary job elimination may be paid from a SUB plan).

In many states,² the SUB plan does not have to be implemented at all facilities maintained by the employer and the employer may designate which facilities will provide SUB pay (vs. severance pay).

History of SUB Plans

SUB plans originated in response to organized labor's claims during the 1950s that state unemployment benefits were insufficient to aid employees during periods of layoffs resulting from technological, cyclical, and seasonal demands. Organized labor considered it critical that supplemental pay be excluded from the definition of "wages" because the states generally disallowed unemployment compensation while employees received remuneration for employment (i.e., "wages").

Thus, absent an exception, SUB pay would be wages, and receiving SUB pay would disqualify individuals from receiving the benefits the pay was intended to supplement. To correct this anomaly, the IRS created an administrative exception to the definition of wages for SUB pay.³ In addition to alleviating conflicts with qualification for state benefits, excluding SUB pay from the definition of wages made the pay exempt from FICA and FUTA taxes.

Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

² Certain states require that SUB Pay plans are offered to all employees across the domestic population. KPMG can assist in determining the specific requirements of each state. In addition, SUB Pay plans are subject to the requirements of the Employee Retirement Income Security Act ("ERISA") and its accompanying nondiscrimination requirements (discussed in detail below). Care should be taken that the provision of SUB Pay to some, but not all, employees does not result in an impermissible discriminatory benefit.

³ Rev. Rul. 56-249.

After the IRS made this determination, the popularity of SUB plans increased dramatically. In 1958, section 501(a)(17) was added to the Code, allowing the creation of a tax-exempt trust. As the use of SUB plans grew, the IRS issued additional guidance on SUB plans. Each ruling recognized the exception for SUB pay from the definition of wages for FICA and FUTA purposes. In 1969, the government again recognized SUB plans by adding section 3402(o), which clarified that employers must withhold federal income tax on SUB plan payments. In 1989, the IRS announced an extensive study of the tax treatment of SUB pay. The result of this study was the issuance of Revenue Ruling 90-72, in which the IRS continued to recognize an administrative exclusion from FICA and FUTA taxes for SUB pay.

Tax Treatment of SUB Pay

Although SUB payments are treated as taxable income for the former employees, employers do not withhold or remit FICA or pay FUTA tax on SUB payments. The tax treatment of SUB pay for SUI purposes varies by state. As noted above, employers must withhold federal income tax on payments made from the SUB plan.⁴

Employers may deduct SUB pay if the pay would otherwise be deductible under section 162 as an ordinary and necessary business expense.

Determining Benefits

The design of the benefits available pursuant to a SUB plan is generally the employer's decision, but a SUB plan typically pays a supplement to an individual's weekly state unemployment benefit that, when added to the unemployment benefit, will equal 100 percent of the individual's last normal weekly gross pay.

During Period of Unemployment

For example, if an individual is eligible to receive 20 weeks of severance pay at gross weekly rate of \$1,000 or \$20,000 in total benefit, the individual would receive a gross weekly benefit of \$1,000 comprised of, for example, \$300 of state unemployment benefits and \$700 of SUB pay while the individual is unemployed.

⁴ Section 3402(o).

With a SUB plan in place, the company can design the plan so that a former employee⁵ can receive the same company paid benefits over a longer period of time if paid from the SUB plan. In this example, the former employee could receive \$700 per week for 28 plus weeks. Without a SUB plan in place, the individual would receive \$1,000 per week for 20 weeks.

At Time of Re-Employment

If an individual finds another job while receiving state unemployment benefits and SUB pay, he or she will no longer be eligible for state unemployment benefits and should stop receiving SUB pay. The remaining benefits may be paid under a separate severance plan, if that result is considered desirable, and those benefits would be subject to applicable employment taxes when paid.

Continuing the example above, if, after 12 weeks of receiving SUB pay, the individual finds a job he or she may be entitled to benefits under a severance plan, if applicable.

\$20,000 total severance pay

- \$8,400 paid as SUB (12 weeks x \$700)

\$11,600 remaining balance paid under severance plan

The balance of \$11,600 if paid from a severance plan in weekly installments of \$1,000 per week should be subject to applicable taxes, including FICA, FUTA, and SUI taxes.

SUB Plan Considerations

Considerations in the design and implementation of a SUB plan include the following:

- Generally, payment of SUB benefits may not be made in a lump sum while the terminated employee remains unemployed (certain states have specific requirements that may dictate SUB plan design). Once a terminated employee has found employment, a lump sum may be paid from a separate severance plan, but that payment will be subject to employment tax at that time.

⁵ "Tax savings" SUB plan design is not permitted by all states. KPMG can assist in determining the specific requirements of each state.

- Terminated employees are required to apply for and be eligible to receive state unemployment benefits. Some states require documentation showing that an individual is receiving state unemployment insurance benefits prior to the date on which the individual receives SUB pay benefits.
- Terminated employees residing in states that allow “double dipping” (simultaneous receipt of severance and state benefits) will not receive more than 100 percent of prior pay⁶ (as can happen in a severance plan).
- Coordination between payroll and any third party administrator monitoring unemployment benefits is important to maintain proper withholding and amount of benefit—based on whether SUB benefits are being paid or, if the employee has found employment, severance benefits are being paid. Third party administrators are companies hired to administer SUB payments for employers (as well as monitor each individual’s ongoing eligibility) and keep track of state unemployment benefits (as well as changes in the amount of benefits). This administrative cost must be factored into the determination to pay SUB plan benefits.

Company Advantages

Paying separation benefits as SUB pay can result in employment tax savings for the employer (or may allow the employer to pay benefits longer without additional cost), especially in a low employment market. Some employers pay SUB plan benefits to protect employees whom they hope to hire again when possible.

In addition to monetary savings for the employer, the resulting savings to the former employee in the form of non-taxability for FICA purposes can be a positive note in the overall issues involved in a separation event.

***What's News in Tax* is a publication from the Washington National Tax practice of KPMG LLP (“KPMG”) that contains thoughtful analysis of new developments and practical, relevant discussions of existing rules and recurring tax issues.**

⁶ A “tax savings” SUB pay plan design may result in 100 percent of prior pay, state unemployment insurance benefits, and related tax savings from payment through the SUB pay plan.



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