

March 31, 2014

To Our Readers,

This edition of the Tax Section Newsletter opens with an article by Commission Kevin Sullivan regarding tax policy and recent changes at the Department of Revenue Services.

Beginning on page 6 is an article by Dan Smolnik regarding the Treasury Department's final repair regulations.

Beginning on page 9 is an article by Peter Gruen and Heather Eskey-Hamasaki of Wiggin and Dana LLP summarizing 2013 Connecticut conveyance tax and property tax developments.

Beginning on page 12 is an article by Rachel Arnedt of Wiggin and Dana LLP entitled "ACA Employer Mandate Final Regulations: An Overview."

Lastly, beginning on page 17 is an article by Bryan Lihzis of Total Management Solutions, Inc. regarding supplemental unemployment benefits.

As editors of the Newsletter we would like to thank those who have contributed materials for publication, and we hope that you will find the materials informative and useful. Please feel free to contact us with any suggestions that you may have regarding future topics or ways to improve the Newsletter. The next edition of the Newsletter will be published on or about June 30, 2014.

Your Editors,

Lindsay M. LaCava
McDemott Will & Emery LLP
(212) 547-5344
llacava@mwe.com

Luke Tashjian
Stuart B. Ratner, PC
(203) 323-4900
luke@ratnerlawfirm.com

WHAT IS THE BEST SEVERANCE STRATEGY IN THE WAKE OF THE QUALITY STORES CASE?

Bryan Lihzis
Total Management Solutions, Inc.
blihzis@subpay.com

For the last decade, there has been an ongoing debate about whether severance paid to certain employees should not be considered wages for FICA purposes and that they should in effect be treated as Supplemental Unemployment Benefit (“SUB-Pay”) benefits.

On March 25, 2014, the U.S. Supreme Court ruled in favor of the IRS in *United States v. Quality Stores, Inc.*, the closely watched case involving whether employers are eligible for a refund of FICA taxes remitted on certain types of severance pay.

The Court unanimously rejected a \$1 million refund bid by defunct agricultural specialty retailer Quality Stores, and said severance payments the company made to 3,100 people were subject to FICA tax. In addition, more than \$1 billion in FICA tax protective refund claims filed by employers across the country will not be paid.

This case had broad implications on whether employers continue to provide SUB-Pay Plans, which are linked to the receipt of state unemployment insurance (“UI”) benefits which, pursuant to the IRS’s administrative position going back to the 1950s, is not subject to FICA or FUTA taxes. Under the Court’s ruling SUB-Pay Plans will remain valid. Companies that implement a SUB-Pay Plan today can supplement the receipt of their former employee’s amount of state UI benefits thereby reducing their severance costs by as much as 45% (or more). In addition, the same SUB-Pay benefits are exempt from employer FICA, FUTA and SUTA taxes and employee FICA taxes.

History and Overview of SUB-Pay Programs

SUB-Pay plans were first negotiated in the 1950’s by the Department of Labor, the Treasury Department and private sector employers from the automobile industry in response to the labor union’s assertions that state UI benefits were insufficient to support employees during periods of a furlough. In response, labor unions sought to provide additional supplements to state UI benefits, however most states denied UI benefits to workers who received separation payments during temporary layoffs. To address this, the IRS issued a ruling, which allowed employers to provide SUB-Pay benefits which did not disqualify employees from state UI benefit eligibility. Employers could now pay amounts that supplement what employees would receive from state UI benefits up to 100 percent of their pre-layoff wage. This satisfied state laws and provided an added benefit to employers as SUB-Pay benefits were considered exempt from FICA and FUTA taxes. In addition, SUB-Pay benefits were also exempt from SUTA tax.

Tied Up in Court for Over a Decade

Since 2002, District, Federal Circuit and U.S. Appeals courts have been considering whether severance pay is considered wages for FICA tax purposes.

CSX Corp. v. United States

During 1984 to 1990, CSX reduced its workforce significantly and paid the employer's share of FICA taxes on the severance payments. CSX filed claims for a FICA tax refund on the basis that severance is SUB-Pay as defined by an Internal Revenue Code for income tax withholding purposes, and therefore is not taxable for FICA purposes. The CSX Corp. case remained in appeal until March 6, 2008 when the U.S. Court of Appeals ruled CSX did not establish that the severance payments satisfied the requirements for "non-wage" treatment as described in various IRS SUB-Pay Plan Revenue Rulings from 1956 and 1990.

United States v. Quality Stores, Inc.

In October 2001, Quality Stores, Inc. closed its stores and distribution centers, involuntarily terminated its remaining workforce, provided its terminated employees with severance, withheld federal income tax and the employees' share of FICA tax, and paid the employer's share of FICA taxes on the severance pay. In 2002, Quality Stores filed refund claims with the IRS seeking to recover \$1 million in FICA taxes.

The IRS's position in the *United States v. Quality Stores, Inc.* case was that "supplemental unemployment compensation benefits," as defined in Internal Revenue Code section 3402(o), and other severance payments are not FICA-tax exempt. On the other hand, the IRS's administrative position, pursuant to IRS revenue rulings and private letter rulings going back to the 1950s, was that supplemental unemployment compensation benefits paid under a properly designed and administered plan is not subject to FICA or Federal Unemployment Tax Act (FUTA) taxes.¹

While the Federal Claims court affirmed in *United States v. CSX* that severance payments were not considered SUB-Pay benefits, and therefore were wages for FICA tax purposes because they did not meet the IRS's definition of SUB-Pay in its Revenue Rulings, in *United States v. Quality Stores, Inc.* the Court of Appeals for the Sixth Circuit affirmed that payments made to employees pursuant to an employer's severance plan were not "wages" for FICA tax purposes. The Sixth Circuit held that severance payments made by Quality Stores were not wages for FICA tax purposes because the payments fell within the definition of SUB-Pay under a statute specifically relating to income tax withholding, not FICA taxes, in the Internal Revenue Code.

¹"The Advantages of Offering Supplemental Unemployment Benefits Instead of Severance, Part I: FICA Taxes and More," by Vicki M. Nielsen, Counsel, Ogletree Deakins (August 26, 2013).

Quality Stores Goes to the US Supreme Court

In response to the Sixth Circuits decision, on May 31, 2013, the federal government, after requesting two extensions, filed a long-awaited petition for writ of certiorari seeking U.S. Supreme Court review of the decision by the Sixth Circuit. The Court agreed to hear the case and oral arguments began on January 14, 2014. On March 25, 2014, the Supreme Court ruled in favor of the IRS.

As a result of the ruling, in order to get a guaranteed FICA tax savings and the additional benefits that SUB-Pay provides, you must have a SUB-Pay Plan that is compliant with IRS rulings.

SUB-Pay Plans Provide FICA Tax Savings Now

Companies that implement and operate a SUB-Pay Plan that complies with IRS Revenue Rulings are able to receive an immediate and guaranteed FICA tax savings. Plans that comply with these rulings are not only still recognized at the federal level, but they're also still recognized at the individual state level too.

How SUB-Pay Plans Work

Today, successful SUB-Pay plans follow a particular pattern. Workers are eligible for SUB-Pay if laid off by the company, either in an involuntary permanent or temporary reduction in force or in a temporary layoff. These payments are contingent upon workers remaining eligible for state UI benefits. In addition, these former employees have no vested interest in amounts the employer pays into the plan or fund. Employees leaving the company voluntarily or who are discharged for misconduct are not eligible for a benefit.

Finally, payments must be periodic and cannot be made as a lump sum.

SUB-Pay Plans Are Advantageous to Both Company and Employee

Implementing a SUB-Pay plan, rather than a severance plan, can significantly reduce severance costs and provide tax savings to displaced workers.

A SUB-Pay plan can save a company 7.65 percent in severance costs from FICA payroll tax savings on the separation payments and federal and state unemployment tax savings of about 3 percent, depending upon the state, the employer's experience rating, and the time of year that the reduction in force occurs.

A SUB-Pay plan also can save a company 45 percent or more of total severance costs by supplementing the separation payments with state UI benefits the former employees are eligible to receive. For example, if an employee's pre-layoff wage was \$1,000 a week and the state UI benefit is \$500 a week, the company pays only \$500 a week in separation pay to keep the employee at the pre-layoff wage and saves 7.65 percent in FICA tax. Also, because SUB-Pay must be made on a periodic basis, there is predictability to the process that can be a significant

benefit to the company's cash flow.

There are a number of significant benefits to the employee as well. The downsized employees receive 7.65 percent more net income and get a regular income for the duration of their separation plan. Contrast this with lump-sum severance payments that, when added to employee year-to-date compensation, may elevate the employee into a higher tax bracket. Because SUB-Pay Plans are paid on a periodic basis, the former employee is provided with steady income during their reemployment transition, and may be relieved of the additional tax burden associated with lump-sum severance payments.

Additional Benefits of a SUB-Pay Plan

As with severance plans, once a SUB-Pay Plan is established it can continue to be used indefinitely for any involuntary staff reductions.

Summary of SUB-Pay Benefits

Benefits to the Company:

- Saves 7.65% in severance costs from FICA tax savings;
- Payments are exempt from both FUTA and SUTA;
- Saves 45% or more of severance costs when state unemployment benefits are coordinated with separation pay;
- Reduces the impact of severance costs on the company's cash flow;
- The company can outsource the laid-off worker's support and assistance to a third-party administrator for the duration of their plan.

Benefits to the Employee:

- Provides 7.65% more separation pay because SUB-Pay is not subject to FICA tax;
- SUB-Pay Plans are paid on a periodic basis which provides the former employee with steady income during their reemployment transition and may reduce the additional tax burden associated with lump-sum severance payments;
- A dedicated SUB-Pay Plan partner provides laid-off workers with a ready resource to help them during their transition period including individual call center assistance plus, IVR and web support services;
- Provides laid off workers with an "Advocate" to help them with state unemployment claims opening or issues that may come up.