



In Light Of United States vs Quality Stores, Let's Look At SUB-Pay *Severance payments employers made to involuntarily laid-off employees are "wages" and are taxable under FICA*

The decade-long debate over whether or not severance paid to certain employees is considered wages for Federal Income Contributions Act ("FICA") tax purposes is over. On March 25, 2014, the US Supreme Court ruled in favor of the IRS in *United States v. Quality Stores, Inc.*, deciding that severance payments employers made to involuntarily laid-off employees are "wages" and are taxable under FICA. The Court based its decision on an analysis of (1) the definition of "wages" in FICA—a statute that taxes "wages" paid by an employer or received by an employee "with respect to employment," to fund Social Security and Medicare benefits—and (2) Internal Revenue Code (IRC) §3402(o)—which governs income-tax withholding.¹

This closely watched case involved 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 also had broad implications on whether employers continue to provide Supplemental Unemployment Benefits ("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

The debate on whether or not severance paid to certain employees is considered wages for FICA purposes is not new. In fact, since 2002, District, Federal Circuit and US Appeals courts have considered 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 IRC §3402(o) which governs income-tax withholding, and therefore is not taxable for FICA purposes. The CSX Corp. case remained in appeal until March 6, 2008 when the US Court of Appeals ruled

¹ "Employers' Huge Tax Refund Hopes Dashed by Supreme Court Severance Pay Ruling," by Amanda Haverstick, Contributor, Forbes.com



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 IRC §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 SUB-Pay benefits paid under a properly designed and administered plan is not subject to FICA or Federal Unemployment Tax Act ("FUTA") taxes.²

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.

Quality Stores Goes to the US Supreme Court

In response to the Sixth Circuit's decision, on May 31, 2013, the federal government, after requesting two extensions, filed a long-awaited petition for writ of certiorari seeking US 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, a \$1 million refund bid by Quality Stores was denied, more than \$1 billion in FICA tax protective refund claims filed by employers across the country will not be satisfied, and the only way to get a guaranteed FICA tax savings, and the additional benefits that SUB-Pay provides, is to have a SUB-Pay Plan that is compliant with IRS Revenue 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 benefits 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. Employees leaving the company voluntarily or who are discharged for misconduct are not eligible for SUB-Pay benefits. Finally, SUB-Pay benefits must be periodic and cannot be made as a lump sum.

² "[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



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 benefits 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.



About the Author

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About Total Management Solutions

Total Management Solutions (TMS) is a trusted advisor to Fortune 1000 and mid-sized US companies, helping them change, manage and administrate their corporate severance plans. Through our Supplemental Unemployment Benefit ("SUB-Pay") Plans, we help companies reduce the high cost, stress and burden associated with implementing employee severance plans resulting from a merger, acquisition, business realignment or economic downturn. With a SUB-Pay Plan, our clients typically save 45% or more of traditional severance costs, while providing more separation benefits to laid-off employees.

With over 25 years of experience, TMS is the pioneer and only company solely dedicated to the design, implementation and administration of SUB-Pay Plans. Each SUB-Pay Plan is customized to meet your company's financial and cultural requirements and is supported by a management team of experts in SUB-Pay Plans, sophisticated technology and unparalleled customer service. Once the SUB-Pay Plan is designed and implemented, TMS manages the day-to-day aspects of the plan administration for you, while our personal service provides displaced employees with full support services from our in-house Client Service Support Center.

We literally own the URL www.subpay.com. To learn how a SUB-Pay Plan can help your company save money, please visit our web site at www.subpay.com or contact us at (800) 464-7755.