The Advantages of Offering Supplemental Unemployment Benefits Instead of Severance, Part I: FICA Taxes and More

August 26, 2013

According to the Internal Revenue Service (IRS), severance is subject to Federal Insurance Contribution Act (FICA) tax and certain supplemental unemployment benefits are not. That’s right . . . employers can provide today, just as they have for years, termination benefits that are FICA-tax exempt. One of the primary benefits of providing termination benefits that qualify for the IRS-recognized exclusion from FICA tax is that those benefits typically do not impact the employee’s eligibility for, or amount of, state unemployment benefits.

The IRS’s position in the *United States v. Quality Stores, Inc.* case is 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, is 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. For purposes of this blog series, supplemental unemployment compensation benefits that are exempt from FICA and FUTA taxes pursuant to the IRS’s administrative position are referred to as “traditional SUB-Pay” or “SUB-Pay.”

This two-part series compares the differences between severance and traditional SUB-Pay. Part one considers traditional SUB-Pay and outlines several advantages these plans offer to employers.

What Is a Traditional Supplemental Unemployment Benefits Plan?

A Supplemental Unemployment Benefit Plan is a unique type of severance plan designed to assist employees following an involuntary termination due to a reduction in force, job elimination, reorganization, or similar circumstance. SUB-Pay is designed to supplement the receipt of state unemployment compensation. For that reason, a SUB-Pay plan works in many ways like state unemployment benefits. For example:

1. Former employees are required to apply, and be eligible for, state unemployment benefits in order to receive SUB-Pay.
2. Each week, former employees must verify that they are still unemployed and capable and available for work.
3. SUB-Pay may not be paid in a lump sum. SUB-Pay must be paid on a weekly or payroll-by-payroll frequency basis.
In addition, SUB-Pay plans generally must comply with state law requirements (which may differ from the IRS's requirements) and some states are required to approve SUB-Pay plans. As state unemployment insurance trust funds dwindle, that process has become more difficult in certain states. Additionally, certain plan designs receive more scrutiny from the state regulators than others. If benefits are recognized as SUB-Pay at the state level, SUB-Pay is not subject to state unemployment taxes. As stated above, pursuant to IRS revenue rulings and private letter rulings, SUB-Pay paid under a properly designed and administered SUB-Pay Plan is not subject to FICA or FUTA taxes.

Depending on the SUB-Pay Plan design, employers may realize additional significant savings while ensuring that their former employees receive 100 percent of their pre-termination wages while unemployed. For example, under a traditional SUB-Pay Plan, once a former employee becomes re-employed or is otherwise ineligible for state unemployment benefits, the former employee is no longer eligible to receive SUB-Pay, creating the potential for additional cost savings to the employer. In addition, if the SUB-Pay Plan is designed as an "offset plan," which may be required in some states, the amount that the employer pays the employee is reduced by state unemployment benefits (resulting in significant additional savings). Employers may provide additional benefits depending on the plan design. For example, some employers provide a separate employment incentive payment, the purpose of which is to provide former employees with a financial incentive to find another job as quickly as possible.

Some employers choose to administer SUB-Pay themselves, while others outsource SUB-Pay Plan administration to third-party administrators. Third-party administrators can facilitate the entire SUB-Pay process once a plan is up and running, from helping former employees file their unemployment claims, handling SUB-Pay benefit and payroll questions, monitoring employment status and eligibility for state unemployment benefits and SUB-Pay benefits, and paying SUB-Pay benefits, thereby allowing the employer the ability to terminate its relationship with the former employee when the employee is discharged even though the former employee continues to receive benefits from the employer.

Bryan Lihzis, the Senior Vice President of Client Services at Total Management Solutions, Inc. (TMS), a firm that has been administering SUB-Pay plans since 1988, commented that:

"While some employers create and administer SUB-Pay plans in-house, outsourcing SUB-Pay administration to a reputable company can significantly alleviate the additional work and stress that layoffs can bring to HR and payroll departments. Another added benefit is that TMS has relationships at the state level, which they use to assist their clients in reducing the complexities of and maintaining compliance with state regulations associated with SUB-Pay Plans."

He also explained that "TMS acts as an "advocate" to laid off workers assisting them with state unemployment insurance claim openings or other issues that may arise."

Unless state law requires otherwise, SUB-Pay may be paid from the employer's general assets. Alternatively, employers may pay SUB-Pay from a trust, which can but need not, take the form of a tax exempt 501(c)(17) trust or a 501(c)(9) voluntary employees' beneficiary association (VEBA).

Why Do Employers Adopt SUB-Pay Plans?
SUB-Pay Plans are generally adopted for three purposes:

1. to allow a company to pay “severance” benefits to former employees, without impacting the employees' eligibility for, or amount of, state unemployment benefits;

2. to reduce FICA and FUTA taxes otherwise payable in typical severance arrangements (resulting in a savings to the employer and employee of up to 75 percent each); and

3. to allow a company to efficiently use payroll taxes already provided to the state for unemployment benefits (in certain plan designs).

Part two of this series, “The Advantages of Offering Supplemental Unemployment Benefits Instead of Severance, Part II: FICA Taxes and More,” highlights the key differences between traditional SUB-Pay and severance and the future of traditional SUB-Pay in light of the Quality Stores decision.