Evolving Employee Benefits:
A Reimagined Approach to Traditional Severance

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Transition Services, Inc.

Session Topics

- Separation Benefit Options: Traditional Severance and Supplemental Unemployment Benefits
- The Supplemental Unemployment Benefits (SUB) Plan: Origins, Regulatory Background and Functionality
- Plan design alternatives: balancing costs and benefits
- Key considerations: ERISA, release of claims, individual state requirements and considerations
- Alternative use for a SUB Plan: Retaining a workforce during a work stoppage

Today's Speakers

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Strategies for a Reduction in Force

Organization change and restructuring are all too frequent.

When was the last time you strategized about the best option for managing a RIF?

Have you evaluated which separation benefits offer the most value with the least cost?

What are the key factors to evaluate when looking at the alternatives?

Traditional Severance

Bridge to New Employment

Severance:

- Originally intended as a bridge to new employment
- Evolved into a fixed benefit based on years of service
- Typically paid as a lump sum
- Formal or informal policy
- Release & Waiver

Potential concurrent benefits:

- Health Insurance
- Outplacement

A cost efficient alternative to severance:

Supplemental Unemployment Benefits

A Supplemental Unemployment Benefit ("SUB") Plan is an alternative structure for paying severance or separation benefits following permanent or temporary involuntary terminations.

Three Elements:

- **Integration with State Unemployment Compensation ("UI") benefits.** The displaced employee's income is maintained, but now comes from two sources, the state and the employer. Former employees must periodically verify that they are still unemployed and available for work.
- **Duration Management.** Because benefits are tied to UI benefits, SUB payments cease when employees find a new job. A taxable "Re-employment Bonus" of some percentage of the remaining benefit can be issued if employment is found before the benefit period expires.
- **Elimination of Payroll Tax. P**ayments are classified as benefits rather than as wages and are therefore not subject to payroll taxes for either the employer or the employee. Employees' income is increased while the employer realizes additional savings.

SUB Plans establish a better balance between employee and company interests.

Severance vs. SUB

- Severance and SUB Pay both provide **financial support** to employees affected by a reduction in force.
- As with traditional severance, benefits are typically provided in exchange for a **Release and Waiver**.
- A SUB Plan creates **benefit equity** for the entire employee population across multiple states.
- SUB Plan payments are designed to meet the primary need of the displaced employee – **income protection**. The terminated employee's pre-displacement wage is maintained during the unemployment period or the benefit period, whichever is less.
- SUB Plan payments are classified as benefits, not wages, and therefore are **FICA non-taxable** for both the employer and the employee, resulting in a combined 15.3% FICA savings.
- Traditional concurrent benefits (outplacement and health insurance) can still be provided.
- Severance and SUB Pay both have significant **design flexibility**.

History of SUB Plans

- SUB Plans were first adopted in the 1950s in response to recognition that state unemployment benefits were inadequate to aid employees during temporary layoffs.
- Corporate management considered it critical that SUB pay be excluded from the definition of "wages" since state law generally precluded entitlement to unemployment compensation for a pay period during which an employee received remuneration for employment – i.e., "wages."
- Unions, particularly in auto and steel industries with seasonal layoffs, advocated for supplemental pay.
- SUB Plans were aimed to bridge the income gap between an employee's previous wages and State Unemployment.
- The IRS created an administrative exemption for supplemental unemployment benefits with the issuance of Revenue Ruling 56-249, 1956-1 C.B. 488. Revenue Ruling 56-249 created a limited exemption from the definition of wages for FICA, FUTA, and federal income tax withholding purposes for certain payments made following the involuntary termination of an employee.

IRS Requirements

Eight Key Features

1. Benefits are paid only to unemployed former employees laid off by the employer;
2. Eligibility for benefits depends upon meeting prescribed conditions after terminating employment;
3. Benefits are paid by trustees of independent trusts*;
4. Benefits are payable in an amount based on state unemployment benefits, other compensation allowable under state laws, and the amount of straight-time weekly pay;
5. Duration of benefits is affected by the fund level and the employee's seniority*;
6. The right to benefits does not accrue until a prescribed period after termination of employment;
7. Benefits are not attributable to the rendering of particular services; and
8. No employee has any right, title, or interest in the fund until qualified and eligible to receive benefits. Employees are required to report to and register for state unemployment. Individuals receiving benefits must be "unemployed" and genuinely available for suitable work.

* *Subsequent rulings modified this feature; details reviewed below.*

Subsequent IRS Revenue Rulings

Rulings subsequent to 56-249 are broader, offering greater SUB Plan flexibility to the plan sponsor however, the IRS still requires that SUB pay be linked to the receipt of state unemployment compensation.

- IRS Revenue Ruling 58-128, 1958-1 C.B. 89 holds the same exemption from "wages" for FICA and FUTA purposes applied even if the SUB plan is unilaterally instituted by the employer, rather than being negotiated with a labor union, thus expanding the SUB Plan's applicability to an entire employee population.
- Revenue Ruling 60-330, 1960-2 C.B. 46, concludes that benefits, if paid from the employer's general assets, rather than from a trust, are still exempt from FICA and FUTA taxes.
- Revenue Ruling 90-72 continues the FICA and FUTA exemption for Supplemental Unemployment Benefits, but only if receipt of the SUB pay is actually linked to the receipt of state unemployment compensation.
- PLR 9523023 approved the payment of a lump-sum "Employment Incentive Payment" to former employees whose SUB payments terminated upon finding new employment. This Employment Incentive Payment ranged between two and eight weeks' worth of pay, an amount less than the maximum number of weeks of SUB pay still available had the former employee not found new employment.

United States v. Quality Stores, Inc.

- **Decided: March 25, 2014**
- **Issue: Whether severance that satisfies the definition of supplemental unemployment compensation benefits in Code section 3402(0) is subject to FICA**
- **Arguments:**
  - Taxpayer - severance paid pursuant to a plan upon involuntary termination due to RIF or discontinuance of plant/operation is FICA exempt (based on definition in Code section 3402(o))
  - Government – severance is subject to FICA; only exception is severance that is linked to the receipt of state unemployment compensation and is not paid in a lump sum (based on IRS revenue rulings)
- **Held:**
  - Severance is subject to FICA
  - Case did not involve payments that were linked to state unemployment benefits so court declined to consider whether exclusion for SUB-Pay in IRS revenue rulings is consistent with the FICA statute
- **Practical impact:**
  - Taxpayer's refund denied; IRS to deny other taxpayer refund claims
  - Employers may want to consider offering SUB Pay instead of severance

Summary

For over sixty years, the SUB Plan structure has allowed employers to provide FICA non-taxable payments integrated with State Unemployment to maintain the income of severed employees while unemployed and save 35% - 45% compared to traditional severance.

Key Reasons for a SUB Plan

- Fiscal responsibility
- Benefit equity across all states
- Integration with State Unemployment
- Tax savings
- Consistent with original intent of severance: a bridge to new employment

Severance vs SUB - an individual example

- An employee with a weekly base pay of $2,000 is terminated in CA due to a RIF and is eligible for 12 weeks of SUB.
- The employee applies for state unemployment compensation benefits and is eligible to receive $450 per week in state unemployment benefits. Regular verification of unemployment is required.
- Therefore, the SUB payable by the employer is $1,550 per week.
- Together, the two benefits equal 100% of the former employee's weekly base pay ($2,000).
- The SUB-Pay of $1,550 per week is exempt from Social Security and Medicare (FICA) taxes.

54%
Savings

Comparison of employee benefit over 12 weeks

Employee takes home $1,836 more under a SUB Plan than a severance plan

Severance Plan		SUB Plan	
$2,000 x 12 weeks	$24,000	$450 state UI x 12 weeks	$5,400
FICA taxes 7.65%	($1,836)	$1,550 SUB Benefit x 12 weeks	$18,600
		FICA taxes 7.65%	$0
Total Benefit	$22,164	**Total Benefit**	$24,000

Comparison of employer cost over 12 weeks

Employer saves $7,884 by using a SUB Plan rather than a severance plan

Severance Plan		SUB Plan	
$2,000 x 12 weeks	$24,000	$1,550 SUB x 12 weeks	$18,600
FICA taxes (7.65%)	$1,836	FICA taxes (7.65%)	$0
FUTA, SUTA (2.7%)	$648	FUTA, SUTA (2.7%)	$0
Total Benefit	$26,484	**Total Benefit**	$18,600

Median UI payment across all states is $427 per week.

SUB Plans - Design Alternatives

Design alternatives for a SUB Plan may be selected to create greater savings for the employer or more benefit for the plan participants.

1. A **Reemployment Bonus** (typically 30%-50% of the remaining benefit) may be paid should an individual become reemployed prior to the expiration of the benefit period. This incents individuals to return to work while allowing the company to obtain meaningful duration savings.
2. The **Extended Plan** uses savings achieved during the benefit period to provide additional assistance to individuals remaining unemployed beyond the initial Benefit Period.
3. Under a **Flat Benefit Structure**, an employer may pay a standard benefit amount to each separated employee, regardless of the actual amount of UI they receive. (i.e. each employee receives SUB Pay of $200/week during their benefit period).
4. **Suspension of Benefit** due to Part-Time and/or Temporary Work allows individuals to take work and suspend separation benefits temporarily. Individuals may be reluctant to take part-time or temporary work if it results in the loss of separation benefits, yet permanent employment sometimes occurs as a result of temporary work.
5. **Retirement**: If an employee (e.g., over age 55) elects to retire and not look for continued employment, retirees may receive the normal (non-SUB) severance benefit (subject to FICA tax) but would not be eligible for state unemployment benefits (i.e. retirement).

Design Option: Re-Employment Bonus

A lump sum, FICA taxable bonus

- Upon new employment, the employer pays a percent, typically 30% - 50%, of the remaining benefit as a lump sum, FICA taxable payment.
- This incentive to the employee typically results in a shortened benefit period, allowing for additional savings to the employer.
- For example, if the same employee were to gain new employment 6 weeks into her allotted 12 week benefit period, a benefit of $3,600 would remain. As shown below, incentivizing the employee with a 30%-50% bonus, would result in additional savings to the employer of $1,800 - $2,520.

	SUB-Pay	Remaining Benefit
Termination	---	$18,600
Week 1	$1,550	$17,050
Week 2	$1,550	$15,500
Week 3	$1,550	$13,950
Week 4	$1,550	$12,400
Week 5	$1,550	$10,850
Week 6	$1,550	$9,300

$3,600 Remaining Benefit	FICA Taxable Bonus Paid To Employee	Additional Savings To The Company From A Shortened Benefit Duration
30% bonus	$2,790	$6,510
50% bonus	$4,650	$4,650

Design Options: Benefit Extension

Extension of the Benefit Period

- Upon expiration of the benefit period, if the terminated employee has not yet found work, the employer has the option to use the savings achieved through the UI offset to extend the benefit period as long as he/she remains eligible for UI.
- Per our previous example, the savings generated amounted to $7,884. As shown in the table to the right, this amount of savings has the potential to extend the benefit period for an additional 6 weeks for a total of 18 benefit weeks.

	SUB-Pay	Remaining Benefit
Week 12	$1,550	$0
Week 13	$1,550	**$7,884**
Week 14	$1,550	$6,334
Week 15	$1,550	$4,784
Week 16	$1,550	$3,234
Week 17	$1,550	$1,684
Week 18	$134	$134

SUB Plans ERISA

ERISA REQUIREMENTS

- Plan and summary plan description
- Claims procedure
- Plan administrator/fiduciary
- Annual report and disclosure
- Funding not required

SUB Plan State Approval

Some states require prior approval or registration of a SUB Plan:

Arkansas	Iowa	New Hampshire	Pennsylvania*
Delaware	Montana*	North Dakota	South Dakota
Georgia*	Nebraska	Ohio	Utah
Illinois	Nevada	Oklahoma	Wisconsin

The state review and approval cycle time ranges from approximately 14 days to three months.
*States requiring a trust.

Trust Requirements

- IRS Revenue Ruling 56-249 originally required the use of a trust for the disbursement of SUB Plan benefits.
- Subsequent rulings modified that requirement, and the IRS now allows SUB Plan benefits to be issued from the general assets of the organization.
- Georgia, Idaho, Pennsylvania and Montana still retain this requirement.
- **Types of trust include:**
  - Code section 501(c)(17)
  - Code section 501(c)(9)
  - Trust under state law

Concurrent Collection:
Severance and State Unemployment

19 states allow a person to collect both severance (paid as wages) and state unemployment benefits at the same time. This “double dipping” allows The remaining states do not allow this concurrent collection of benefits. All states, however, allow the concurrent collection of supplemental unemployment benefits at the same time as state unemployment benefits.

Alabama	Illinois	New Jersey	Texas*
California	Kansas*	Oregon	Virgin Islands
Colorado	Kentucky*	Pennsylvania*	Washington
Hawaii	Maryland*	Puerto Rico	West Virginia
Idaho	Michigan*	South Carolina	

*Severance not allowed based on state conditions.

Severance and Unemployment Disqualification:

39 states do not allow a person to collect severance paid as wages and unemployment benefits at the same time. A person's unemployment may be delayed for the full period that the severance payment covers or the week in which the severance payment was paid. All states, however, allow the concurrent collection of supplemental unemployment benefits at the same time as state unemployment benefits.

State UI may not be collected for full severance allocation period, and therefore eligibility for UI and SUB Pay begins after the full severance period expires.

Arkansas	Indiana	Massachusetts	New Mexico	South Dakota
Connecticut	Iowa	Michigan*	New York	Tennessee
Delaware	Kansas*	Minnesota	North Carolina	Texas*
District of Columbia	Louisiana	Missouri	Ohio	Utah
Florida	Maine	Nebraska	Pennsylvania*	Vermont
Georgia	Maryland*	New Hampshire	Rhode Island	Virginia

State UI may not be collected for the week in which severance is paid, and therefore eligibility for UI and SUB Pay does not begin until the following week.

Alaska	Montana	Oklahoma
Arizona	Nevada	Wisconsin
Mississippi	North Dakota	Wyoming

*Severance may be allocated based on state regulation.

Impact of Paid Time Off on UI Eligibility

Upon separation from an organization, an employee is paid for accrued, unused vacation or Paid Time Off (PTO). How these payments are treated by the states may affect an individual's ability to collect state UI. The following summarizes how states treat PTO wages and the effect on UI eligibility.

PTO has no impact on an individual's ability to collect SUB Pay:

Alabama	Kansas	New Mexico	Tennessee
California	Kentucky	North Caroline	Texas
Delaware	Maryland	North Dakota	Virgin Islands
Florida	Massachusetts	Oklahoma	Washington
Georgia	Minnesota	Oregon	West Virginia
Idaho	Mississippi	Pennsylvania	
Illinois	New Jersey	Rhode Island	

Impact of Paid Time Off on UI Eligibility (CONT'D)

State UI may not be collected for full PTO period, and therefore eligibility for UI and SUB Pay begins after the full PTO period expires.

Arizona	Iowa	Montana	Ohio
Colorado	Indiana	Nebraska	Puerto Rico
Connecticut	Louisiana	Nevada	South Dakota
District of Columbia	Maine	New Hampshire	Utah
Hawaii	Missouri	New York	

State UI may not be collected for the week in which PTO is paid, and therefore eligibility for UI and SUB Pay does not begin until the following week.

Arkansas	Michigan	Vermont	Wisconsin
Arizona	South Carolina	Virginia	Wyoming

Testimonial

Considerations

Administration:

- May seem more complex than severance.
- Requires tracking of unemployment status.
- HR and employee education is important.
- A third-party administrator is an efficient way to ensure smooth operations. Third party vendors have experience with state unemployment departments to keep abreast of the local rules benefit levels.

Employee Impact:

- Management typically imagines far greater employee pushback than actually occurs.
- Some employees may feel like the plan is a “take-away” and the FICA tax savings are inconsequential however, many employees believe this is a fair structure.
- Employees adapt quickly.

Savings Illustrations

Case Study: Permanent Separations

- Client: worldwide manufacturer of materials processing machinery and aerial work platforms.
- Background: Partnered with TSI in 2009 to design a SUB Plan program for permanent separations
- Goals: Maintain income for permanently released employees while also creating meaningful cost savings for the company.
- Results: Since 2009 TSI has processed SUB benefits for nearly 2,000 employees across 35 states
- Savings: Over $12M or 46% saved compared to traditional severance.

A	$24,853,989	Total Payments Pre-SUB
B	$1,744,148	FICA Taxes
C	$26,598,137	Total Benefit Cost Pre-SUB
D	$8,246,795	State UI Offset Savings
E	$1,744,148	FICA Tax Savings
	2,321,302	Duration Savings
F	$14,285,891	Total Cost under TSI Plan
G	$12,312,245	Savings through TSI
H	46%	Percent Savings through TSI

Case Study: Temporary Furloughs

Client: National maintenance and construction services company with employees across 21 states

Background: Partnered with TSI in 2015 to design a SUB Plan for weather related work stoppages

Goals: Reduce cost of retention pay / offer employees their regular wage rates during downtime rather than a prescribed fixed rate.

Results: Reduced the cost of retention, kept employee wages whole during downtime.

Savings: Over $2.6M or 68% compared to traditional retention pay.

A	$3,686,075	Total Payments Pre-SUB
B	$276,790	FICA Taxes
C	$3,962,865	Total Benefit Cost Pre-SUB
D	$2,422,120	State UI Offset Savings
E	$276,790	FICA Tax Savings
F	$1,263,955	Total Cost under TSI Plan
G	$2,698,910	Savings through TSI
H	68%	Percent Savings through TSI

Checklist for Effective Implementation

- Perform analysis to determine potential savings.
- Establish a cross-functional implementation team with representatives from HR, Payroll, HR Legal, and HRIT.
- Develop Plan design and employee eligibility.
- Draft Summary Plan Description.
- Create supporting documents – Trust (if necessary), Participant Communication, Release & Waiver.
- Obtain State Approvals and establish Trust where necessary.
- Build and implement communications plan.
- Establish detailed process flows and data exchange procedures.
- Create and deliver training for HR Management.

QUESTIONS

THANK YOU!

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