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Perspectives

AN EXECUTIVE COMPENSATION, BENEFITS & HUMAN RESOURCES LAW UPDATE

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A LETTER TO OUR READERS…

Dear Reader: This issue of Perspectives focuses on recent ERISA fiduciary and tax decisions—three from the U.S. Supreme Court and one from the Eighth Circuit—which have special importance to plan sponsors and plan fiduciaries.

First is a discussion of the U.S. Supreme Court's recent decision in *Fifth Third Bancorp v. Dudenhoeffer,* which unanimously held that the "presumption of prudence" for ESOP fiduciaries has no basis in ERISA law and stated that ESOP fiduciaries are subject to the same fiduciary standards as other ERISA fiduciaries, other than the exception for ESOPs from the duty to diversify plan investments.

Second is an article on breach of fiduciary duty claims due to the payment of excessive mutual fund fees and recordkeeping fees. Over the past few years, a number of Circuit Court cases have addressed the role of 401(k) plan fiduciaries in selecting mutual funds with disparate levels of fees. Recently, the Court of Appeals for the Eighth Circuit held in *Tussey v. ABB* that the 401(k) plan recordkeeping fees being funded with fees on the mutual funds were excessive. The Court held the ABB fiduciaries responsible for alleged unreasonable recordkeeping payments to Fidelity which were being used to subsidize other services being provided to the plan sponsor.

Third, the Supreme Court held arbitration clauses enforceable that are linked to class action waivers in *American Express Co. v. Italian Colors Restaurant* and *AT&T Mobility LLC v. Concepcion*. Thus, the risk of class actions could be significantly reduced by having plan participants enter into an arbitration agreement that includes a class action waiver.

Finally, the Supreme Court addressed whether supplemental unemployment benefits, i.e. severance pay, is subject to FICA tax withholding. It unanimously held in *United States v. Quality Stores, Inc*. that such payments (unless tied to state unemployment benefits) are subject to FICA because such payments are "wages."

Thank you. We look forward to hearing your comments.

—Susan Serota
Leader, Executive Compensation & Benefits Practice

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DON'T "MOENCH"ION IT: SUPREME COURT REJECTS PRESUMPTION OF PRUDENCE FOR ESOP FIDUCIARIES

by Susan P. Serota & Kathleen D. Bardunias

On June 25, 2014, the U.S. Supreme Court in *Fifth Third Bancorp v. Dudenhoeffer* rejected the presumption of prudence theory that many employee stock ownership plan (ESOP) fiduciaries relied on when challenging a claim of breach of fiduciary duty. The Court also addressed a number of federal securities law issues that fiduciaries of public company ESOPs who have inside information must face and provided specific guidance for courts to consider with respect to the requirements for pleading an ERISA fiduciary breach of a fiduciary's duty of prudence claim in connection with publicly traded employer stock drop cases. Employers sponsoring ESOPs and 401(k) plans with employer stock funds and plan fiduciaries should take heed of this "new world" set forth by the Court for analyzing an ESOP fiduciary's breach of his fiduciary duty of prudence and determine whether to take any affirmative action in light of this new framework.

The *Moench* Presumption

Prior to the Supreme Court's decision in *Dudenhoeffer*, a majority of the Circuit Court of Appeals had adopted some form of a presumption of prudence for ESOP fiduciaries (commonly referred to as the "*Moench* Presumption" for the Third Circuit case *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995), which first established this presumption of prudence for ESOP fiduciaries). This presumption of prudence had been a welcome protection for ESOP fiduciaries and created an uphill battle for plaintiffs alleging that an ESOP fiduciary breached his fiduciary duty of prudence in ERISA "stock drop" cases.

Fifth Third Bancorp v. Dudenhoeffer – The Facts

Fifth Third Bancorp sponsored a 401(k) plan for its employees and provided a matching contribution of up to 4 percent of a plan participant's compensation. While plan participants could allocate their contributions to the plan among the 20 different investment funds available under the plan, including investment in an employer stock fund which invested in Fifth Third shares of common stock (the ESOP), Fifth Third's matching contributions were always initially invested in the ESOP. Participants could subsequently move amounts in their ESOP account to another available investment fund in the 401(k) plan. The 401(k) plan document required that the ESOP be invested primarily in shares of Fifth Third common stock.

The plaintiffs—former plan participants—alleged that the ESOP fiduciaries breached their ERISA fiduciary duty of prudence. Specifically, the plaintiffs alleged that the ESOP fiduciaries should have known, based on public and non-public information, that Fifth Third stock was "overpriced and excessively risky." In connection with the subprime mortgage crisis, Fifth Third's stock price declined by 74 percent between July 2007 and September 2009.

The district court dismissed the complaint for failure to state a claim, holding that the ESOP fiduciaries were entitled to a presumption of prudence with respect to the decision to permit the ESOP's investment in Fifth Third stock. While the Sixth Circuit acknowledged that the ESOP fiduciaries were entitled to a presumption of prudence, it reversed the district court's decision holding that the presumption is evidentiary only so that it did not apply at the motion to dismiss stage of the case.

Don't "Moench"ion It: Supreme Court Rejects Presumption of Prudence for ESOP Fiduciaries

U.S. Supreme Court's New Framework for ESOP Fiduciaries

The U.S. Supreme Court rejected the "*Moench*" presumption of prudence in connection with an ESOP fiduciary's decision to hold or purchase employer stock and held that an ESOP fiduciary is subject to ERISA's general standard of prudence as provided in ERISA §404(a)(1)(B), as limited by the statutory exception in ERISA §407(b)(1)(B) that an ESOP fiduciary is not subject to the duty to diversify plan investments. The Court reasoned that in applying a more expansive presumption of prudence, the courts were inappropriately going beyond the statutory exception expressly afforded to ESOP fiduciaries, which "makes no reference to a special 'presumption' in favor of ESOP fiduciaries."

The Court also noted that an ESOP fiduciary's "duty of prudence will trump the instructions of a plan document, such as an instruction to invest primarily in employer stock even if financial goals demand the contrary." This will be unwelcome news for many plan sponsors and ESOP fiduciaries who added language to plan documents requiring that the ESOP be invested in employer stock as a method to further shield ESOP fiduciaries from a breach of fiduciary duty claim.

The Court did, however, recognize the need to protect ESOP fiduciaries from meritless claims and provided additional guidance for courts to consider at the pleading stage of a breach of fiduciary duty claim relating to ESOP plan sponsors who trade their shares on a public market in light of certain federal securities law requirements:

- ***Public Information:*** Allegations that a fiduciary should have recognized from publicly available information that the market was over- or undervaluing publicly traded stock are "implausible as a general rule, at least in the absence of special circumstances." The Court did not give examples about what might be considered a "special circumstance" where a fiduciary's reliance on the public market's valuation of the employer stock would be imprudent.
- ***Non-Public Information:*** Allegations that a fiduciary should have acted based on non-public, inside information must "allege an alternative action that the defendant could have taken that would have been consistent with the securities laws and that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than to help it."
    - The Court stated that ERISA's fiduciary duties cannot require a fiduciary to break the law, including federal securities insider-trading laws, and the courts should consider whether refraining from making a planned transaction on the basis of inside information or disclosing inside information to the public (as a method to "correct" the employer stock price) could conflict with federal securities laws. The Court encouraged the SEC to provide its views on this issue.
    - The Court also noted that courts should consider whether a prudent fiduciary could have concluded that stopping purchases of employer stock or publicly disclosing inside information could cause a drop in the employer stock that would do more harm than good to the value of the employer stock already held by the ESOP.

Next Steps for ESOP Plan Sponsors and Fiduciaries

- As a result of *Dudenhoeffer*, ESOP fiduciaries are no longer able to rely on plan language requiring that an ESOP invest primarily in employer stock or that a plan, like a 401(k) plan, maintain an employer stock fund as an available investment option to satisfy their duty of prudence. ESOP fiduciaries should establish and document a process for monitoring an employer stock fund similar to their review of other investment options under the plan (acknowledging that the duty to diversify plan assets does not apply to the employer stock fund). For publicly-traded employer stock, this may include periodic monitoring of market price and assessing for any potential "special considerations."

- Many ESOP fiduciaries are employees of the ESOP plan sponsor who have access to inside, non-public information. In light of the Court's decision in *Dudenhoeffer*, plan sponsors may want to consider the following alternatives to mitigate litigation risks:
    - Appoint an independent fiduciary to oversee the ESOP;
    - Consider limiting ESOP fiduciaries to employees who are not likely to have regular access to inside information;
    - As a matter of plan design for non-leveraged ESOPs in 401(k) plans, consider offering employer stock as an investment only through a plan participant's investment election under a 404(c) plan or a brokerage window;
    - Cease to offer employer stock as an investment option under the plan and implement a 423 stock purchase plan (which is not subject to ERISA).

In all events, plan documents and communications to participants, including summary plan descriptions and plan prospectuses, should be reviewed in light of the Supreme Court's decision in *Dudenhoeffer*. ■

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AVOIDING CLAIMS OF EXCESSIVE FUND FEES

by Howard L. Clemons

Over the past five years, several Circuit Courts of the United States Courts of Appeals have issued rulings in cases dealing with claims against fiduciaries of employer-sponsored defined contribution retirement plans alleging breaches of fiduciary duties under the Employee Retirement Income Security Act of 1974 (“ERISA”) based on the payment of excessive mutual fund fees. Each of the cases dealt with participant-directed investment arrangements. If a retirement plan such as a 401(k) plan provides for a participant to exercise discretion to select investments for his or her account, and the plan complies with regulations issued by the Department of Labor under Section 404(c) of ERISA, and the participant in fact exercises control, the participant is not deemed to be a fiduciary and, most importantly, no person who is otherwise a fiduciary is liable for any loss by reason of any breach that is the direct and necessary result of the participant’s exercise of control.

The Circuit Court decisions discussed below address fee discrepancies in funds offered by different vendors and in different classes of shares of the same fund. It is well recognized that investment offerings provided by a 401(k) plan, including investments in mutual funds, with similar investment objectives from different vendors have expense charges which vary greatly. Further, many individual funds offer separate share classes which are identical investment vehicles, except that the shares are charged with different amounts of fund expenses. For example, a retail class of shares typically carries a higher expense charge than an institutional class from the same fund.

These cases, including the most recent decision by the 8th Circuit in *Tussey v. ABB,* 2014 WL 1044831 (8th Cir. 2014), are instructive for plan fiduciaries seeking to understand their fiduciary duties when making fund selection choices, at least as those duties relate to evaluating the fund fees.

Background

Before addressing *Tussey*, this article provides a review of several cases which preceded the Eighth Circuit’s decision in *Tussey*. While each of the cases discussed in this article also dealt with other claims of breaches of ERISA fiduciary duties, the discussion in this article is limited to the claims relating to breaches of fiduciary duty for offering mutual funds with excessive expense charges.

In *Hecker v. Deere & Company,* 556 F.3d 575 (7th Cir. 2009), the plan participants argued that fiduciaries breached their fiduciary duties by selecting funds with unreasonably high fees. The plan offered participants 20 primary mutual funds and access to more than 2,500 mutual funds through a brokerage window. The Seventh Circuit concluded that the range of funds offered included expense ratios, ranging from 0.07 percent to over 1 percent, and all of the funds were funds available to the overall public, and therefore, the fees charged would have been set “against the backdrop of market competition.” On these facts, the Court determined that there was no reasonable doubt that the plan offered a sufficient mix of investments, concluding that “nothing in ERISA requires every fiduciary to scour the market to find and offer the cheapest possible fund (which might, of course, be plagued by other problems).” With over 2,500 funds, the Court concluded that if a participant in fact paid excessive fees it must have been the result of the participant’s selection.

Avoiding Claims of Excessive Fund Fees

In *Braden v. Wal-Mart Stores Inc.,* 588 F.3d 590 (8th Cir. 2009), however, the Eighth Circuit refused to uphold the District Court's dismissal of claims against the plan fiduciaries on grounds similar to those the Seventh Circuit had in *Hecker*. In *Braden*, the retirement plan offered only the retail class of mutual funds shares, and only ten funds plus a stable value fund were offered. In sending the case back to the District Court for further consideration, the Circuit Court noted plaintiffs' claim that plans of similar size have the ability to obtain mutual fund class shares which charge lower fees.

More recently, in *Renfro v. Unisys Corporation*, 671 F.3d. 314 (3rd Cir. 2011), the Third Circuit was faced with a plan with 73 investment options. The plaintiffs' claimed that the selection and inclusion of retail class mutual funds in the investment options was a breach of fiduciary duty. Based on the facts presented and the large number of available funds with a variety of risk profiles, investment strategies and fees, the Third Circuit concluded that participants had not plausibly alleged a breach of ERISA fiduciary duty.

Using similar logic, the Seventh Circuit in *Loomis v. Exelon Corporation*, 658 F.3d 667 (7th Cir. 2011), followed its earlier decision in *Hecker*. In *Loomis*, the plaintiff claim involved a plan offering 32 funds, of which 24 were retail class funds. The Seventh Circuit concluded that the range of funds and fees charged included high-expense funds, low-expense index funds and low-expense, low-risk, modest-return bond funds, which offered participants the opportunity to make a choice of the type of fund and fees to be paid, and that the fiduciaries would not be faulted for doing so.

While a casual reading of the cases discussed above might lead one to believe that the number of funds is the key determining factor, *Hecker, Renfro* and *Loomis* each acknowledge and repeat the fact that the available funds had a wide range of fees from which participants could select.

Focus on Embedded Administrative Fees

While these earlier cases focused on the absolute total of fees paid on the funds, the plaintiffs' allegations, to the extent made at all, were not as well developed as in two more recent cases on the issue of whether using retail class funds is a breach of fiduciary duty because it results in payment of higher fees than necessary to compensate the bundled service provider. That is, these later cases focus more clearly on the amount of mutual funds fees that are rebated back to the administrative service provider in the form of 12b-1 fees, subaccounting fees or fee sharing within the same family of companies to cover costs of plan administration provided to a plan.

In *Tibble v. Edison International,* 729 F.3d 1110 (9th Cir. 2013), the Ninth Circuit was faced with a plan with 10 institutional and commingled funds, 40 mutual funds and one employer stock fund. The Circuit Court concluded that the selection of the high fee funds by the plan fiduciaries would not be protected under ERISA Section 404(c) because the cost incurred by participants were not the necessary result of participant direction. While concluding that the inclusion of retail class funds would not itself be a breach of fiduciary duty, the Court did ultimately uphold the District Court's conclusion that the fiduciaries had been imprudent in introducing the retail class shares of three mutual funds because the fiduciaries failed to investigate the possibility of selecting the institutional class shares of the same funds with lower expense charges. In this case, the plan's investment consultant Hewitt Financial Services did not advise the fiduciaries to investigate the possible availability of the institutional class shares and such reliance on the consultant's faulty advice was insufficient to protect the fiduciaries. As the Ninth Circuit noted, "Hewitt is its consultant, not the fiduciary." Thus, a lesson from *Tibble* is that a plan fiduciary is not protected solely by offering a wide range of funds and fees; when the opportunity exists, the fiduciary must also evaluate whether it can obtain a better economic deal for the plan's participants.

Now, in *Tussey v. ABB, Inc.,* 746 F.3d 327 (8th Cir. 2014), the Eighth Circuit has again addressed the fund fee question. While the ABB plan offered a range of funds with various fees, in *Tussey* the Circuit Court's focus was clearly on whether those funds and fees paid were excessive because the fiduciaries were overcompensating Fidelity Management Trust Company

(“Fidelity”) for the administrative services it provided to the plan. As stated in the Eighth Circuit’s opinion, the District Court had found, as a matter of fact, that the “ABB fiduciaries failed to (1) calculate the amount the Plan was paying Fidelity for recordkeeping through revenue sharing, (2) determine whether Fidelity’s pricing was competitive, (3) adequately leverage the Plan’s size to reduce fees, and (4) ‘make a good faith effort to prevent the subsidization of administrative costs of ABB corporate services’ with Plan assets” even though their outside consultant notified them that the Plan was overpaying for recordkeeping services. Thus, the facts in *Tussey* evidenced that the fiduciaries had ignored advice that the fees being received by Fidelity exceeded reasonable fees for the services received by the plan and were subsidizing other services being provided to ABB. As a result, the Circuit Court concluded that reliance on *Hecker* and its progeny was misplaced and upheld the District Court’s finding that the plan fiduciaries had breached their duties under ERISA to the plan.

Summary

While each of the cases tends to be very fact specific, the cases provide the following guidance to plan fiduciaries:

- Inclusion of the retail class of mutual funds with high fees is not by itself a breach of fiduciary duty.
- A large number of funds with a range of expense ratios is beneficial in defending claims that cheaper funds should have been made available.
- Blind reliance on the advice of a consultant is not a defense to a breach of fiduciary duty. Fiduciaries should consider the advice received and question anything which appears omitted or is unclear. In contrast, failure to act on good advice from a consultant, as was the case in *Tussey*, is even more likely to result in a breach of fiduciary duty,
- When a plan sponsor has other business relationships with a service provider to a retirement plan, the plan’s fiduciaries should take extra steps to be certain that the retirement plan business is not subsidizing the cost of any other business with the vendor.
- The revenue obtained by a plan services vendor, whether in the form of direct payments, and rebated fees or allocation of internal expense charges, should be no more than reasonable fees for the administrative services rendered. New disclosure rules required by the Department of Labor make the evaluation of the fees being paid much easier than in the past. The difficult issue still remains of determining what amount is reasonable for the services received. Consultants who have experience with many plans can be very helpful in providing this type of information.
- The larger the plan in terms of asset size, the higher the level of scrutiny applied to the fiduciaries’ actions. A fiduciary’s duty under Section 404 of ERISA is to “act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.” The plans involved in these cases were all very large plans. It is not surprising that under the ERISA fiduciary standard, a fiduciary with a large amount of assets, large fees payments and, potentially, greater negotiating leverage, would be expected to act differently and with more attention and expertise than a small plan. ■

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RISK OF ERISA CLASS ACTIONS CAN BE REDUCED BY USE OF PLAN ARBITRATION PROVISIONS

by Frederick A. Brodie and Susan P. Serota

Under recent Supreme Court authority, it now appears possible to avoid class actions under the Employee Retirement Income Security Act of 1974, as amended ("ERISA") by requiring that plan participants sign an arbitration agreement containing a class action waiver. Plan sponsors should consider whether to pursue this option, which would entail some loss of control over the employee benefit plans to which it applies.

Background

Employee Stock Ownership Plans ("ESOP") and 401(k) Plans often provide participants with the opportunity to invest in employer stock. Plans providing for investment in employer stock have been a main target of ERISA class actions over the past decade. When the employer stock loses value, plaintiffs argue that the fiduciaries should have monitored the company stock for suitability, anticipated the events that led to the loss, and (i) disinvested the plan from company stock, wholly or partially; or (ii) ceased purchasing company stock for the plan.

Under recent Supreme Court precedent, arbitration clauses that are linked to class action waivers are enforceable. *See American Express Co. v. Italian Colors Restaurant*, 133 S.Ct. 2304, 2308, 2311-12 (2013); *AT&T Mobility LLC v. Concepcion,* 131 S.Ct. 1740, 1751-53 (2011).

The Second Circuit has held that ERISA claims for breach of fiduciary duty are arbitrable. *See Bird v. Shearson Lehman/ American Express*, 926 F.2d 116, 122 (2d Cir. 1991). The Second Circuit does not appear to have decided whether that extends to claims for benefits under ERISA section 502(a)(1)(B); however, other courts have held that an ERISA plan can make arbitration the exclusive remedy. See, e.g., *Chappel v. Laboratory Corp. of America,* 232 F.3d 719, 725 (9th Cir. 2000) (involving health plan); *VanPamel v. TRW Vehicle Safety Sys., Inc.,* 723 F.3d 664, 669-70 (6th Cir. 2013) (involving collective bargaining agreement).

Recently the California Supreme Court, in *Iskanian v. CLS Transportation Los Angeles, LLC,* **(link)** (6/23/14), held that arbitration agreements with mandatory class waivers are generally enforceable and overruled its prior decision in *Gentry v. Superior Court,* 165 P.3d 556 (2007). Thus, California courts may not refuse to enforce an employment agreement arbitration agreement simply because it contains a class action waiver (except in a representative action under the California Private Attorney General Act). The Court further held rejected the argument that a class action waiver is unlawful under the National Labor Relations Act.

Therefore, based on the current state of the law, the risk of ERISA class actions could be significantly reduced by having plan participants enter into an arbitration agreement that contains a class action waiver. See, e.g., *Hornsby v. Macon County Greyhound Park, Inc.,* 2012 WL 2135470, **9-10 (M.D. Ala. Jun. 13, 2012) (in ERISA case, upholding arbitration clause that did not permit classwide arbitration); *Luchini v. Carmax, Inc.,* 2012 WL 2995483, **3, 16 (E.D. Cal. July 23, 2012) (plaintiff's ERISA and other claims were covered by arbitration clause that did not provide for class arbitration); *Tenet HealthSystem Philadelphia, Inc. v. Rooney,* 2012 WL 3550496, **1, 5 (E.D. Pa. Aug. 17, 2012) (in case where plaintiff brought claims under ERISA and other statutes, confirming arbitrator's construction of agreement as not authorizing class arbitration).

Risk of ERISA Class Actions Can Be Reduced by Use of Plan Arbitration Provisions

Implementation of Plan Arbitration Provisions

These agreements may be executed separately by each employee/participant, or else consented to specifically in other documents that the participant signs as part of the initial employment agreement. *See, e.g., Sutherland v. Ernst & Young LLP,* 726 F.3d 290, 293-94 (2d Cir. 2013) (arbitration agreement and class action waiver were contained in "Common Ground Dispute Resolution Program" which was attached to employee's offer letter and confidentiality agreement, both of which were countersigned by employee); *Hendricks v. UBS Fin. Servs., Inc.,* 2013 WL 5969888, *1 (5th Cir. Nov. 11, 2013) (arbitration agreement was set forth as independent section of Compensation Plan; each plaintiff signed letters of understanding and acknowledgements in which they agreed to be bound by terms of Compensation Plan). The employee's separate execution of a document manifesting agreement to the arbitration clause and class action waiver should be sufficient to establish the employee's consent to such a program. *Compare Nelson v. Cyprus Bagdad Copper Corp.,* 119 F.3d 756, 762 (9th Cir. 1997) ("the unilateral promulgation by an employer of arbitration provisions in an Employee Handbook does not constitute a 'knowing agreement' on the part of an employee to waive a statutory remedy provided by a civil rights law," even if employee acknowledges receipt of handbook and agrees to read and understand it). Further, having an individual agreement with each participant affords the plan sponsor flexibility: The plan sponsor can choose, based on the circumstances of each individual case, whether to enforce the arbitration clause without establishing a precedent as to how it will conduct itself under the plan as a whole.

Other Considerations

Most plan sponsors carry fiduciary insurance that would mitigate the costs of a class action. Still, indemnification of the members of a Plan investment committee and the board of directors or other fiduciary which retains the responsibility to monitor the actions of an investment committee adds to the cost when the plan sponsor, board and the committee members are all sued. Even with insurance, the costs of a class action can be significant.

The potential costs of ERISA class actions must be weighed against the value of maintaining control over claims administration and the construction and application of plan provisions. Benefits decisions are usually made in the first instance by a plan committee, which is composed of company personnel. If the claimant challenges the committee's decision, it is then reviewed by a U.S. District Court under the liberal deference or "abuse of discretion"/ "arbitrary and capricious" standard, and usually sustained.

Arbitration would remove such disputes from the control of the plan committee, and place them under the control of a non-party arbitrator. An arbitrator probably would not accord the same respect to the plan sponsor's position that a committee would. Nor could multiple arbitrators deciding multiple claims adopt a uniform approach to construing and applying key provisions of the plan, the way a committee presumably would. Non-party arbitrators also would likely be unfamiliar with the plan sponsor's benefit programs, and—unlike a plan committee—would need to be educated on the subject anew in each case. Additionally, by choosing arbitration, a plan sponsor would give up its right to appeal an adverse determination in most cases.

Finally, if a plan sponsor chooses to implement an arbitration agreement, it must comply with DOL regulations that set criteria to be met by procedures for determining ERISA claims. *See* 29 C.F.R. §2560.503-1(b), (e)-(j). A plan's provisions should be reviewed to determine if they meet these requirements. ■

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SEVERANCE PAY IS SUBJECT TO FICA TAXES (WITH LIMITED EXCEPTIONS)—*QUALITY STORES* MAKES IT OFFICIAL

by Scott E. Landau and Bradley A. Benedict

In *United States vs. Quality Stores, Inc.*, the U.S. Supreme Court confirmed the IRS's position that severance payments generally fall within the scope of "wages" subject to Social Security and Medicare taxes on employers and employees under the Federal Insurance Contributions Act ("FICA taxes"). The March 25, 2014 ruling dashed the hopes of hundreds of companies that made protective refund claims for FICA taxes paid on severance amounts after the Sixth Circuit Court of Appeals upheld Quality Stores' contention that the severance payments it made to thousands of its employees in connection with the company's bankruptcy were exempt from FICA. Notably, however, the exemption from FICA taxation for certain severance programs tied to state unemployment insurance benefits (which were not at issue in *Quality Stores*) remains intact.

FICA's Definition(s) of "Wages"

FICA taxes apply to wages paid by an employer or received by an employee "with respect to employment," and FICA's definition of "wages" in the Internal Revenue Code of 1986, as amended (the "Code") includes "any remuneration for employment," subject to certain enumerated exceptions. In 1939, Congress actually created an exception from the then-applicable statutory definition for "dismissal payments which the employer is not legally required to make," but that exception was repealed in 1950. The Supreme Court's ruling relies in part on FICA's broad definition and takes note of Congress' treatment of severance type payments as an explicit exception in the past. Though the result seems straightforward, Quality Stores pointed to arguably conflicting language in the Code regarding wage withholding.

"Wages" for Withholding Purposes

Code Section 3402(o) states that, for purposes of employer withholding on wages for federal income tax, "any supplemental unemployment compensation benefit[1] paid to an individual ... shall be treated *as if it were* a payment of wages by an employer to an employee for a payroll period" (emphasis added). Quality Stores argued that since severance payments are to be treated *as if they were wages,* they must not *actually be* wages for purposes of withholding. Further, existing precedent holds that the definition of "wages" applicable to withholding requirements should be construed the same as the FICA definition whenever possible. Therefore, Quality Stores reasoned, if severance payments are not wages for income tax withholding, then they should not be wages subject to FICA tax. But the Supreme Court rejected the premise that the "as if it were" phrasing precluded severance payments from being wages. The language is consistent with the idea that most severance payments are considered wages (in accordance with the broad FICA and withholding definitions), but some types of severance are not. As the U.S. Court of Appeals Federal Circuit Court stated in *CSX Corp. v. United States,* another case on severance taxation, "the statement that all men shall be treated as if they were six feet tall does not imply that no men are six feet tall."

Section 3402(o)'s legislative history explains what types of severance may not be considered "wages." Starting in the 1950s, certain employers established severance programs designed to work in conjunction with state unemployment benefits so that employees would continue to receive a certain level of income for a period of time after a qualifying termination

[1] The term "supplemental unemployment compensation benefit" is defined to include most severance payments.

of employment (e.g., due to a plant shutdown). The intention was for payments made under these plans (so-called "SUB pay") to supplement the unemployment insurance benefits the former employee would receive. However, certain state laws made individuals who are receiving wages ineligible for unemployment benefits, which would undermine the intention of the plans if SUB pay were to be considered wages. Because these state laws generally followed federal tax treatment for determining what constitutes "wages," the IRS issued a number of Revenue Rulings finding that severance benefits in the form of payments designed to supplement state unemployment benefits are not "wages" within the meaning of the FICA and withholding definitions. Although SUB pay was therefore originally exempt from withholding, it was still taxable income, and individuals receiving SUB pay could sustain large tax burdens when filing their taxes for the year. Thus, Congress passed the legislation resulting in Section 3402(o), which requires that all severance payments be treated as "wages," whether or not the IRS deems such payments to fall within the applicable definitions.

NOTE: Quality Stores related to a reduction in force in connection with the company's bankruptcy. There is no question that severance payments made in connection with individual employee terminations are "wages" subject to FICA tax.

The Future of SUB Pay Plans

Quality Stores did not involve a SUB pay plan related to state unemployment benefits, and the Supreme Court holding does not affect the IRS Revenue Rulings establishing the exemption from FICA taxes (and taxes under the Federal Unemployment Tax Act ("FUTA")) for such SUB pay plans. There is an open question as to whether the IRS has the authority under the applicable statutes to provide for these exemptions. Nevertheless, for the time being, properly structured SUB pay plans offer employers an opportunity to provide post-employment protection to employees in a tax efficient manner.

Certain criteria have developed for SUB pay plan benefits to qualify for the IRS's "administrative exemption" from FICA and FUTA taxes. A 1956 IRS Revenue Ruling established the guiding principle: the payments must be designed to supplement the receipt of state unemployment compensation and actually be tied to the receipt of state unemployment benefits. Hallmarks of a qualifying SUB pay plan include: (1) eligibility for benefits is limited to individuals whose employment termination is involuntary (such as a layoff); (2) entitlement to SUB pay, and the continuation of payments under the plan, are linked to ongoing eligibility for state unemployment benefits (although certain exceptions have been recognized); and (3) benefits cannot be attributable to the rendering of particular services, but the level of benefits may be based in part on the employee's seniority. Lump sum payments, however, cannot qualify as SUB pay because the amount of the benefit received is not linked to the length of the individual's unemployment.

Ultimately, there is no bright-line test for what qualifies as a SUB pay plan exempt from FICA, but it is clear that the more a plan varies from the prototypical arrangements previously approved by the IRS, the greater the risk that the plan payments could be treated as regular wages subject to FICA and FUTA taxes. ■

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