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# HARNESSING THE POWER OF *Supplemental Unemployment Benefit Plans*



Supplemental unemployment benefit plans (SUB plans) provide compensation to employees beyond state unemployment insurance during layoff periods. When designed correctly, SUB plans can ease the financial stress of layoffs, generate peace of mind and worker loyalty, and offer significant tax advantages compared to severance pay.

SUB plans are particularly well suited for contractors that are subject to prevailing wage rules as the plans can be funded with fringe benefit payments required under the *Davis-Bacon Act* or state prevailing wage regulations.

## BACKGROUND

SUB plans “originated in response to organized labor’s claims during the 1950s that state unemployment benefits were insufficient to aid employees during periods of layoffs.”<sup>1</sup> Organized labor groups wanted to exclude supplemental unemployment benefits from the definition of wages because a worker’s receipt of wages triggered the cessation of state unemployment benefits.

Therefore, by classifying supplemental unemployment benefits as something other than wages, laid-off workers would be eligible to receive both state unemployment benefits *and* supplemental unemployment benefits. Furthermore, because supplemental unemployment benefits are not wages, tax consequences attach differently, thereby providing planning opportunities to contractors.

The exemption for supplemental unemployment benefits treatment as “wages” was codified in 1956, when the IRS created an administrative exception through the issuance of IRS Rev. Rul. 56-249. This ruling both removes supplemental unemployment benefits from classification as “wages” and excludes these benefits from FICA and FUTA taxes. Subsequent revenue rulings (Rev. Rul. 60-330 and Rev. Rul. 90-72) have broadened the scope of Rev. Rul. 56-249.

## ESSENTIAL REQUIREMENTS OF A SUB PLAN

With some limited exceptions, in order to be exempt from wages (and therefore exempt from FICA and FUTA taxes), SUB plans must be substantially the

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same or identical to those described in Rev. Rul. 56-249, as modified by Rev. Rul. 90-72. Together, these rulings require SUB plans to supplement state unemployment benefits and link the benefits to the receipt of state unemployment compensation. The key elements of a SUB plan follow.

### Definition of Layoffs

Benefits are paid only to unemployed former employees who are laid off by the employer. IRC § 3402(o)(2)(A) defines a layoff for purposes of a SUB plan as an involuntary separation from employment (whether or not the separation is temporary) resulting directly from a seasonal layoff, reduction in force, discontinuance of a plant or operation, or other similar condition.

If permitted by state unemployment law, the definition can be further expanded to include a reduction of hours of service that renders the employee eligible to collect state unemployment benefits. However, the definition of a layoff does not include an employee who is terminated for cause or voluntarily resigns. It is also important to note that benefits must cease to be payable as of the date that the employee returns to work for *any* employer (even if it is not the employer that established the SUB plan).

### Prescribed Conditions

Eligibility for supplemental unemployment benefits depends upon meeting prescribed conditions after employment termination. The primary condition is that an employee must be eligible for state unemployment benefits.

Three limited exceptions to this rule were established by Rev. Rul. 90-72, which permits an employee to receive benefits if he or she is ineligible for state unemployment because:

- 1) The employee does not have sufficient employment to be covered under the state system;
- 2) The employee has exhausted the duration of state unemployment benefits; or
- 3) The employee has not met the requisite waiting period.

### Amount of Weekly Benefits

The amount of weekly benefits payable is based upon state unemployment benefits, other compensation allowable under state laws, and the amount of regular weekly pay. This broad requirement allows room for creative benefit formulas. More information about this requirement, and some ideas on the strategies available, will be discussed later.

### Right to Benefits

No employee has any right, title, or interest in the benefits until such employee is qualified and eligible to receive ben-

efits, and the benefits do not accrue until a prescribed period after termination of employment.

### Rendering of Services

The benefits are not attributable to the rendering of particular services by the recipient during the period of unemployment. The employer cannot require that the employee perform any services whatsoever in return for unemployment benefits.

### Frequency of Payments

Benefits may not be paid in a lump sum. Unemployment benefits must be linked to state unemployment benefits. Receipt of these benefits in the form of a lump sum rather than periodic payments would allow the same amount of benefits to be received regardless of how long an individual remains unemployed, and thus would not satisfy the requirement to be linked to state unemployment benefits.

## ADVANTAGES & REQUIREMENTS OF USING A TRUST

Most employers elect to provide SUB plans through a trust fund rather than directly through the company.

A trust fund that meets the necessary qualification requirements is tax exempt and, therefore, the contributions made by the employer to fund SUB plans are deductible at the time of contribution. Any earnings on the corpus of the trust are also tax-exempt.

A tax-exempt supplemental unemployment benefit trust is most commonly organized under IRC § 501(c)(17) or IRC § 501(c)(9). The necessary requirements are:

- 1) The trust is a valid, existing trust under local law as evidenced by an executed written document.
- 2) The trust is part of a written plan established and maintained by the employer that meets all requirements for the sole purpose of providing unemployment benefits.
- 3) The trust is part of a plan that provides that the corpus and income of the trust cannot be used for, or diverted to, any purpose other than the provision of benefits or administration of the plan.

Once funds are contributed to the trust, they can only be used for SUB plans. Funds cannot revert to the employer or be transferred to other benefit plans (e.g., retirement, death benefits, etc.).

However, IRC 501(c)(17) permits sick and accident benefits to be paid under the plan provided they are subordinate to the separation benefits.

- 4) The trust is part of a plan with eligibility conditions and benefits that do not discriminate in favor of highly compensated employees. A highly compensated employee is an individual who:



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- Owned more than 5% of the interest in the business at any time during the year or the preceding year, regardless of how much compensation that person earned or received, or
  - For the preceding year, received compensation from the business of more than \$120,000 (if the preceding year is 2016 or 2017), and, if the employer so chooses, was in the top 20% of employees when ranked by compensation.
- 5) The trust is part of a plan that requires benefits to be determined according to objective standards; that is, benefits cannot be determined solely in the discretion of the trustee or sponsor.

There are potential challenges to using a 501(c)(17) or 501(c)(9). Consideration should be made for complications that could arise from the following:

- 1) The trust will not qualify as tax-exempt under 501(c)(9) or 501(c)(17) unless it files for recognition of its tax-exempt status on IRS Form 1024, Application for Recognition of Exemption Under Section 501(a), within 15 months after the end of the month in which it was formed.
- 2) The trust must be run by an independent trustee.
- 3) As a tax-exempt entity, the trust must annually file IRS Form 990, Return of Organization Exempt From Income Tax.
- 4) The termination of a funded trust when no longer needed is subject to somewhat complicated rules regarding the use of the remaining assets.

### ADVANTAGES & STRATEGIES FOR PREVAILING WAGE CONTRACTORS

Construction companies that contract with the government (federal government, many state governments, municipalities, school districts, etc.) are subject to special requirements that dictate mandatory wage and fringe benefit payments commonly referred to as prevailing wage regulations (*Davis-Bacon Act*, *McNamara-O'Hara Service Contract Act*, and state prevailing wage laws).

The fringe benefit portion of the prevailing wage regulations are particularly complicated and often misapplied by contractors, especially those that are not subject to a collective bargaining agreement that provides bona fide fringe benefits. The fringe benefit portion of prevailing wage regulations typically require a contractor to provide a certain dollar level of bona fide fringe benefits for each hour worked or provide an equivalent amount in additional wages.

Bona fide benefits include both health and welfare benefits and retirement benefits. In addition to supplemental unemployment benefits, other permitted benefits include:

- Pension or retirement plan (defined benefit or defined contribution)
- Medical insurance
- Dental insurance
- Life insurance
- Disability insurance
- Vacation, holiday, and/or sick pay
- Apprenticeship and safety training

SUB plans are particularly well suited for contractors that commonly have interruptions in their work, and therefore a reduced need for labor (e.g., seasonal shutdowns, weather conditions, job scheduling, equipment or material supply problems, or delays caused by engineering or other subcontractors).

These interruptions cannot always be effectively handled with a temporary layoff. Acquiring and keeping skilled workers has become a critical factor in most contractors' growth potential. Laying off valuable workers during an interruption can have unintended consequences, such as morale issues resulting from reduced income or employees finding work with another employer (including a competitor).

The construction industry is no stranger to such consequences, and as a result, companies often keep workers "busy" on other tasks, such as "shop work," rather than risk the workers not being available when needed.

However, SUB plans alleviate the risks associated with temporary layoff for a number of reasons:

- Payments from the SUB plan can provide the additional income necessary to equalize or even exceed the wages the employee receives while working;
- Depending on state rules, employees can receive payments for short work weeks (less than 40 hours worked) where their hours were interrupted by weather or some other short-term factor;
- The payments received by employees are not subject to FICA taxes (7.65%); and
- SUB plans can be funded with fringe benefit payments already required under prevailing wage regulations and therefore do not create an additional company expense or liability.

### Plan Design Strategies

Although SUB plans can be beneficial for contractors subject to prevailing wage regulations, care must be taken in the

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design of the plan to ensure maximum effectiveness.

### **Trust/Funded Plans**

SUB plans work best when administered through a trust, as referenced previously. Irrevocable contributions of fringe benefit dollars paid to a trustee pursuant to a bona fide fringe benefit trust fund, plan, or program on a regular basis by contractors engaged in public works qualify as a “funded plan” under 29 CFR § 5.26-5.27.

Contributions to funded plans can be credited toward meeting the prevailing fringe benefit requirements of the *Davis-Bacon Act*, SCA, and state prevailing wage laws; in addition, they do not need U.S. Department of Labor approval, though state rules vary.

### **Contribution Formulas**

The contribution formula of the plan dictates the amount of money the employer is obligated to fund to the employee’s benefit account. If the intent is to fund the plan solely with fringe benefit dollars obligated under prevailing wage regulations, then the contribution formula must clearly express this intent.

A properly written contribution formula limits an employee to receiving only the amount that has been credited to his or her benefit account and protects the employer from any obligation to make additional payments to the plan.

### **Benefit Formulas**

As discussed, the amount of weekly benefits payable is based upon state unemployment benefits, other compensation allowable under state laws, and regular weekly pay amounts.

A common yet incorrect assumption regarding this requirement is that the SUB plan weekly benefit cannot exceed what would have normally been earned as regular weekly pay when combined with the state’s unemployment benefits. This is incorrect because “based upon” means just that; it provides flexible variables in how to calculate benefits.

For example, benefit formulas can include a multiple of state unemployment benefits and/or a multiple of regular weekly

pay up to a maximum threshold. As long as the formula is “based upon” the required criteria, the formula is compliant.

### **SUMMARY**

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Providing a SUB plan as part of your prevailing wage fringe benefit strategy can be a win-win for your company and employees. Making a temporary layoff a welcome respite rather than a time of stress and financial difficulty can help build employee loyalty and secure your workforce.

Funding a plan with prevailing wage fringe contributions is tax-efficient and provides a cost advantage over paying fringe contributions as cash wages.

The rules related to SUB plans combined with prevailing wage regulations can be extremely complicated. Consult with the proper accounting professional to help you develop strategies to address and comply with them. ■

### **Endnote**

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1. *Amicus Curiae* Brief of the North America’s Building Trades Unions in support of the Indiana-Illinois-Iowa Foundation for Fair Contracting, Intervenor, in *PWCA and NAPWC v. Secretary of Labor*. [www.dol.gov/arb/briefs/16-019\\_16-021/Amicus\\_Brief.pdf](http://www.dol.gov/arb/briefs/16-019_16-021/Amicus_Brief.pdf).

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