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Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
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Date:
September 22, 2011

Legend

Taxpayer =
Insurance Plan =
State A =

Dear :

This is in response to your letter dated March 23, 2011, requesting a ruling that certain insurance premium payments made by and on behalf of employees, and certain benefit payments made to employees, under the Insurance Plan are not subject to employment taxes.

FACTS

Taxpayer's employees may participate in the Insurance Plan. At issue in this ruling request are the tax consequences of premium payments made, and benefit payments received, pursuant to two participation options.

The first participation option (Option 1) is available to employees with less than two years of service. Employees participating in the Insurance Plan under this option will voluntarily make premium payments with their own after-tax dollars. The amounts of these premium payments will be based on prevailing market rates and the experience rating attributable to the individual's employment. These employees will have the option

to request that Taxpayer withhold these premium payments from their paychecks.

The second participation option (Option 2) is available to certain employees with two or more years of service. Taxpayer will make premium payments on behalf of employees who participate in the Insurance Plan under this option.

Benefit payments received by employees under either Option 1 or 2 will supplement State A's public unemployment insurance benefits and will allow the employees, or Taxpayer, to purchase insurance which together with the state unemployment benefits covers 50 percent of the insured's wages.

Participants in the Insurance Plan are entitled to benefit payments only if they are eligible for benefits under state A's public unemployment insurance plan. The Plan further restricts and modifies benefit payments in the following ways:

(1) Only individuals who are involuntarily unemployed from full-time employment are entitled to benefit payments;

(2) An unemployed person who starts working part-time after starting to receive unemployment benefits, and therefore suffers a reduction in his benefits, will be treated under the Insurance Plan as unemployed and will receive the same amount of benefits as the individual received before he started the part-time work; and

(3) The Insurance Plan will not provide benefit payments to an individual who has lost the covered employment due to illness or disability.

Benefit payments under the Insurance Plan will be paid periodically and will begin after the individual has received unemployment benefits for two weeks. Plan benefits will cease at the earlier of the cessation of State A benefits or 24 weeks of payments under the Insurance Plan.

RULINGS REQUESTED

(1) Unemployment insurance purchased by employees with after-tax dollars under the Insurance Plan does not constitute a taxable employer-provided benefit for the employees,

(2) Unemployment insurance premium payments purchased on behalf of employees by the Taxpayer under the Insurance Plan are excluded from gross income as working condition fringe benefits under section 132(d) of the code, and

(3) Unemployment insurance benefit payments received by employees, deriving from premium payments purchased by Taxpayer on behalf of those employees, are not

wages subject to taxes imposed under the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA).

LAW

1. Payments Subject to Employment Taxes

For purposes of this ruling, the term “employment taxes” means the FICA tax imposed on employers and employees, the FUTA tax imposed on employers, and federal Income Tax Withholding (ITW). Employers withhold and pay employment taxes on wages they pay to their employees.

Sections 3101 and 3111 of the Code impose FICA taxes on wages, as that term is defined in section 3121(a), with respect to “employment,” as that term is defined in section 3121(b). FICA taxes consist of the Old-Age, Survivors and Disability Insurance tax (social security tax) and the Hospital Insurance tax (Medicare tax). These taxes are imposed on both the employer and employee. Sections 3101(a) and 3101(b) impose the employee portions of the social security tax and the Medicare tax, respectively. Sections 3111(a) and 3111(b) impose the employer portions of the social security tax and the Medicare tax, respectively.

Section 3121(a) of the Code defines wages for FICA purposes as all remuneration for employment, with certain specific exceptions. Section 3121(b) defines the term employment as any service, of whatever nature, performed by an employee for the person employing him, with certain specific exceptions.

Section 31.3121(a)-1(b) of the Employment Tax Regulations provides that the term wages means all remuneration for employment unless specifically excepted under section 3121(a). Section 31.3121(a)-1(c) provides that the name by which the remuneration for employment is designated is immaterial. Salaries, fees, and bonuses are wages, if paid as compensation for employment. Section 31.3121(a)-1(d) provides that generally the basis upon which the remuneration is paid is immaterial in determining whether the remuneration is wages. Section 31.3121(b)-3(b) defines employment as services performed by an employee for an employer, unless specifically excepted under section 3121(b).

The FUTA taxation provisions are similar to the FICA provisions, except that only the employer pays the tax imposed under FUTA. See sections 3301 and 3306(b) and the regulations thereunder. Although there are differences in the statutory exceptions to what constitutes wages and employment, the general definitions of the terms wages and employment for FUTA purposes are similar to the definitions for FICA purposes. See sections 3306(b) and 3306(c).

Section 3402(a), relating to ITW, generally requires every employer making a payment of wages to deduct and withhold upon those wages a tax determined in accordance with prescribed tables or computational procedures. The term wages is defined in section 3401(a) for ITW purposes as all remuneration for services performed by an employee for his employer, with certain specific exceptions. Section 31.3401(a)-1(a)(2) of the Employment Tax Regulations provides that the name by which remuneration for services is designated is immaterial. Thus, salaries, fees and bonuses are wages if paid as compensation for services performed by the employee for his employer. Section 31.3401(a)-1(a)(3) provides that generally the basis upon which the remuneration is paid is immaterial in determining whether the remuneration is wages. Unlike the FICA and the FUTA, the ITW provisions do not include a definition of employment.

2. Working Condition Fringe Benefits

Section 61(a) of the Code defines “gross income” as, unless otherwise excluded, all income from whatever source derived, including (but not limited to) compensation for services such as fees, commissions, fringe benefits, and similar items. Section 1.61-1(a) of the Income Tax Regulations provides that gross income includes income derived in any form, whether in money, property, or services. Section 1.61-21(a)(1) of the regulations provides that a fringe benefit may include, for example, an employer-provided discount on property or services.

Section 1.61-21(b) of the regulations provides that an employee must include in gross income the amount by which the fair market value of an item exceeds the amount, if any, paid for the benefit by or on behalf of the recipient. Under section 1.61-21(b)(2), the fair market value of a benefit is the amount that an individual would have to pay for the particular fringe benefit in an arm's length transaction.

Section 132(a)(3) of the Code excludes from gross income any fringe benefit that qualifies as a “working condition fringe.” Section 132(d) defines the term working condition fringe as any property or services provided by an employer to an employee to the extent that, if the employee paid for the property or services, the payment would be allowable as a deduction under section 162 (ordinary and necessary trade or business expenses) or section 167 (concerning depreciation).

Section 1.132-5(a)(1)(iii) of the regulations provides that “an amount that would be deductible by an employee under a section other than section 162 or 167, such as section 212, is not a working condition fringe.”

Section 162(a) of the Internal Revenue Code allows a taxpayer to deduct all ordinary and necessary business expenses paid or incurred during the tax year in carrying on any trade or business.

It has long been recognized that an employee is engaged in the business of being an employee, and that an expense which is essential to the continuance of the employment is deductible for income tax purposes. Noland v. Commissioner, 269 F.2d 108 (4th Cir. 1959); Schmidlapp v. Commissioner, 96 F.2d 680 (2nd Cir. 1938). Furthermore, an employee is engaged in the trade or business of performing services as an employee separate and apart from the performance of those services for his existing employer. Motto v. Commissioner, 54 T.C. 558 (1970); Primuth v. Commissioner, 54 T.C. 374 (1970); Rev. Rul. 75-120, 1975-1 C.B. 55. Because an employee's trade or business exists apart from the employee's performance of services for one particular employer, expenses that an employee incurs in seeking new employment in the same trade or business are deductible, as are expenses an employee incurs in suing a former employer for wrongful termination. Rev. Rul. 75-120, supra; Biehl v. Commissioner, 118 T.C. 467 (2002), affd. 351 F.3d 982 (9th Cir. 2003).

Rev. Rul. 81-193, 1981-2 C.B. 52, considered whether contributions by employees to private plans for payment of non-occupation disability benefits under the New Jersey Temporary Disability Benefits Law are deductible business expenses. In reaching the conclusion that the expenses are not deductible business expenses, but are rather nondeductible personal expenses, that ruling concluded that:

> Amounts paid by employees to fund private plans for the payment of disability benefits are not paid or accrued in carrying on a trade or business because they are incurred to provide indemnity coverage for loss of wages due to unemployment from nonoccupational hazards rather than from business hazards. The nonoccupational personal nature of the benefit aspect of the private disability plans makes the contributions to the private plans nondeductible personal expenses under section 262 of the Code.

Section 1.132-5(a)(2)(i) of the Income Tax Regulations clarifies that it not sufficient for the property or service to merely be deductible under section 162 of the Code for that property or service to constitute a working condition fringe. Rather, the property or service must be allowable as a deduction under section 162 with respect to the employee's specific trade or business of being an employee of the employer. Thus, not all expenses deductible by the employee under section 162 will meet this standard. See the examples section 1.132-5(a)(2)(ii) of the Income Tax Regulations. Revenue Ruling 92-69, 1992-2 C.B. 51, provides that this requirement is generally satisfied if, under all the facts and circumstances, (1) the employer derives a substantial business benefit from the provision of the property or services that is distinct from the benefit that it would derive from the mere payment of additional compensation, and (2) the employee's hypothetical payment for the property or services would otherwise be allowable as a deduction by the employee under section 162.

Revenue Ruling 92-69 lists the following examples of benefits from which the "employer derives a substantial business benefit" that is distinct from the benefit it would derive from the mere payment of additional compensation: "promoting a positive corporate image, maintaining employee morale, and avoiding wrongful termination suits."

3. FICA and FUTA Tax Exclusion for SUB Pay

Section 31.3401(a)-1(b)(4) of the Employment Tax Regulations specifically provides that, for purposes of ITW, any payments made by an employer to an employee on account of dismissal (i.e., involuntary separation from the service of the employer) constitute wages regardless of whether the employer is legally bound by contract, statute, or otherwise to make such payments. Although there are no similar provisions in the regulations relating to FICA and FUTA taxes, the same conclusion generally applies. See H.R. Rep. No. 1300, 81st Cong., 1st. Sess. 124 (1949), 1950-2 C.B. 255, 277, & 300. See also Rev. Rul. 90-72, 1990-2 C.B. 211, Rev. Rul. 71-408, 1971-2 C.B. 340, and Rev. Rul. 75-44, 1975-1 C.B. 15.

The Service, however, created an administrative exception from employment taxes for supplemental unemployment benefits (SUB pay)—certain payments made upon the involuntary separation of an employee from the service of the employer—with the issuance of Rev. Rul. 56-249, 1956-1 C.B. 488. The exception applies only if the payments are designed to supplement the receipt of state unemployment compensation and are actually tied to the receipt of state unemployment benefits, and in three limited situations where the employee is ineligible to receive state unemployment benefits; i.e., (1) where the employee does not have sufficient employment to be covered under the state system, (2) where the employee has exhausted the duration of state unemployment benefits, or (3) where the employee has not met the requisite waiting period.

The plan at issue in Rev. Rul. 56-249 is specifically "designed to supplement state system unemployment benefits payable to certain former employees." Employees must report to and register for employment with the state employment service. The plan also incorporates all of the state unemployment compensation law requirements designed to limit benefit payments to individuals who are "unemployed" and genuinely available for any suitable work. The plan benefits are payable only after an employee is unemployed for "x" weeks. The plan benefits are paid in varying amounts and for varying periods depending, in part, on the amount of state unemployment benefits available. Finally, in a state where SUB pay does not reduce state unemployment benefits, the unemployed individual cannot receive any other remuneration which would disqualify the individual from the state benefit, i.e., a plan payment is not SUB pay if the sum of that benefit and other remuneration from the employer disqualifies the recipient from receiving unemployment benefits in that state. In very limited situations, the plan benefits disqualify the recipient from state unemployment benefits, thereby entitling the individual to the payment of a substitute benefit. However, the plan is designed in such a manner

that the benefits generally do not disqualify the recipient from state unemployment benefits.

The ruling summarizes the following eight features of the plan: (1) benefits are paid only to unemployed former employees who are laid off by the employer; (2) eligibility for benefits depends upon meeting prescribed conditions after terminating employment with the employer; (3) benefits are paid by trustees of independent trusts; (4) the amount of weekly benefits payable is based upon state unemployment benefits, other compensation allowable under state laws, and the amount of straight-time weekly pay after withholding of all taxes and contributions; (5) the duration of the 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) the benefits are not attributable to the rendering of particular services by the recipient during the period of unemployment; and (8) no employee has any right, title, or interest in the fund until such employee is qualified and eligible to receive benefits. Revenue Ruling 56-249 concludes that the plan benefits do not constitute “wages” for purposes of FICA tax, FUTA tax, or federal income tax withholding.

Subsequent revenue rulings have broadened the scope of Rev. Rul. 56-249, but only to the extent that the plans in question are “similar in all material details” or are “substantially the same” as the plan in Rev. Rul. 56-249. If the plans are substantially the same or similar in all material details to the plan described in Rev. Rul. 56-249, then the absence of a single element may not be a material or controlling factor. The question is whether each plan's basic or fundamental purposes and conditions are the same as the purposes and conditions of the plan in Rev. Rul. 56-249.

In Rev. Rul. 60-330, 1960-2 C.B. 46, the Service amplified Rev. Rul. 56-249 and concluded that a plan's failure to provide for the accumulation of funds in a trust account does not alter the conclusion of Rev. Rul. 56-249.

In Rev. Rul. 80-124, 1980-1 C.B. 212, the Service emphasized that a payment qualifies as SUB pay under Rev. Rul. 56-249 only if the payment is “for a layoff that is involuntary on the part of the employee.”

In Rev. Rul. 90-72, 1990-2 C.B. 211, the Service continued to recognize an administrative wage exclusion, albeit modified, for SUB pay. Rev. Rul. 90-72 holds that SUB pay is excluded from “wages” for FICA and FUTA tax purposes only if the receipt of SUB pay is actually linked to the receipt of state unemployment compensation (i.e., the plan payments satisfy the plan's design and purpose of supplementing the receipt of state unemployment compensation). Furthermore, it holds that lump-sum payments are not linked to state unemployment compensation since the amount of the benefit received is the same regardless of the length of the individual's unemployment.

Therefore, to qualify as SUB pay for FICA and FUTA tax purposes, payments under a plan must be specifically designed to supplement state unemployment benefits and, under the terms of the plan, the employee must be unemployed and must meet the requirements necessary to receive state unemployment compensation benefits.

Section 3402 of the Code, as added by section 805(g) of the Tax Reform Act of 1969, Pub. L. No. 91-172, 1969-3 C.B. 10, extends ITW to any supplemental unemployment compensation benefit paid to an individual, regardless of whether it would otherwise be considered wages. Section 3402(o)(2)(A) defines "supplemental unemployment compensation benefits" as amounts paid to an employee pursuant to a plan to which the employer is a party, because of an employee's involuntary separation from employment (whether or not such separation is temporary) resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions, but only to the extent such benefits are includible in the employee's gross income.

ANALYSIS

1. Benefit payments under Option 1 are not subject to Employment Taxes

Benefit payments under Option 1 are not subject to Employment Taxes. The premium payments under Option 1 were purchased by employees with after-tax dollars in their individual capacities pursuant to a plan in which the employer, Taxpayer, is not a party. These benefits therefore do not constitute wages.

2. Premum Payments under Option 2 are Working Condition Fringe Benefits.

Premium payments made by Taxpayer on behalf of employees under Option 2 are not subject to employment taxes, and are not includable in employees' gross incomes, because they satisfy the definition of working condition fringe under section 132(d) of the Code, and the requirements set forth in 1.132-5(a)(2)(i) of the Income Tax Regulations. That is, if the employees had made the payments themselves such payments: (1) would be deductible by the employees under section 162 of the Code, and (2) would be deductible with respect to the employees' specific trade or business of being employees to Taxpayer.

In particular, if Taxpayer's employees made the premium payments under Option 2 themselves, they would be entitled to deduct those payments under section 162 of the Code. That is, the premiums paid under the insurance contract are intended to insure wage continuation at a level based on an employee's existing salary for a stated benefit period during which the employee is unemployed. The premiums are analogous to the types of contributions made to insure against business contingencies that Rev. Rul. 81-193 strongly infers are deductible. The insurance contract provides indemnity coverage for lost wages due to unemployment resulting from occupational or business hazards. It

is a recognized aspect of employment that an employee may be terminated for business reasons. The insurance contract insures against this occupational risk and permits the taxpayer to carry on in the trade or business of being an employee.

Since the insurance contract provides indemnity coverage for lost wages due to unemployment resulting from occupational or business hazards, an employee would be entitled to deduct the cost of premium payments for such an insurance contract as a business expense under section 162(a) of the Code.

Furthermore, the employees would be entitled to deduct these premium payments as business expenses relating to their business of being employees of Taxpayer because Taxpayer derives a benefit from the Insurance Policy that is distinct from the benefit it would derive from the mere payment of additional compensation. As discussed earlier, examples of benefits that the Service has determined meet this requirement include benefits that serve to maintain employee morale, and those that minimize the risk that the employer will incur a wrongful termination suit. The Insurance Policy serves these goals.

3. Benefit Payments under Option 2 are SUB pay.

The Plan is a SUB plan because it is similar in all material respects to the plan described in Rev. Rul. 56-249, as modified by Rev. Rul. 90-72; i.e., the Plan is designed to supplement state unemployment benefits and the benefits are linked to the receipt of state unemployment compensation. Benefit payments that employees receive under Option 2 are therefore not subject to FICA or FUTA taxes.

These benefit payments are, however, subject to ITW to the extent that they are includible in employees' gross incomes, under section 3402(o) of the Code.

RULING

Based on the information submitted and the representations made, we rule that:

(1) Benefit payments under Option 1 are not subject to employment taxes,

(2) Premium payments under Option 2 are neither includible in employees' gross incomes nor subject to employment taxes because they constitute working condition fringe benefits under section 132(d) of the Code, and

(3) Benefit payments under Option 2 are not subject to FICA or FUTA taxes because the plan is a SUB plan.

This private letter ruling is directed only to Taxpayer, who requested it. Code section 6110(k)(3) provides that it may not be used or cited as precedent.

A copy of this letter ruling must be attached to any federal income tax return to which it is relevant.

Sincerely,

Lynne Camillo
Chief, Employment Tax Branch 2
Tax Exempt and Government Entities