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US Supreme Court nixes FICA tax break for downsizing firms. Depriving companies that reduce their workforces of a potential saving, the Court held, in *United States v. Quality Stores, Inc*., 2014 US LEXIS 2213 (March 25, 2014), that severance payments to discharged workers are not entitled to a statutory exclusion from FICA tax. The ruling overturned a 6th Circuit Court of Appeals holding that led hundreds of companies to file protective refund claims for themselves and their former employees. Left intact – but possibly in jeopardy – was a much narrower FICA exemption that the IRS has fashioned administratively in rulings going back 60 years.

The employer's argument didn't rely on anything in section 3121 of the Internal Revenue Code, which defines "wages" for FICA purposes. Instead, it pointed to section 3402, the definition of "wages" that are subject to income tax withholding. The Supreme Court held that, except where the statute says otherwise, the word has the same meaning in both places. *Rowan Companies, Inc. v. United States*, 452 US 247, 101 S. Ct. 2288, 68 L. Ed. 2d 814 (1981).

Section 3402(o) addresses "supplemental unemployment compensation benefits," which are defined as:

> amounts which are 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. [IRC, §3402(o)(2)(A)]

The section provides that, for withholding purposes, a payment of this kind "shall be treated *as if it were a payment of wages* by an employer to an employee. . . ." IRC, §3402(o)(1)(A) (emphasis added).

Over 30 years after section 3402(o) became law, an imaginative employer persuaded the Court of Claims to accept the implication of "as if it were a payment of wages" and to hold that, since "wages" has the same meaning in section 3121 as in section 3401, "supplemental unemployment compensation benefits" are not FICA wages; and section 3121 does not state that they are to be treated *as if* they were wages. The court's conclusion was that they therefore were exempt from FICA tax. *CSX Corporation v. United States*, 52 Fed. Cl. 208 (Ct.Cls., 2002).

The US Court of Appeals for the Federal Circuit eventually reversed the Court of Claims' ruling in *CSX*, 518 F.3d 1328 (Fed. Cir., 2008), but Quality Stores had better luck making the same argument to the 6th Circuit. *In re Quality Stores, Inc*., 693 F.3d 605 (6th Cir., 2012), *cert. granted*, 134 S. Ct. 49 (2013).

The US Supreme Court didn't find the inference compelling. The reasoning of Justice Kennedy's opinion for a unanimous Court (Justice Kagan not participating), was brisk. It quoted *Social Security Board v. Nierotko*, 327 US 358, 366-66 (1946) for the proposition that the "service" for which FICA wages are paid "means not only work actually done but the entire employer-employee relationship for which compensation is paid to the employee by the employer". Severance pay stems from the employer-employee relationship and is not excluded by any provision in section 3121. It follows that the "plain meaning" of the statute includes it in wages subject to FICA tax.

What of section 3402(o)'s implication that "supplemental unemployment compensation benefits" are outside the scope of "wages" and the Court's own dictate that "wages" must have a consistent meaning unless Congress explicitly says otherwise?

The Court responded that, when section 3402(o) was enacted, the IRS administratively classified *some* severance pay as non-wages. Revenue Ruling 56-249, 1956-1 C.B. 488, as modified by later rulings, had carved out a FICA exemption for payments to former employees that met all of the substantive conditions for the receipt of state unemployment benefits and continued only while those conditions were satisfied (thus terminating when the individual found new employment, exhausted his weeks of eligibility or dropped out of the labor market). The purpose of section 3402(o) was to ensure that *those* payments, and any similar ones that the IRS might later decide were not "wages," were subject to income tax withholding. It was not to expand the limited, IRS-created FICA exemption.

The administrative exemption has not gone away. Its latest incarnation is found in Revenue Ruling 90-72, 1990-2 CB 211, and it remains in use, most often in programs established through collective bargaining. Some language in Justice Kennedy's opinion could raise questions about its validity. On its face, the Court's reasoning suggests that section 3402(o) was superfluous, because the general principles of *Nierotko* and *Rowan* demand that severance payments of any kind be included in "wages" for both FICA and withholding, from which one might think that the IRS has no authority to devise exceptions.

Omitted from the opinion, however, is the interesting sequel to *Rowan*. Congress responded to the decision by amending section 3121(a) to add this proviso:

> Nothing in the regulations prescribed for purposes of chapter 24 (relating to income tax withholding) which provides an exclusion from "wages" as used in such chapter shall be construed to require a similar exclusion from "wages" in the regulations prescribed for purposes of this chapter.

The purpose, according to the legislative history, was "to ensure that the determination of whether payments are included within 'wages' for FICA purposes would not be dictated by whether the same payments would be treated as 'wages' for income tax purposes," and the IRS has consistently interpreted it as having exactly that effect.

In *CSX*, the Federal Circuit held that, regardless of the legislators' intentions, they had failed to accomplish what they set out to do, because the provision "addresses the construction of the regulations rather than chapter 24 itself; . . . it does not state that the term 'wages' in section 3401 will be defined independently from the term 'wages' in section 3121." 518 F.3d at 1344.

The Supreme Court may well agree, as it did not find the alleged legislative supersession worthy of so much as a footnote. On the other hand, the "decoupling" interpretation was accepted by a court in a case in which it was directly at issue. *See Public Employees' Retirement Board v. Shalala*, 1996 US Dist. LEXIS 10078 (D. N.M., 1996), *aff'd*, 153 F.3d 1160 (10th Cir., 1998). Since the IRS seems to believe that it can construe the two sections differently to serve their different purposes, it may feel no compulsion to overturn a long-established ruling position in response to a mere judicial hint.

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There is, in any event, a way to sidestep FICA taxation of severance pay without following the narrow path of Revenue Ruling 90-72, though it is not open to all employers and requires careful planning. A company with a defined benefit pension plan may be able to amend the plan to increase the benefits of laid-off workers, then give them the option of receiving the increase as a lump sum or in installments over a relatively short period. Distributions from qualified plans are exempted from FICA wages by section 3121(a)(5). The need for care arises from a variety of obstacles, including nondiscrimination requirements, restrictions on lump sum and installment payments by underfunded pension plans and penalty taxes on participants who receive distributions before age 55. The possible savings for both companies and workers may nonetheless make this alternative attractive where it is feasible.

Eighth Circuit lets investment vehicles retain float income, chides fiduciaries for letting revenue sharing subsidize services to employer, suggests some fiduciary decisions may be entitled to Firestone deference. In a decision that gave some solace to both the plaintiffs' and the defense bars, *Tussey v. ABB, Inc.*, 2014 US App. LEXIS 5118 (8th Cir., March 19, 2014) partly affirmed, partly vacated and partly reversed a $50 million judgment against fiduciaries of ABB's two 401(k) plans and the plans' recordkeeper, Fidelity, whose mutual funds were major items on the plans' investment menus. The district court decision, discussed in a previous ERISA Advisory (May 3, 2012), sharply reprimanded the defendants' conduct, finding three distinct ERISA violations:

- failure by ABB's Pension Review Committee to ensure that revenue sharing paid by the plans' investment options to compensate Fidelity for services rendered to the plans themselves rather than to other plans or the employer ("recordkeeping claim");
- the replacement of a balanced fund by target date funds without adherence to the process prescribed by the plans' written policies for evaluating and changing investment options and in violation of the fiduciaries' duties of prudence and loyalty ("investment selection and mapping claims"); and
- retention by the mutual funds in which the plans invested of float income that properly belonged to the plan ("float claim").

Damages were $13.4 million for the recordkeeping claim, $21.8 million for the investment selection and mapping claims and $1.7 million for the float claim. To that the district court added a $13.4 million award of attorneys' fees and court costs. 2012 US Dist. LEXIS 45240 (W.D. Mo., 2012).

The 8th Circuit upheld the district court's decision on the recordkeeping claim, vacated its decision on the investment selection and mapping claims and, by a two-to-one vote, reversed the decision on the float claim. The fate of the attorneys' fees will depend on what happens on remand to the district court, which has been asked to clarify the standards that it used in reviewing the fiduciaries' choice of investments.

The court's decision on the float claim has attracted a fair amount of attention. Unlike the district court, the appellate court majority took seriously the principle that basic property law determines what assets belong to a plan. On that basis, the "float" was an asset of the mutual funds, and the plans thus had no right to any of the income on that float.

Also of great interest was the court's discussion of the relationship between fiduciary duties and the deference that courts are supposed to give to discretionary decisions of plan administrators and fiduciaries under *Firestone Tire & Rubber Co. v. Bruch*, 489 US 101 (1989). The court took an expansive view of the circumstances under which judges should accept fiduciary decisions that are not "arbitrary and capricious," but it left in doubt how far the expansion goes.

The final point underscored by the 8th Circuit's decision is that revenue sharing generated by an ERISA plan cannot be allowed to subsidize the cost of services provided to other plans, much less to the employer itself, and that indifference to such a diversion of funds can lead to a finding that the ERISA plan paid excessive fees to service providers.

<u>What Income Should Float Where?</u>

The process that Fidelity, one of the ABB plans' investment providers, followed in purchasing mutual fund shares and in making distributions was not unusual. When contributions were made to the plan or when a participant elected to make an exchange between funds (selling one and buying the other), Fidelity recorded the transaction as if it had occurred on the day of the contribution or instruction. The cash generally was placed overnight in a Fidelity depository account, which invested it.

Similarly, when a participant received a distribution, mutual fund shares held in his account were redeemed, and the proceeds were transferred to a bank account maintained by Fidelity, which then remitted withholding taxes and sent the net payments to participants through either electronic transfer or check. During the period between the redemption and the receipt of payment by the distributee, the bank account invested the cash that it held.

The income earned on the float was used to pay bank charges, with the balance being distributed to the Fidelity mutual funds. Surprisingly, the district court held that this arrangement was a fiduciary violation, because income generated by plan assets was not used exclusively for the benefit of the plan. The appellate court majority disagreed with the district court, because it did not regard the float as a plan asset. The Department of Labor has stated frequently that ordinary principles of property law are applied in order to identify plan assets, and it is black letter law that, as a general proposition, the ownership of property passes at the same time as the risk and reward of future changes in its value. Under the procedure that Fidelity had set up, the plan assumed that risk and reward for mutual fund shares as soon as a contribution was made or a participant directed an investment exchange. Similarly, its risk and reward ceased as soon as shares were redeemed. By the same token, the cash held in the depository account and the redemption bank account belonged to the party that now possessed the risk and reward on the cash, namely, the mutual funds, and the income generated by that cash belonged to them, too.

In the case of distributions, Fidelity earned income while checks cleared, but that too was consistent with ordinary property law and DOL's longstanding position on float. The check was drawn on Fidelity's account, and every bank account holder can earn interest during the period when checks that he writes remain outstanding. A check is for the amount stated, not that amount plus interest.

The dissenting judge took the position that basic property law had somehow been supplanted by DOL's regulation defining the point at which elective contributions withheld from employees' paychecks become plan assets, so that retaining them in the employer's general account past that point is a prohibited transaction. Of course, that regulation does not purport to define the point at which amounts designated for investment in a mutual fund *cease* to be plan assets, which was the issue presented in *Tussey*. In short, we think the majority was entirely correct in relying on basic property law to resolve that issue. The key point is that the contributions were immediately used to purchase mutual fund shares; the plan's gain or loss on that investment was then measured from the moment of purchase, not from the later time when the cash made its way to the mutual fund. Letting it simultaneously enjoy investment return and interest on the purchase price would be a windfall.

<u>When Should Judges Defer to Fiduciaries?</u>

The largest portion of the district court's award stemmed from the investment selection and mapping claims, which challenged the defendant fiduciaries' decision to drop a balanced fund from the plan's investment options and replace it with a set of target date funds. Participants who had previously chosen the balanced fund could reinvest in different funds. If they did nothing, their previous balanced fund investments were mapped to target date funds corresponding to their anticipated retirement dates.

During the next several years, the balanced fund outperformed its replacements. The district court found that the procedure by which it was removed from the plan's menu deviated from that prescribed by the "investment policy statement" adopted by ABB's pension review committee, the body that oversaw the selection of investment options, and that this deviation was a breach of the fiduciaries' duty to act in accordance with the documents and instruments governing the plan. Moreover, according to the court, the fiduciaries' conclusions regarding the relative merits of the balanced and the target date funds were rendered imprudent by a "lack of research and analysis," and the default mapping to the target date funds was disloyal, because those funds generated greater revenue sharing than the balanced fund, and some of that revenue benefited the employer rather than the plan (for reasons discussed in the next section of this advisory).

The 8th Circuit found fault with the lower court's opinion in three respects: it had based its decision regarding the prudence of the investment largely on hindsight; its assumption that target date fund participants would have unanimously preferred the balanced fund was unrealistic; and, most interestingly, it did not appear to have given the proper degree of deference to the plan fiduciaries' discretionary determinations.

Firestone Tire & Rubber Co. v. Bruch established the principle that benefit determinations of plan administrators and fiduciaries are reviewed by the courts only for abuse of discretion, if the plan grants those parties discretionary authority to determine eligibility for benefits or to construe the plan's terms. If the plan contains the proper language, courts will overturn a denial of benefits only if it was "arbitrary and capricious." The ABB plaintiffs argued that *Firestone* extends no further than discretionary benefit determinations and that the conduct challenged in this case should be reviewed *de novo*.

The court of appeals was not willing to read *Firestone* that narrowly, though the extent of its horizon was left in shadows. What it said was:

> ERISA represents a " 'careful balancing' between ensuring fair and prompt enforcement of rights under a plan and the encouragement of the creation of such plans." *Conkright*, 559 US at 517 (quoting *Aetna Health Inc. v. Davila*, 542 US 200, 215, 124 S. Ct. 2488, 159 L. Ed. 2d 312 (2004)). Preserving that balance "by permitting an employer to grant primary interpretive authority over an ERISA plan to the plan administrator," *Firestone* deference (1) encourages employers to offer ERISA plans by controlling administrative costs and litigation expenses; (2) creates administrative efficiency; (3) "promotes predictability, as an employer can rely on the expertise of the plan administrator rather than worry about unexpected and inaccurate plan interpretations that might result from de novo judicial review;" and (4) "serves the interest of uniformity, helping to avoid a patchwork of different interpretations of a plan." *Id.*
>
> Like most circuits to address the issue, we see no compelling reason to limit *Firestone* deference to benefit claims. [footnote omitted] "'Where discretion is conferred upon the trustee with respect to the exercise of a power, its exercise is not subject to control by the court except to prevent an abuse by the trustee of his discretion.'" *Firestone*, 489 US at 111 (quoting *Restatement (Second) of Trusts* §187 (1959) (alterations omitted)). "This deferential standard reflects our general hesitancy to interfere with the administration of a benefits plan." *Layes v. Mead Corp.*, 132 F.3d 1246, 1250 (8th Cir. 1998). Given the grant of discretion in this case, the district court should have reviewed the plan administrator's determinations under the plan for abuse of discretion.

Does this mean that the district court should have reviewed all decisions of the pension review committee deferentially, overturning them only if they were "arbitrary and capricious"? The most recent of the cases cited by the court, *Tibble v. Edison International*, 729 F.3d 1110, 1130 (9th Cir. 2013), certainly seemed to say so at one time, *but* the judges later amended their opinion to emphasize that the particular challenge in question asserted *only* a violation of section 404(a)(1)(D) of ERISA, failure to act in accordance with the instruments and documents governing the plan. On the question of what those documents commanded, the plan fiduciaries were entitled to deference, but perhaps not on other fiduciary issues. 2013 US App. LEXIS 16051 (9th Cir., Aug. 1, 2013).

In *Tussey*, the plaintiffs alleged violations of three distinct fiduciary duties: the decision to drop the balanced fund in favor of the target date funds was made in violation of a governing document; the fund selection and removal process was imprudent; and the replacement of the balanced fund with the target date fund and default mapping of balanced fund investments to the target date funds was designed to benefit ABB through increased revenue sharing and was therefore disloyal. There is little doubt that the 8th Circuit has directed the district court, on remand, to grant *Firestone* deference on the first issue (the one that appears to have weighed most heavily in that Court's original decision). The role of deference in evaluating the other two claims is murkier.

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The appellate decision sidestepped one important argument raised by the defendants: that the investment policy statement ("IPS") was not a governing plan document but, rather, no more than an internal committee guideline, to which the committee had no ERISA duty to adhere. The Department of Labor had taken the contrary position in its amicus curiae brief, arguing that the committee had "formally adopted the IPS as a plan document under the authority the Plans conferred on it 'to control and manage the investment of the assets of the Plan.'" In a footnote, the 8th Circuit rightfully expressed concern that "construing all investor policy statements as binding plan documents will discourage their use" and questioned "whether a policy statement like the one in this case—informally implemented to provide a framework for administering the Plan itself—constitutes a binding Plan document." But the 8th Circuit went on to say that there was no need to resolve that issue because the district court "found breaches of the duties of loyalty and prudence independent of the IPS" in evaluating the defendants' decisions "with respect to recordkeeping and selecting investment options."

Read in isolation, the footnote explanation of why the 8th Circuit found it unnecessary to resolve the "plan document" issue makes it difficult to understand why the court would devote an entire section of its opinion to a discussion of the proper scope of *Firestone* deference. Indeed, in affirming the district court's judgment on the recordkeeping claim (discussed in the next section of this advisory), the 8th Circuit stated explicitly that "[a]ny failure by the district court to afford discretion to the Plan administrator's interpretation of the Plan with respect to recordkeeping and revenue sharing was harmless under the circumstances." So why address the scope of *Firestone* deference in the first place? The answer, in the 8th Circuit's view, seems to be that the judgment *on the investment selection and mapping claims* relied so "heavily" on the district court's own "interpretation of the Plan and the provisions of the IPS" that the failure to defer to the plan administrator's interpretation could have been outcome determinative on those claims. And the 8th Circuit apparently preferred to remand the investment selection and mapping claims on that hazy ground rather than confront the "plan document" issue head on.

The 8th Circuit also directed the district court on remand to reevaluate its method of calculating any damage award for the investment selection and mapping claims. The district court had calculated damages by assuming that participants who invested in the target date funds would have put their money into the balanced fund if they had still had that opportunity. The 8th Circuit not only found that assumption speculative, but also criticized the district court for ignoring both the rising popularity of target date funds and the IPS's requirement that target date funds be added to the plans' investment platform. The 8th Circuit suggested that a more accurate measure of damages, if any, would be to compare "the difference between the performance of the [chosen target date funds] and the minimum return of the subset of [target date] funds the ABB fiduciaries could have chosen without breaching their fiduciary obligations."

The damage measure articulated by the 8th Circuit in *Tussey* is more circumscribed than the often-cited measure articulated in *Donovan v. Bierwirth*, 754 F.2d 1049, 1056 (2d Cir. 1985), which says that "where several alternative investments strategies were equally plausible, the court should presume that the funds would have been used in the most profitable of these." The *Bierwirth* measure has been criticized for failing to account for the uncertainty of investments and yielding a windfall to the extent it is construed to mean that "at the time of suit the court should look back and decide which of those investment strategies has proved most profitable." *Leister v. Dovetail, Inc.*, 546 F.3d 875, 881 (7th Cir. 2008) (Posner, J.). The

Tussey measure minimizes the likelihood of any such windfall by focusing on the minimum return of the alternative investments the fiduciary could have selected without breaching its duties.

What Does Loyalty Demand?

Fidelity became the ABB plans' recordkeeper in 1995. At first, it charged a flat per-participant fee for its services, but it gradually moved toward receiving most of its compensation from revenue sharing, *i.e.*, the payment of a percentage of the plan's investment income (the percentage varying among different investment options) to the recordkeeper. Over the years, Fidelity also expanded its relationship with ABB to include services to other retirement and welfare plans and to the company itself.

The court found no fault with revenue sharing *per se*, but held that there was "ample support in the record" for the district court's conclusion that, in their handling of it, the plan fiduciaries breached their duties under ERISA. The court rejected the fiduciaries' defense that participants were not harmed by the availability of investment options that paid "excessive" revenue sharing, because they also were offered a wide range of low-priced funds. That argument has prevailed in other cases. *See, e.g.*, *Renfro v. Unisys,* 671 F.3d 314, 326-27 (3d Cir. 2011); *Loomis v. Exelon Corp.*, 658 F.3d 667, 671 (7th Cir., 2011); *Hecker v. Deere & Co.*, 556 F.3d 575, 586 (7th Cir. 2009), *reh'g denied*, 569 F.3d 708. It failed here, however, because "[t]he facts of this case … involve significant allegations of wrongdoing, including allegations that ABB used revenue sharing to benefit ABB and Fidelity at the Plan's expense." The clear moral is that, in a case alleging excessive fees, evidence that ERISA plans paid *sub rosa* for services rendered to other plans or to the employer can undermine any attempt to defend the reasonableness of the fees.