

Federal Appeals Court Rules That Severance Pay Is Not ‘Wages’ Subject to FICA Taxes

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The most significant pro-taxpayer payroll tax decision in the past 10 years was issued by the Federal Court of Appeals for the Sixth Circuit on September 7, 2012. The decision may have a favorable financial impact on millions of unemployed workers and on thousands of businesses that have had to downsize their workforces due to financial hardships in recent years. As described below, the APA, with the assistance of its tax counsel, has been deeply involved in this issue generally and with this case specifically.

A landmark decision

Summary. In *United States v. Quality Stores, Inc.*, No. 10-1563 (September 7, 2012), the Sixth Circuit examined whether severance payments constitute taxable “wages” for social security and Medicare (FICA) tax purposes. At issue was whether the downsizing payments were paid as supplemental unemployment compensation benefits (SUB-Pay) and, therefore, were exempt from FICA taxes.

SUB-Pay is defined in two different ways: (i) a statutory definition found in the Internal Revenue Code’s federal income tax withholding (FITW) provisions, and (ii) an IRS administrative definition derived from a series of revenue rulings.

The statutory test adopted by the Sixth Circuit is straightforward, easily understood, and readily applied. By contrast, the IRS administrative definition imposes a complex, multi-factor test that has fluctuated so much over the years that even the Federal Circuit in a 2008 decision misidentified the precise eight-factor test that the IRS

applies to downsizing payments. See *CSX Corp. v. U.S.*, 518 F.3d 1328 (adopting an IRS administrative definition and holding that the severance payments at issue were subject to FICA and RRTA (railroad retirement) taxes.

The Sixth Circuit categorically rejected these shifting IRS SUB-Pay revenue rulings as inconsistent with congressional intent. Instead, the Sixth Circuit adopted the statutory definition and upheld the taxpayer's \$1 million refund claim.

Facts. Quality Stores operated a chain of stores specializing in agricultural supplies and related products. Due to financial hardship, Quality Stores closed its stores and distribution centers, and terminated all of its employees. Quality Stores made downsizing payments to terminated employees pursuant to severance plans that were similar to those maintained by many employers. Executives, salaried employees, and hourly employees received either periodic or lump-sum payments equal to a period of months or weeks based on the employee's position and/or years of service. The payments were not connected to the receipt of state unemployment compensation nor were they attributable to the performance of any particular employment services.

Quality Stores reported the severance payments as wages on Forms W-2 and withheld and paid both the employees' and the employer's share of FICA taxes on the payments. In 2002, Quality Stores filed refund claims with the IRS, seeking to recover \$1 million in overpaid FICA taxes based on the statutory definition of SUB-Pay. Both the bankruptcy court and the district court held that the statutory definition applied and that the FICA taxes should be refunded.

Appeals court's reasoning

In reviewing the lower courts' decisions granting the refund, the Sixth Circuit

acknowledged that whether SUB-Pay constitutes taxable FICA “wages” is “a complex question” because the Code does not expressly include or exclude SUB-Pay, nor has the IRS issued FICA regulations that directly address the subject. Therefore, the Sixth Circuit examined how Congress has defined SUB-Pay for purposes of the parallel FITW provisions.

IRC §3402(o) says that for FITW purposes, SUB-Pay “shall be treated as if it were a payment of wages.” It also defines SUB-Pay 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.”

Although the Sixth Circuit recognized ambiguity in the statutory structure, it looked to the legislative history to confirm its interpretation that the statutory definition controls, not the IRS administrative approach. The Sixth Circuit concluded that both the title to the legislation and the legislative history clarify any ambiguity regarding Congress’ characterization of SUB-Pay as non-wages for FITW.

The court approved the lower court’s reasoning that if SUB-Pay is not wages for FITW purposes (but is only deemed to be wages for FITW purposes), then SUB-Pay is also not wages for FICA purposes on the basis that the FICA and FITW provisions should be interpreted similarly except as otherwise provided in IRS regulations. In that regard, the Sixth Circuit noted that the IRS has failed to issue FICA regulations addressing the definition of SUB-Pay; therefore, the FITW definition of SUB-Pay also

applies for FICA purposes.

Furthermore, the Sixth Circuit refused to give deference to the IRS administrative definition of SUB-Pay although the court recognized that in appropriate circumstances the courts will give deference to “longstanding and reasonable interpretations” of IRS rulings. The Sixth Circuit concluded that the IRS SUB-Pay rulings have failed to take congressional intent fully into account.

Although *Quality Stores* involves “only” a \$1 million refund, its significance stems from the millions of employees who received downsizing payments upon which the IRS imposed both employer and employee FICA taxes. As a result of the Sixth Circuit’s decision, significant potential refunds may be available to thousands of companies that were forced to downsize their business operations and, of course, the millions of terminated workers—many of whom remain either unemployed or underemployed.

While most advisors assume that the Department of Justice and the IRS will seek review by the Supreme Court, the government is sending mixed signals regarding whether it will or will not seek such a review. Regardless of such a Supreme Court review, employers should consider what next steps to take to preserve their rights and those of their former employees.

Comments from APA’s Tax Counsel on pursuing FICA tax claims: Next steps

Tax counsel from Morgan, Lewis & Bockius in Washington, D.C., represented the American Payroll Association (APA) as amicus curiae or “friend of the court” in its brief and in oral argument in the appeal of the *Quality Stores* matter before the Sixth Circuit. APA’s representatives from Morgan Lewis included Mary B. Hevener, the APA’s longtime tax counsel, and David R. Fuller, the IRS’s former subject matter expert on

SUB-Pay issues. APA tax counsel also provided assistance to the taxpayer and its representatives in the appeal of *Quality Stores* to the Sixth Circuit.

After the decision in *Quality Stores*, payroll professionals are faced with the same two basic questions they had to answer after the initial CSX decision. First, can payroll professionals simply stop collecting and paying FICA taxes on severance pay? And second, should companies preserve their rights to credits or refunds of FICA taxes paid to the IRS for past and future years?

On the first issue, the IRS has advised that pending action on this case, the IRS Service Centers will continue to challenge these refund claims—notwithstanding that five of the six courts that have considered this issue have applied the statutory definition of SUB-Pay. APA's counsel cautions payroll professionals to continue collecting and paying FICA taxes on severance pay pending ultimate resolution of this FICA tax issue. Otherwise, if the *Quality Stores* decision is reversed by the Supreme Court, the employer would owe the IRS both the employer and employee portions of FICA taxes.

On the second issue of how companies should preserve their rights for past and future years, Mary Hevener and David Fuller stress that *Quality Stores* provides important support for filing refund claims. Prior to the issuance of this strong pro-taxpayer decision, some employers may have questioned the utility of filing refund claims since conflicting advice has been circulating among tax advisors in recent years.

APA's tax counsel have long advised employers that strong legal arguments (now supplemented by *Quality Stores*) exist to support the refund of FICA taxes remitted on downsizing payments. Although employers should continue to remit these FICA taxes, payroll professionals can and should continue to file refund claims for the

FICA taxes they withhold and pay on severance pay. While the IRS's next steps will undoubtedly impact how each employer should specifically respond to its own unique refund opportunities and the different choices available to it, there are immediate proactive steps that all employers should consider in the interim to address these refund opportunities for past and future years.

Filing refund claims for past years. Employers that have paid downsizing payments but have not previously filed refund claims, should begin to file these FICA tax refund claims as soon as administratively practical for all open payroll tax periods (calendar years after 2008). Whether these should be filed as "protective" refund claims or more traditional refund claims is an issue that each affected employer should discuss with its tax advisors. While the differences between these types of refund claims are somewhat nuanced, these claims should now generally be filed as traditional refund claims, not as protective claims. In addition, employers should appeal any denials of these refund claims.

Perfecting existing refund claims for past years. If an employer previously filed protective refund claims, it should now consider "perfecting" those claims. This process consists primarily of data collection to substantiate both the amount and the type of the SUB-Pay claims. Most employers anticipate that their downsizing arrangements will satisfy the statutory definition of SUB-Pay, but some employers undertaking the substantiation process are surprised to learn that their existing severance plans also satisfy the far more rigorous IRS administrative definition of SUB-Pay and that their refund claims would not be challenged by the IRS. In perfecting refund claims in one such situation, a refund of more than \$5 million was identified that

the IRS conceded satisfied its administrative definition even though the taxpayer initially believed the plan failed the IRS administrative definition.

Filing refund suits for past years. Obviously, the Sixth Circuit's decision in *Quality Stores* may be the catalyst for thousands of employers that have not yet filed refund claims (or that stopped filing refund claims) to file claims for past, current, and future years. A far smaller number of employers with pending or disallowed claims should consider whether and when to commence FICA refund suits. In a limited number of situations, it may be advisable to file FICA refund suits on such downsizing payments. Several taxpayers filed FICA refund suits in anticipation of the favorable *Quality Stores'* decision.

Future years. At least four significant options exist to reduce FICA tax obligations for future years if an employer is considering a significant workforce restructuring. Three of these involve the following SUB-Pay options: (i) file refund claims based on the statutory SUB-Pay definition, (ii) modify existing severance arrangements to fully qualify with the IRS's administrative definition, or (iii) modify existing severance arrangements to conform with the underlying purpose of the IRS administrative definition—even if all eight of the specific IRS revenue ruling requirements cannot be independently satisfied. As indicated previously, many employers are surprised that with relatively minor modifications to their existing severance arrangements, the IRS is far more likely to concede that downsizing arrangements satisfy the FICA exemption requirements.

Conclusion

Five of the six courts that have looked at the SUB-Pay FICA tax exemption for

downsizing payments have adopted the statutory definition of SUB-Pay. Those decisions are well reasoned and consistent with the approach that the IRS actually maintained for almost two decades prior to changing to its current ruling and audit positions. In these harsh economic times, both employers and their terminated employees may benefit from *Quality Stores'* well-reasoned approach regarding the correct definition to apply for purposes of the FICA tax exemption for SUB-Pay. A proper understanding of the *Quality Stores'* victory and its impact on the applicability of the statutory definition of SUB-Pay versus the IRS's far narrower administrative definition may result in substantial FICA tax refunds. Businesses that have had to restructure can certainly benefit from the additional revenue boost and, of course, the downsized workers will also benefit. One taxpayer has received a refund in excess of \$50 million on this issue for itself and its former employees.