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Sixth Circuit Will Not Rehear Quality Stores Decision that Severance Pay in Connection with a Reduction in Force is not Subject to FICA; Supreme Court Next Step?

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On September 7, 2012, the Sixth Circuit Court of Appeals held in *United States v. Quality Stores, Inc.* that severance payments to former employees pursuant to an involuntary reduction in force are not taxable "wages" for purposes of Social Security and Medicare withholding under the Federal Insurance Contributions Act, or FICA. The decision is significant in two respects. First, the Sixth Circuit chose not to follow a contrary decision reached by the Federal Circuit Court of Appeals in *CSX Corp. v. United States*, 518 F.3d 1328 (2008), thereby creating a split in the federal circuits that may ultimately be resolved by the Supreme Court. Second, the Sixth Circuit's pro-taxpayer decision substantially impacts unemployed workers and businesses that have reduced their workforce in recent years. On January 4, 2013, the Sixth Circuit denied the government's petition for rehearing *en banc*. The government has until April 4, 2013 to petition the Supreme Court to address the case.

Many employers that paid FICA taxes on involuntary severance payments in calendar year 2009 or thereafter are considering filing a protective refund claim to preserve their right to a refund pending further guidance and resolution of this issue. This Client Alert summarizes some of the key issues to consider.

Mechanics of FICA Tax Payment

FICA tax consists of both Social Security and Medicare taxes. The employer pays the employer portion to the government, withholds the equal employee portion from each employee's wages, and pays the employee portion to the government as well. Note that taxes on self-employment income are different. Self-employment income cannot be classified as wages because an employer-employee relationship does not exist between the payer and payee. In lieu of FICA tax, the Internal Revenue Code (the "Code") imposes a self-employment tax on self-employment income.

Summary of the Decision

In *United States v. Quality Stores, Inc.* the Sixth Circuit considered whether supplemental unemployment compensation benefits ("SUB payments") paid to employees pursuant to an involuntary reduction in force were taxable as "wages" under FICA. SUB payments are treated as wages for income tax withholding purposes. However, it is not clear that SUB payments are included in the FICA definition of "wages."

Quality Stores, Inc. ("Quality Stores") made periodic and lump-sum payments to employees involuntarily terminated in connection with the closing of hundreds of company facilities in 2001. Because the payments constituted income for federal income tax purposes, Quality Stores reported the pay on each employee's W-2 and withheld federal income tax. It also paid the employer's share of FICA tax and withheld each employee's share of FICA tax. The company subsequently sought a refund of the FICA amounts, believing that the payments made to its employees were not wages but instead constituted SUB payments that were not taxable under FICA. The Internal Revenue Service (IRS) took a contrary position, seeking to have the payments classified as "wages" for purposes of FICA withholding.

Congress defined "wages" for FICA purposes as "all remuneration *for employment*, including the cash value of all remuneration (including benefits) paid in any medium other than cash . . . ." Code Section 3121(a) (emphasis provided). Although the statute does not expressly include or exclude SUB payments from the definition of "wages," the Sixth Circuit explained that "SUB pay falls outside the broad statutory meaning of service performed by an employee for an employer because, by definition, an employee is not eligible for SUB pay until service to the employer has ended and such benefits provide compensation for the lost job."

Congress expressly defined SUB payments for purposes of *federal income tax* withholding in Code Section 3402(o), entitled: "Extension of Withholding to Certain Payments *Other Than Wages*." (emphasis provided). Section 3402(o) defines SUB payments 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."

Relying on the Supreme Court's conclusion in *Rowan Cos. v. United States*, 452 U.S. 247 (1981) that Congress intended the term "wages" to carry the same meaning for purposes of FICA and federal income tax withholding, the court held that the payments made by Quality Stores to its former employees satisfied the definition provided in Section 3402(o) and the payments were therefore excludible from the definition of "wages" for FICA purposes.

The IRS urged the opposite conclusion, arguing that intervening legislation in the form of the "decoupling amendment" made *Rowan* no longer good law. As part of the Social Security Amendments of 1983, the decoupling amendment authorizes the Treasury Department to promulgate regulations to provide for different exclusions from "wages" under FICA than under the income tax withholding provisions. The court held that *Rowan* was still good law, noting that the decoupling amendment merely granted Congress the authority to promulgate these regulations but the Treasury Department has not yet done so.

The government also cited IRS revenue rulings and private letter rulings concluding that the "definition of SUB pay under section 3402(o) is not applicable for FICA . . . . [and] SUB pay is defined solely through a series of administrative pronouncements published by the Service." Rev. Rul. 90-72, 1990-2 C.B. 211. Under IRS guidance, to be exempt from "wages" under FICA, SUB payments must be made to involuntarily separated employees pursuant to a plan that is designed to supplement the receipt of state unemployment compensation and do not include payments made in a lump sum because such payments are not considered linked to state unemployment compensation. The Sixth Circuit disagreed that this IRS guidance should control the outcome in the case and noted that IRS revenue rulings and private letter rulings do not hold the same significance as Congressional intent.

The court's conclusion departs from an important decision by the Federal Circuit in *CSX Corp.* In *CSX Corp.*, the Federal Circuit affirmed the Supreme Court's decision in *Rowan*, but did so with respect to federal income tax withholding only and did not conclude that the same statutory definition of "wages" applied for purposes of FICA tax withholding. Accordingly, the Federal Circuit held that the SUB payments in *CSX Corp.* were wages subject to FICA. The Sixth Circuit in *Quality Stores* labeled this an "inconsistency" and chose to extend the reasoning in *Rowan* to amounts withheld under FICA.

It is unknown whether the IRS will seek certiorari to the Supreme Court. Given the significance of the opinion, the split in the circuits, and the billion dollars claimed by the IRS to be at stake, the Supreme Court might decide to take this case if it is presented.

Impact on Employers

The *Quality Stores* decision represents an opportunity for employers in the Sixth Circuit (Tennessee, Michigan, Ohio and Kentucky) and potentially in other Circuits to obtain a refund for FICA taxes paid and withheld on SUB payments.

Generally, if an employer believes that FICA taxes were overpaid, the employer can file a refund claim. The refund claim is made on the employer's behalf for the employer portion and on each employee's behalf for the employee portion. Before a refund claim can be paid, the employer is required to attempt to contact each affected employee and ask for the employee's consent to pursue the refund claim on his or her behalf. When the refund claim is paid, the employer will receive the entire employer portion. The employer will also receive the employee portion for consenting employees and must distribute these funds to them.

Employers that have made SUB payments in connection with a reduction in force or a discontinuance of operations should consider filing a protectiverefund claim. A taxpayer may file a protective claim in situations where the statute of limitations for the refund claim may expire before the resolution of a future event. A protective claim would preserve the statute of limitations on employment tax refund claims for open years and would require later filing of a supplementary claim with necessary employee consents and exact calculations. The deadline for filing a protective claim is three years from April 15 of the calendar year following the year in which the payments were made. For example, for FICA taxes paid in 2009, a protective claim should be filed by April 15, 2013.

Additionally, employers whose claims were denied in the wake of the *CSX Corp.* decision should consider filing a Form 907 agreement to extend the time to bring suit with the IRS.

It is unclear at this time how the IRS will respond to refund claims. New claims filed as a result of the *Quality Stores* decision may be rejected by the IRS due to the split in the circuits or may be held without action. Until this controversy is resolved, it is prudent for employers to continue withholding FICA taxes on SUB payments made in connection with the present or future involuntary termination of employees that do not meet the strict definition provided in IRS Revenue Ruling 90-72 for exemption.

If you have any questions regarding the *Quality Stores* decision, filing a protective claim, or this client alert, please feel free to contact any of the lawyers listed in this alert.

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