Certain Severance Benefits Are Not Subject to FICA Payroll Taxation: Sixth Circuit Denies Petition for *En Banc* Rehearing of Its Holding in *Quality Stores*

January 15, 2013

On January 4, 2013, the Sixth Circuit denied the U.S. government's petition for *en banc* review of its September 2012 decision in ***United States v. Quality Stores*** that certain severance payments qualified as supplemental unemployment compensation benefits ("SUB payments") and therefore did not constitute "wages" for purposes of Social Security and Medicare taxation under the Federal Insurance Contribution Act (FICA).[1] This case may have a significant impact on companies and individual taxpayers alike, given the number of businesses that have downsized their workforces in recent years.

Note that the Sixth Circuit's decision appears limited to severance payments in the context of a reduction in force, plant/operation closure or similar circumstance and may not be applicable to performance-based or other one-off terminations of employment that do not meet those facts. It is also unclear whether the Sixth Circuit would have reached the conclusion that it did if the payment of the severance was subject to an employee's post-termination obligations, such as compliance with restrictive covenants.

Many observers are predicting that the government will ask the U.S. Supreme Court to review the Sixth Circuit's decision. If so, it is possible, and perhaps even likely, that the Supreme Court will accept the case, as there is now a circuit split on the issue. In its 2008 decision in ***CSX Corp. v. United States***, the Federal Circuit[2] held that certain severance payments that were treated by statute as SUB payments constituted "wages" for FICA purposes.

Background

Quality Stores, Inc., which was the subject of an involuntary Chapter 11 bankruptcy petition in 2001, made severance payments to its terminated employees. The severance payments, which were made to employees ranging from senior management to rank-and-file employees, were made as a result of either a reduction in force or the discontinuance of a plant or operation. The payments were made under two plans, a pre-petition severance plan and a post-petition severance plan. They were not tied to the receipt

[1] FICA is comprised of Social Security and Medicare. The employee tax rate for Social Security is 6.2% (prior to January 1, 2013, the employee tax rate for Social Security was 4.2%). The employer tax rate for Social Security remains unchanged at 6.2%. The Social Security wage base limit is currently $113,700. The Medicare tax rate is 1.45% each for the employee and employer, which is unchanged from 2012. There is no wage base limit for Medicare tax. In addition to withholding Medicare tax at 1.45%, an employer must withhold a 0.9% additional Medicare tax from wages paid to an employee in excess of $200,000 in a calendar year. Additional Medicare tax is only imposed on the employee; there is no employer share of additional Medicare tax. All wages that are subject to Medicare tax are subject to additional Medicare tax withholding if paid in excess of the $200,000 withholding threshold.

[2] The Federal Circuit is an appellate court with jurisdiction over certain appeals from the federal district courts, appeals from certain administrative agencies and appeals under certain statutes. The Federal Circuit has exclusive jurisdiction over certain appeals, including from the Court of Federal Claims, which hears monetary cases against the U.S. government.

of state unemployment compensation, nor were they attributable to the provision of any particular services by the employees.

Because the severance payments constituted gross income to the employees for federal income tax purposes, Quality Stores reported them as wages on W-2 forms and withheld federal income tax. Although it did not agree with the position of the Internal Revenue Service (IRS) that the payments constituted wages for FICA purposes, it collected and paid the FICA tax. Quality Stores then asked 3,100 former employees to allow it to file FICA tax refund claims on their behalf, and 1,850 former employees consented. In 2002, Quality Stores timely sought a refund of $1,000,125, consisting of $571,127 for the employer share and $428,998 for the employee share of the FICA tax. When the IRS did not allow or deny the refund claims, Quality Stores filed an adversary action in bankruptcy court.

Sixth Circuit's Analysis

The Sixth Circuit noted that Congress generally 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" and "employment" as used in the statute as "any service, of whatever nature, performed . . . by an employee for the person employing him."

While the Sixth Circuit quoted the Supreme Court's explanation in ***Coffy v. Republic Steel*** that "'service' as used by Congress in this definitive phrase means not only work actually done but the entire employer-employee relationship for which compensation is paid to the employee by the employer," it also focused on the Supreme Court's "particular instruction 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."

The Sixth Circuit acknowledged that whether SUB payments are "wages" for FICA purposes is a complex question, because the statute does not expressly include or exclude SUB payments, and the applicable Treasury regulations do not address the subject. However, the Sixth Circuit looked to the definition and treatment of SUB payments in the federal income withholding tax statute (Section 3402(o)(2)(A) of the Internal Revenue Code) and concluded that SUB payments were not "wages" for federal income tax withholding purposes, and therefore should not be treated as "wages" for FICA purposes. The Sixth Circuit went on to explain that a SUB payment is:

1. an amount paid to an employee;
2. pursuant to an employer's plan;
3. because of an employee's involuntary separation from employment, whether temporary or permanent;
4. resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions; and
5. included in the employee's gross income.

The Sixth Circuit then concluded that all of Quality Stores' severance payments satisfied this five-part statutory test to qualify as SUB payments. In doing so, the Sixth Circuit disagreed with an eight-part definition[3] of SUB payments that the IRS had developed in a 1956 Revenue Ruling, as well as a 1990

[3] The IRS's eight-part definition of a SUB payment requires the following: (1) the benefits were paid only to unemployed former employees who were laid off by the employer; (2) eligibility for benefits depended on meeting prescribed conditions after employment terminated; (3) benefits were paid by trustees of independent trusts; (4) the amount of weekly benefits payable was based on state unemployment benefits, other compensation allowed under state unemployment laws and the amount of straight-time weekly pay after withholding all taxes and contributions; (5) the duration of the benefits was affected by the fund level and the employee's seniority; (6) the right to benefits did not accrue until a prescribed time after termination of employment; (7) the benefits

Revenue Ruling in which the IRS reasoned that, in order to be exempt from FICA taxation, SUB payments must be made to involuntarily separated employees pursuant to a plan that is designed to supplement the receipt of state unemployment compensation. (In *CSX*, the Federal Circuit adopted and applied the IRS's eight-part definition.) The Sixth Circuit stated, "We decline to imbue the IRS revenue rulings and private letter rulings with greater significance than the congressional intent expressed in the applicable statutes and legislative histories . . . . In appropriate circumstances we may give substantial judicial deference to longstanding and reasonable interpretations of IRS regulations and revenue rulings . . . , but in this case we conclude . . . that the IRS has not taken congressional intent fully into account."

The Sixth Circuit did agree with the Federal Circuit in *CSX* in one respect: "We acknowledge that this issue of statutory construction is complex and that the correct resolution of the issue is far from obvious." The Sixth Court also foreshadowed the possibility that the Supreme Court might provide a "correct resolution of these difficult issues under the law as it currently stands."

Implications

While it is possible that the government will seek the Supreme Court's review, in the meantime, the *Quality Stores* decision is binding authority in the states of Kentucky, Michigan, Ohio and Tennessee and may serve as potentially persuasive authority elsewhere for employers and employees seeking FICA tax refunds for amounts previously paid in connection with severance payments that qualify as SUB payments. Employers generally have three years from April 15 after the relevant tax year to file FICA tax refund claims (*e.g.*, by April 15, 2013 for 2009). In addition, employers may wish to review their severance plans to evaluate whether or not payments under those plans would comply with the statutory five-part definition of SUB payments.

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were not attributable to the rendering of any particular services; and (8) no employee had any right, title or interest in the fund until such employee was qualified and eligible to receive benefits.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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