

## Sixth Circuit Rules That Payments Made as Part of a Severance Program Are Not Subject to FICA Withholding

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In a case of considerable importance, the U.S. Court of Appeals for the Sixth Circuit (“Court”) recently held that severance payments made to employees under an employer’s severance plan as a direct result of a reduction in workforce and discontinuance of a plant or operation are not “wages” subject to withholding under the Federal Insurance Contributions Act (“FICA”). [\*United States v. Quality Stores, Inc. \(In re Quality Stores, Inc.\)\*, No. 10-1563 \(6th Cir. Sept. 7, 2012\)](#). In so deciding, the Court rejected longstanding Internal Revenue Service (“IRS”) rulings on the treatment of supplemental unemployment benefits (“SUB payments”) under FICA, as well as a contrary decision by the U.S. Court of Appeals for the Federal Circuit in *CSX Corp. v. United States*, 518 F. 1328 (Fed. Cir. 2008). Unless the Court’s decision is overturned on rehearing or U.S. Treasury regulations are promulgated changing the result, the issue is likely to be resolved by the Supreme Court of the United States.

### FICA Taxes on SUB Payments

Employers in general are required to pay and withhold FICA taxes on “wages,” consisting of the following: (1) Social Security, 6.2 percent of which is employer paid and 6.2 percent is employee paid (4.2 percent is employee paid for 2011 and 2012) up to the taxable wage base (\$110,100 for 2012); and (2) Medicare, 1.45 percent of which is employer paid and 1.45 percent is employee paid (for 2012). An employer generally pays its portion and withholds the employee’s portion from the employee’s wages. Historically, SUB payments were instituted under union plans negotiated to ensure annual wage rates following termination of employment by supplementing state unemployment benefits. SUB payments constitute gross income and, therefore, are subject to income tax withholding. There is longstanding IRS guidance stating that SUB payments also are subject to FICA withholding unless the payments meet certain guidelines, including the requirement that the payments are designed to supplement state unemployment benefits. In *Quality Stores, Inc.*, the IRS asserted that the severance payments do not meet those guidelines and, therefore, are subject to both FICA and income tax withholding.

### Facts of the Case

Quality Stores, Inc. (“Company”) was the largest agricultural-specialty retailer in the country. In October 2001, an involuntary Chapter 11 bankruptcy proceeding was filed against the Company. The Company closed each of its 374 stores and 12 distribution

centers. Pursuant to pre-petition and post-petition severance plans, the Company made severance payments to dismissed employees and employees who were retained for a period of time after the Chapter 11 bankruptcy filing. The severance payments were calculated based either on job grade and management level or the employee's compensation for a predetermined period. Pre-petition severance payments were made on the normal payroll schedule, whereas post-petition severance payments were made in a lump sum.

The parties stipulated that (1) the payments were made by the Company to employees whose employment was terminated, (2) the terminations resulted directly from a reduction in workforce or the discontinuance of a plant or operation, and (3) the payments were made pursuant to severance plans maintained by the Company.

Though the Company disagreed with the treatment of the payments as wages subject to FICA withholding, the Company reported the payments on Form W-2 as wages and paid its share of the FICA tax, which amounted to \$571,127, and withheld the employee's share of FICA tax. The Company filed for a refund of its FICA tax payments, as well as a refund of FICA payments in the amount of \$428,998 made on behalf of employees who granted the Company authority to file a refund claim on their behalf.

### **Decision and Rationale of the Court**

The Court held in favor of the Company, notwithstanding the vigorous objection of the government. Fundamentally, the Court relied on the plain meaning of Sections 3402(o) and 3402(o)(1) of the Internal Revenue Code ("Code"), as supported by extensive legislative history. After concluding that the severance payments are SUB payments under Section 3402(o), the Court ruled that Section 3402(o)(1), which provides that a SUB payment should be treated "*as if it were a payment of wages*" (emphasis added), does not make SUB payments "wages" for FICA or income tax purposes. The purpose of Section 3402(o)(1), said the Court, was to facilitate federal income tax withholding on SUB payments, not to subject SUB payments to FICA withholding.

The Court emphasized that the SUB payments were not calculated based on services performed but rather were in the nature of unemployment compensation designed to provide employees with some degree of security if their employment was terminated involuntarily. Indeed, said the Court, the SUB payments cannot be additional compensation for past services, since the payments are made only if the employee loses his or her job. Further, the Court pointed out that the Code does not require, as does the IRS, that to be exempt from FICA the SUB payments must be made periodically and be tied to the employee's receipt of state unemployment compensation benefits.

In reaching its holding, the Court determined that Congress had allowed the Treasury to promulgate regulations that would "decouple" the definition of "wages" for income tax and FICA purposes so that, for example, wages exempt from income tax withholding might not be exempt under FICA. To date, the Treasury has not promulgated such regulations. Accordingly, the Court concluded that, notwithstanding that SUB payments are gross income under general income tax principles and therefore are subject to

income tax withholding, SUB payments are not "wages" for FICA or income tax purposes.

## What Employers Should Do Now

It is unclear whether the Court's decision in *Quality Stores, Inc.* will be upheld. If it is, its principal effect will likely be on FICA taxes for employees other than highly paid employees who reach the annual FICA cap. The holding does not provide a blanket exception from the treatment of severance payments as "wages." Rather, the analysis makes clear that the exception is limited to circumstances where there is a reduction in force, discontinuance of a plant or operation, or similar conditions.

Accordingly, employers should consider doing the following:

- Given that the IRS continues to take the position that severance payments in the circumstances described above are subject to FICA taxes, for the time being employers may want to continue their practice of treating severance payments as "wages" subject to FICA withholding.
- Employers should review payments made under their existing severance plans to see if severance has been paid upon a reduction in force, discontinuance of a plant or operation, or similar conditions that may qualify as SUB payments under the guidelines set forth in *Quality Stores, Inc.*
- Employers that paid FICA taxes on severance payments that may qualify as SUB payments should consider filing a claim, or at least a protective claim, for a refund of the FICA taxes paid. Though a claim would cover only the employer's FICA taxes, as in *Quality Stores, Inc.*, the employer could obtain consent from employees to file a claim for refund on their behalf. If this approach is taken, please note that the statute of limitations for filing a refund claim is three years from the time of filing.

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