THE SIXTH CIRCUIT RULED THAT SEVERANCE PAYMENTS ARE NOT SUBJECT TO FICA TAXES

Pirrone, Maria M.
St. John's University

ABSTRACT
In United States v. Quality Stores, Inc., 693 F.3d 605 (6th Cir. 2012), the U.S. Court of Appeals for the Sixth Circuit Court of Appeals recently held that certain dismissal payments were Supplemental Unemployment Compensation Benefits (SUB) exempt from FICA taxes. In so doing, the Sixth Circuit expressly noted that it did not agree with the U.S. Court of Appeals for the Federal Circuit's decision in CSX Corporation v. United States , 518 F.3d 1328 (Fed. Cir. 2008) causing a split in the circuits. For employers that have made significant reductions of severance payments in recent years, the Quality Stores decision could lead to substantial refunds of FICA tax. It will be interesting to see if the IRS will petition the United States Supreme Court for certiorari given that several billion dollars' worth of FICA taxes could be at issue as a result of this decision.

INTRODUCTION

In the current economic climate, bankruptcies and employment loss are an unfortunate fact of life. Employees often receive severance payments from their employers. It is generally recognized that these payments constitute taxable income. However, the issue of withholding of Federal Insurance Contributions Act (FICA) taxes from these payments has caused much litigation over the past few years. A recent decision in the Sixth Circuit Court of Appeals has caused a split in the circuits on this issue. In *United States v. Quality Stores, Inc.*, 693 F.3d 605 (6th Cir. 2012), the U.S. Court of Appeals for the Sixth Circuit Court of Appeals held that certain dismissal payments were Supplemental Unemployment Compensation Benefits (SUB) exempt from FICA taxes. Given the economic downturn, several billion dollars' worth of FICA taxes could be at issue as a result of this decision. Due to the recent denial of the Government's petition for an en banc rehearing in *Quality Stores*, the IRS has the deadline of April 4, 2013 in order to petition the United States Supreme Court for certiorari. Although it is likely that the IRS will issue a nonacquiesence to Quality Stores and petition the United States for certiorari, the final resolution of this issue will probably take several years.

STATUTORY BACKGROUND

The Court of Appeals for the Sixth Circuit looked to Section 3402 of the Internal Revenue Code of 1986, as Amended (Code) to determine whether supplemental unemployment compensation benefits (SUB) are wages for withholding purposes. Before looking at the facts of the case, it is important to look at this specific code provision.

Code § 3402(o) provides for the Extension of Withholding to Certain Payments Other Than Wages. The general rule is contained in §3402(o) (1) which provides in relevant part under §3402(o)(1)(A) ... that any supplemental unemployment compensation benefit paid to an individual...shall be treated as if it were a payment of wages by an employer to an employee for a payroll period.

Code § 3402(o)(2) provides a definition of a supplemental unemployment compensation benefits. It provides… For purposes of paragraph (1), the term "supplemental unemployment compensation benefit" means 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.

UNITED STATES v. QUALITY STORES

FACTUAL AND PROCEDURAL BACKGROUND

Quality Stores used to be the largest agricultural retailer in the United States. Pursuant to Chapter 11 bankruptcy reorganization, Quality Stores was forced to close all of its 374 stores, its distribution centers and terminated all its employees. The company made severance payments to the employees whose employment was involuntarily terminated. The government and Quality Stores agreed that the severance payments resulted from a reduction in force or the discontinuance of a plant or operation.

The severance payments were made under a Pre-Petition Plan and a Post-Petition Plan. Under the Pre-Petition Plan, severance pay was based on job grade. Payments were made on the normal payroll schedule, not tied to receipt of unemployment compensation, and not attributable to particular services. The Post-Petition Plan was designed to encourage employees to defer their job searches; the lump-sum payments were not tied to receipt of unemployment compensation, nor attributable to provision of particular services.

Quality reported the payments as wages and withheld income tax, paid the employer's share of FICA tax, and withheld each employee's share of FICA. Of $1,000,125 at issue, $382,362 is attributed to the Pre-Petition Plan, $214,000 for the employer share and $168,362 for the employee share; $617,763 is attributed to the Post- Petition Plan, $357,127 for the employer share and $260,636 for the employee share. Quality Stores did not agree with the IRS's current position that the severance payments constituted wages for FICA purposes. Quality stores filed claims for refunds of both the employer tax and, to the extent they received authorizations from the employees, the employee tax. In their claims, Quality Stores took the position that the severance payments were not wages but instead constituted supplemental unemployment compensation benefits (SUB) payments, not taxable under FICA. When the IRS neither granted nor denied the refund, Quality Stores filed an adversary action in the bankruptcy court, which ordered a full refund. The bankruptcy court agreed with Quality Stores that the severance payments were nontaxable SUB payments under FICA and ordered the IRS to refund the overpaid taxes.

Shortly after the bankruptcy court decision, the Federal Circuit held that severance payments are subject to FICA withholding in *CSX Corp v. United States*, 518 F.3d 1328 (Fed. Cir. 2008). The Federal Circuit concluded that Code §3402 should not necessarily apply to FICA withholdings. After the *CSX* decision was issued, the government filed a motion for reconsideration of *Quality Stores* with the bankruptcy court on the basis of that decision. Upon reconsideration, the bankruptcy court ratified its decision.

The government then appealed to the federal district for the Western District of Michigan which affirmed the bankruptcy court's decision. The district court held that the "treated as if it were a payment of wages" language in Code §3402 (o) clearly meant that the SUB payments were not wages. The *Quality Stores* district court also held that since SUB payments are defined as non-

wage payments for income tax withholding, they are also non-wage payments for FICA withholdings under the *Rowan Cos. v. United States, 452 U.S.* 247 (1981).

THE SIXTH CIRCUIT'S HOLDING AND ANALYSIS

The Sixth Circuit held that payments made by Quality Stores to its employees, which the parties had stipulated met the statutory definition of "supplemental unemployment compensation benefits," did not constitute "wages" subject to FICA taxation. The Sixth Circuit's decision on this issue was supported by the statute, the legislative history and the decisions of the United States Supreme Court.

The Sixth Circuit began its analysis by looking at the definition of wages in the FICA contained in Code §3121. Under FICA, employee wages are taxed to fund Social Security and Medicare. The statutory definition, however, does not say whether SUB payments are "wages" under FICA and thus subject to FICA taxes. The court noted that neither the FICA statute nor the corresponding regulations include SUB payments within, or from, the definition of wages. Therefore, the Court looked elsewhere to determine Congress's intent and found it in the Code's rules for federal income tax withholding.

The Sixth Circuit looked to the Code and corresponding IRS regulations for the definition of SUB payments. A SUB payment is defined by statute as (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. I.R.C. § 3402(o)(2)(A) (numbering added). The court determined that all the payments Quality Stores made to its former employees satisfied this five-part statutory test and qualified as SUB payments.

Using the tools of statutory analysis, the Court determined that SUB payments are not wages under income tax withholding law. The Court first analyzed the title of the SUB payment statute § 3402(o), which reads "Extension of withholding to certain payments other than wages." The Court determined that the title's reference to "payments other than wages" (emphasis added) clearly supported its conclusion that Congress knew it was making a distinction between wages and SUB payments. The court determined that all the payments Quality Stores made to its former employees satisfied this five-part statutory test and qualified as SUB payments. Those rules provide SUB payments are subject to withholding as "other than wages.

The court then looked to a prior U.S. Supreme Court decision, *Rowan Cos. v. United States, 452 U.S.* 247 (1981), that concluded Congress intended the term "wages" to have the same meaning for both federal income tax withholding and FICA withholding regimes. Although Congress later amended the Social Security Act to allow the IRS to issue regulations to provide for different exclusions from wages under FICA than under the income tax laws, the IRS has never issued any regulations. Accordingly, the Sixth Circuit concluded that the statutory exemption from the definition of wages for SUB payments must be deemed extended to FICA taxes as well, until the IRS changes the rule by regulation. The Court relied on *Rowan* to reach this conclusion. The Supreme Court reasoned that because Congress adopted nearly identical definitions of wages under FICA and income tax withholding, it intended to coordinate the two schemes "to promote simplicity and ease of administration."

The Court rejected the government's argument that the "decoupling amendment" of the Social Security Amendments of 1983 superseded *Rowan*. While the Court acknowledged that the legislative history of the decoupling amendment aims to decouple the definition of "wages"

between the two schemes, the actual text of the statute merely allows for the Treasury to promulgate different regulations for the exclusions from "wages" under FICA and income tax withholding. The Court also found that the Treasury has never promulgated any regulations under the decoupling amendment. Thus, the Court found that the plain reading of the statute did not supersede *Rowan*, and the case remained good law.

Based on the Sixth Circuit decision in *Quality Stores*, and the reasoning of the lower court decision in *CSX* (reversed by the Federal Circuit), it could be argued that these are the sole criteria to also exempt such payments from FICA and FUTA taxes. However, the IRS in Rev. Rul. 90-72 (1990-2 C.B. 211) significantly narrowed the criteria for determining whether such payments will qualify as FICA/FUTA-exempt payments. The IRS requires that separation payments not be made as a lump sum, that they be specifically designed to supplement state unemployment benefits and that the individual satisfies the requirements to receive state unemployment benefits.

On January 4, 2013, the Sixth Circuit denied the government's petition of rehearing en banc. The Court's order puts the ball back in the government's court to decide whether to seek Supreme Court review. Given the conflict and the importance of having one rule that is applied nationwide, there is a significant possibility that the government will petition the United States for certiorari.

THE NEWLY CREATED SPLIT IN THE CIRCUITS

The split between the Federal Circuit and the Sixth Circuit over the FICA tax treatment of supplemental unemployment compensation benefits is based principally on the differences in each court's interpretation of Code § 3402 and whether it should be applied for FICA purposes.

THE FEDERAL CIRCUIT

In 2008, the Federal Circuit issued a decision in *CSX Corp. v. United States*, 518 F.3d 1328 (Fed. Cir.2008). The Federal Circuit held that SUB payments are subject to FICA withholdings. The IRS won on the grounds that severance payments must meet the requirements of Revenue Ruling 90-72 (1990-2 C.B. 211) and Revenue Ruling 56-249 in order to be considered exempt from FICA. Revenue Ruling 90-72 significantly narrowed the criteria for determining whether certain separation payments qualify as SUB pay. The IRS requires that separation payments not be made as a lump sum, that they be specifically designed to supplement state unemployment benefits and that the individual satisfies the requirements to receive state unemployment benefits.

THE SIXTH CIRCUIT

In the subject matter case, Quality *Stores, the Sixth Circuit held that* severance payments did NOT have to meet the requirements of Revenue Ruling 90-72, thus ruling for a refund of FICA taxes to the taxpayer. The Sixth Circuit disagreed with the Federal Circuit, concluding, "While the Supreme Court may ultimately provide us with the correct resolution of these difficult issues under the law as it currently stands, only Congress can clarify the statutes concerning the imposition of FICA tax on SUB payments. Our role is to interpret the statutory law as it presently exists, and we have done that today."

Instead, the Sixth Circuit looked to Code§ 3402 for a definition of SUB payments and applied rules of statutory construction. A petition for an en banc hearing was recently denied on January 4, 2013. The deadline of April 4, 2013 to petition the Supreme Court of the United States for certiorari is quickly approaching. It will be interesting to see if the IRS petitions the United States Supreme Court for certiorari due to the split in the circuits also on account of the fiscal impact of the IRS having to pay out a large amount of FICA claims.

CONCLUSION

The Sixth Circuit's decision in *Quality* has broad implications for companies making severance payments to employees. It gives employers and their former employees who paid FICA taxes on severance payments made pursuant to an involuntary reduction in the workforce a potential claim for refund. All employers, not just those in the Sixth Circuit (Michigan, Ohio, Kentucky and Tennessee), should consider filing refund claims for FICA taxes paid on severance payments that satisfy the Code's definition of a SUB payment while this matter is being litigated.

It will be interesting to see if the IRS files a petition for certiorari in light of the fact that billions of dollars of FICA refunds are at stake. Given the split in the circuits and the apparent importance of having a uniform nationwide rule, there is a significant possibility that the government will ask the Supreme Court to intervene.

REFERENCES

Code §3121

Code §3402

CSX Corporation v United States, 518 F.3d 1328 (Fed. Cir. 2008)

CSX Corporation v. United States, 52 Fed. Cl. 208 (Fed. Cl. 2002)

Quality Stores, Inc v. United States (In re Quality Stores), 383 B.R. 67 (Bankr. W.D. Mich. 2008)

Reg. § 31.3401(a) - 1(b)(14)(ii)

Revenue Ruling 56-249

Ruling 90-72 (1990-2 C.B. 211)

Rowan Cos. v. United States, 452 U.S. 247 (1981)

United States v. Quality Stores, 693 F.3d 605 (6th Cir. 2012)