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Sixth Circuit Affirms that Severance Is Not "Wages" Subject to FICA, Creating Circuit Split

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In *United States v. Quality Stores, Inc.*, 2012 U.S. App. LEXIS 18820 (6th Cir. Sept. 7, 2012), the Sixth Circuit Court of Appeals affirmed a district court ruling that severance payments were not wages subject to Social Security and Medicare taxes ("FICA" taxes). The decision sets up an explicit conflict with a decision of the Court of Appeals for the Federal Circuit that will likely require congressional action or Supreme Court review to resolve. Based on the circuit split, employers should remain hesitant to stop reporting FICA on severance payments until a more conclusive outcome is reached. Any employer that has paid severance in recent years should also consider filing protective refund claims with the IRS in order to preserve its rights.

Case Background

Quality Stores, Inc. ("Quality") operated a chain of retail stores. Falling on hard times, it entered Chapter 11 bankruptcy in late 2001. As a result, Quality closed many of its retail stores and laid off numerous employees. It eventually closed the remainder of its stores and laid off its remaining employees.

When Quality terminated employees, it made severance payments to them under severance plans. The severance was paid as a direct result of the employees' involuntary separation from employment. The severance payments were not tied to the receipt of state unemployment compensation and were not attributable to the rendering of any particular past or future employment. Quality reported the severance payments as wages on the employees' W-2 forms and withheld federal income tax and the employees' share of FICA taxes. It also paid its share of FICA taxes.

In 2002, Quality filed refund claims with the IRS for overpaid FICA, plus interest, on the severance payments. The claims included the employer's share of FICA, and the employees' share of FICA, for those employees who consented to permit Quality to make the refund request for them.

The bankruptcy court, relying in part upon the Court of Federal Claims decision in *CSX Corp. v. United States*,[1] ruled in favor of Quality, finding that the severance payments were not "wages" for purposes of FICA taxes. In 2008, following the decision of the Court of Appeals for the Federal Circuit,[2] which reversed the Court of Federal Claims in *CSX*, the IRS moved for reconsideration. Upon review, the bankruptcy court again affirmed its decision that the severance payments were

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

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

not wages subject to FICA taxes. The IRS appealed to the federal district court, which affirmed the bankruptcy court, concluding that because the severance payments met the definition of "SUB pay" (supplemental unemployment compensation benefits) under Internal Revenue Code (IRC) section 3402(o)(2), they were not "wages" for purposes of income tax or FICA withholding.

As explained in Littler's March 2010 ASAP,[3] the district court decision did not address a number of issues that might have affected its analysis. For example, the court failed to acknowledge that IRC section 3402(o) had been expressly limited to *income* tax withholding or that, based on the history of SUB pay and why it was created, the initial reasons for excluding SUB pay from wages no longer really existed. The court similarly failed to discuss how Congress's creation of 501(c)(17) trusts specifically to pay SUB pay as other than wages meshed with its conclusion, or to explain the distinction between dismissal pay (which is subject to FICA taxation) and SUB pay.

Not surprisingly, the IRS appealed the district court decision to the U.S. Court of Appeals for the Sixth Circuit. Because the case originated in bankruptcy court, the Sixth Circuit reviewed the bankruptcy court's decision *de novo*, without deference to the district court's decision.

Analysis of the Circuit Court's Decision

The circuit court began by defining the two issues before it as whether the payments by Quality constituted SUB payments under federal law and, if so, whether the payments were taxable under FICA. To answer these questions, the court reviewed the origination of SUB payments among unionized workforces in the 1950s and the Supreme Court's longstanding 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."

Noting that Congress had adopted a "nearly identical" definition of wages for purposes of income tax and FICA withholding, the Court turned its attention to IRC section 3402(o), which both defines SUB payments and mandates income tax withholding on them. Utilizing the definition in IRC section 3402(o), the court quickly determined that the payments qualified as SUB payments because they had been: (1) made to employees; (2) pursuant to company plans; (3) due to the employees' permanent separation of employment; (4) resulting directly from a reduction in force or discontinuance of a plant or operation; and (5) the payments were included in the employees' gross incomes.

Like the district court, the Sixth Circuit relied on IRC section 3402(o)'s designation of SUB payments as a "payment[] *other than wages*," as well as section 3402(o)(1), for guidance that a "SUB shall be treated *as if it were a payment of wages* by an employer to an employee for a payroll period," to conclude that Congress did not intend SUB payments to constitute wages. To confirm this conclusion, the Sixth Circuit looked to the legislative history of the statute, and focused on a committee report that explicitly stated SUB payments "*do not constitute wages or remunerations for services*." On this basis, the court concluded that IRC section 3402(o), which allowed SUB payments to be treated as wages for purposes of federal income tax withholding, was an exception to the rule that SUB payments were not wages and, accordingly, not subject to FICA withholding. The court further noted that the general purpose behind allowing for withholding on "other than wages" was to avoid an individual being hit with a large tax bill on a payment that did not constitute wages and thus was not subject to withholding. In other words, it was seen as beneficial to individuals to have withholding on SUB pay, even though not wages.

After reaching this conclusion, the court then turned its attention to the various counter arguments advanced by the IRS. Chief among these arguments was the IRS's contention that IRC section 3121(a), often called the decoupling amendment, mandated that amounts exempt from income tax "not be exempt from FICA unless Congress provides an explicit FICA tax exclusion." Like the district court, the Sixth Circuit rejected this contention, noting that while this did appear to be Congress's intent – as set forth in the legislative history – the statute itself only empowered the Treasury to enact such decoupling regulations. As the Treasury has not "promulgate[d] regulations to provide for different exclusions from 'wages' under FICA than under the income tax withholding laws," the court found that IRC section 3121(a) did not change its analysis.

Thereafter, the court rejected the IRS's argument that FICA taxes must be deducted from SUB payments as they were a subset of "dismissal pay" that is subject to required deductions under the Social Security Act Amendments of 1939. The court noted that the original exclusion of dismissal payments extended only to payments an employer was not legally required to make, ultimately distinguishing SUB payments from

3 William Hays Weissman, Employers Should Be Cautious of New Decision Holding That Severance is Not "Wages" Subject to FICA, Littler ASAP (Mar. 29, 2010), www.littler.com/publication-press/publication/employers-should-be-cautious-new-decision-holding-severance-not-wages-.

"dismissal pay." The court acknowledged that its holding contradicted a number of prior IRS revenue and private letter rulings, but found that such holdings must yield to congressional intent that SUB payments be excluded from wages subject to FICA taxation.

The Sixth Circuit concluded by acknowledging that, by finding SUB payments were not subject to FICA taxes, it was taking a position in direct contrast to the position taken by the Federal Circuit in *CSX*, and making a thinly-veiled entreaty for the Supreme Court to "provide us with the current resolution of these difficult issues under the law as it currently stands" or for Congress to "clarify the statutes concerning the imposition of FICA taxes on SUB payments."

Considerations for Employers

Given the clear circuit split, the potential cost to the Treasury, and the implications of continued uncertainty for any business that has provided or plans to provide a SUB payment such as severance pay to any former employee, it seems almost certain that this decision will be appealed to the Supreme Court. Alternatively, the IRS could prospectively resolve the problem by promulgating regulations pursuant to IRC section 3121(a), explicitly decoupling SUB pay treatment for FICA and income tax withholding purposes, or Congress could more clearly define SUB pay by amending the Internal Revenue Code.

In light of the current uncertainty, and given the likelihood that the IRS will issue assessments to employers that decline to withhold and remit FICA taxes on severance payments, we recommend that employers continue to withhold FICA on severance payments that fall within the definition of IRC section 3402(o)(2); that is, on severance paid from a plan to workers who were involuntarily terminated on account of a reduction in force or plant closure. The exception to this recommendation would be if the severance payments qualify as "supplemental unemployment benefits" under Revenue Ruling 90-72. However, given the various requirements of Revenue Ruling 90-72, this is unlikely to be easily accomplished without significant planning.

After filing returns and remitting FICA taxes on severance, employers should *strongly* consider the potential costs and benefits of filing claims for refund of their share of FICA and any employee-paid FICA taxes that an employee consents to have refunded. In addition, employers may file refund claims for any such severance payments made for any open statute of limitations period. For example, refund claims for the 2009 tax year must be filed by April 15, 2013. Nonetheless, any protective refund claims that are filed will likely be held by the IRS pending resolution of this issue, which may take years.

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