A Timely Analysis of Legal Developments

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In This Issue:

March 2010

A federal district court in Michigan held that severance payments were not wages subject to FICA taxes. Employers may be cautiously optimistic about the decision, although the case appears to conflict with a decision of the Court of Appeals for the Federal Circuit and also is likely to be challenged by the IRS.

Employers Should Be Cautious of New Decision Holding That Severance is Not "Wages" Subject to FICA

By William Hays Weissman

In *United States v. Quality Stores, Inc.*,[1] a federal district court in Michigan held that severance payments were not wages subject to Social Security and Medicare taxes ("FICA" taxes). This decision appears to conflict with a decision of the Court of Appeals for the Federal Circuit. It also is likely to be challenged by the Internal Revenue Service (IRS). Businesses have reason to be cautiously optimistic, but should be hesitant to stop reporting FICA on severance payments until a more conclusive outcome is reached. Nonetheless, employers that have paid severance in recent years should consider filing protective refund claims with the IRS in order to preserve their rights.

Background

Quality Stores, Inc. ("Quality") operated a chain of retail stores. Falling on hard times, it filed for bankruptcy. 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. For employees receiving severance before October 20, 2001, payments were paid on a weekly or semi-weekly basis on a normal payroll period. Employees terminated after that date received severance in a lump sum.

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*,[2] 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, which reversed the Court of Federal Claims in *CSX*,[3] the IRS moved for reconsideration. Upon review, the Bankruptcy Court again affirmed its decision that the severance payments were not wages subject to FICA taxes. The IRS appealed to the federal district court, which affirmed the Bankruptcy Court.

District Court's Decision

The court began by framing the issue: "This case presents a straightforward, but legally-confounding question: whether severance payments qualify as 'wages' subject to FICA taxation." The IRS argued that the severance payments were "wages" for purposes of FICA and that no statutory exception applied to exclude them from taxation. Further, it argued that the payments did not qualify under the "supplemental unemployment benefits" (SUB) pay exception set forth in guidance from the IRS because the severance payments were not conditioned on eligibility for or receipt of state unemployment benefits.

Finding that the IRS was correct that there was no statutory exception to FICA, the court focused its decision on whether the severance payments constituted SUB pay. The court reviewed a series of IRS revenue rulings issued between 1956 to 1990, in which the IRS addressed whether payments from severance plans purporting to be SUB plans constituted "wages" for purposes of FICA and income tax withholding.

In 1956, the IRS issued Revenue Ruling 56-249, in which the IRS held that a particular SUB plan would not be considered "wages" for purposes of FICA. In 1990, the IRS issued Revenue Ruling 90-72, in which the IRS held that SUB pay must be linked to the receipt of state unemployment compensation and must not be received in a lump sum in order to be excludable from the definition of wages for purposes of FICA taxation and federal income tax withholding. In doing so, the IRS sought to distinguish between true SUB pay and dismissal pay.

The court then reviewed legislative history. It found that in the 1960s, SUB pay was treated as income, but not subject to withholding. This resulted in many workers having a large tax liability at year end. As a result, in 1969, at the request of the Treasury Department, Congress amended the income tax withholding statutes to solve the problem of under-withholding faced by taxpayers who received SUB pay. The new tax withholding provision, IRC section 3402(o), stated that SUB payments "shall be treated as if it were a payment of wages by an employer to an employee for a payroll period."[4]

After reviewing the history of statutory changes and IRS rulings, the court determined that the severance payments in this case meet the definition of "supplemental unemployment compensation benefits" in IRC section 3402(o)(2). Since each payment met the statutory definition of SUB pay, it was excluded from wages under IRC Section 3402(o). The court stated its reasoning as follows:

> The clear import of § 3402(o) is that any payment meeting the definition of "supplemental unemployment compensation benefits" in § 3402(o)(2) is not considered to be "wages." Otherwise, the additional statement, "shall be treated as *if it were a payment of wages* by an employer to an employee for a payroll period" is not only unnecessary but also meaningless. ... if SUB pay already falls within the definition of "wages," there is no need to state that it shall be treated *as if it were* wages. If the SUB pay is already "wages," it is already subject to income tax withholding.

Citing to the case of *Rowan Cos. v. United States*,[5] the court reasoned that the statutory definition of "wages" must be applied in a consistent or reasonable manner for FICA, FUTA, and income tax purposes, and there was simply no justification for the IRS to treat severance as "wages" for FICA, but not for income tax withholding statutes.

The IRS attempted to argue that IRC section 3402(o) was not controlling on whether SUB pay is wages in light of IRC section 3121(a), often called the decoupling amendment, which was enacted after *Rowan* to allow for regulatory distinctions between exclusions in "wages" for income tax withholding and other taxation purposes.

The court rejected this argument as well, finding that *Rowan's* reasoning still applied. The court further added that the IRS had not issued regulations to distinguish between "wages" for income tax withholding and FICA purposes, even though such regulations were allowed by the decoupling amendment. Also, the court found that the revenue rulings did not have the effect of regulations, and, in any event, nothing in the revenue rulings appeared to mandate different treatment for SUB pay under FICA and the income tax withholding statutes. Accordingly, the court found that "despite the decoupling amendment, the reasoning in Rowan remains controlling, and Rev. Rul. 90-72 does not override the specific provisions of § 3402(o)."

The court also rejected the Federal Circuit's reasoning in CSX. The Federal Circuit had concluded that the language in IRC section 3402(o) expressly stating that SUB pay "shall be treated *as if it were a payment of wages* by an employer to an employee for a payroll period" does not necessarily imply that all payments satisfying the definition of SUB pay are non-wages. To the contrary, the court found that the payments met the definition of SUB pay under IRC section 3402(o), and that section 3402(o) controlled, meaning that such payments were nonwages.

Analysis of Court's Decision

The court's decision rests upon a simple and appealing premise: that if a payment meets the definition of "SUB pay" under IRC section 3402(o)(2), and thus is not "wages" for income tax purposes (otherwise it would not need to be treated "as if" it were "wages"), and the definition of "wages" for FICA and income tax withholding must be the same under *Rowan*, then such payment must not be "wages" for FICA purposes either. Accordingly, such SUB pay is not subject to FICA.

One potential problem with this analysis, as pointed out by the Federal Circuit in *CSX*, is that IRC section 3402(o) expressly states that it applies to Chapter 24, the income tax withholding provisions. As the *CSX* court also noted, beginning in 1950 "dismissal pay" is subject to FICA and income tax withholding. All SUB pay is dismissal pay, but not all dismissal pay is SUB pay. Because both dismissal pay and SUB pay are subject to income tax withholding, any distinction is irrelevant for purposes of Chapter 24. However, it does become relevant when FICA and FUTA are considered. Thus, there must be some way to distinguish between dismissal pay that is subject to FICA and SUB pay that is not, given that both are subject to income tax withholding. Thus, when the notion that "severance" is SUB pay and thus exempt from FICA starts to push up against "dismissal pay," it becomes hard to distinguish between them.

Another problem is that the origins of SUB pay arose out of attempts to circumvent a problem relating to the payment of unemployment benefits, not Social Security and Medicare (FICA). As the *CSX* court explained:

> In the mid-1950s, several large American industrial employers adopted plans pursuant to collective bargaining under which the employers agreed to fund trusts that would supplement state unemployment compensation for employees who were laid off. Those payments, denominated SUB payments, depended for their effectiveness in part on their not being characterized as "wages." That was because unemployment benefits in a number of states were not available to employees who were earning "wages" from their employers, and the employees' loss of state unemployment benefits would largely defeat the purpose of the supplemental unemployment benefits. Accordingly, those who adopted such SUB plans sought to ensure that the payments from those plans would not have the legal status of "wages."[6]

Thus, during the 1950s, in order to avoid the problem of involuntarily terminated employees who received severance from being denied unemployment benefits following termination, the need to treat the SUB pay as other than wages was of paramount importance. Accordingly, in Revenue Ruling 56-249, the IRS reviewed such a SUB plan that made payments from a trust, rather than the employer, to separate such payments from any employment relationship. This is a somewhat critical feature of making the SUB pay other than "wages."

In addition, the very problem that the SUB pay was intended to address has largely been eliminated by state legislation. Take California as an example. In a series of judicial decisions beginning in the 1950s,[7] the courts upheld the Employment Development Department's policy of discouraging "double payments" – both private and public – to individuals and the denial of public benefits following termination of employment when an individual received dismissal or vacation pay at the time of termination. As a result of these decisions, the California Legislature enacted Unemployment Insurance Code section 1265, which states in part:

> Notwithstanding any other provisions of this division, payments to an individual under a plan or system established by an employer which makes provisions for his employees generally, or for a class or group of his employees, for the purpose of supplementing unemployment compensation benefits shall not be construed to be wages or compensation for personal services under this division and benefits payable under this division shall not be denied or reduced because of the receipt of payments under such arrangements or plans.

This statute was clearly intended to allow a terminated worker who received severance from his or her employer to also receive unemployment benefits with the severance not being treated as "wages" for purposes of receipt of such benefits. Importantly, such severance was still treated as "wages" for other tax purposes.

An underlying view of the court in *Quality Stores* was that "at some point a line is to be drawn on the taxation of employee financial benefits; otherwise, the benefits become the basis of the very taxes collected to return as benefits. That is, at one end of the spectrum are social security benefits and at the other end of the spectrum are wages/earnings, and at the point on the spectrum where severance payments are intended to serve the same purpose as social security benefits, *i.e.*, support for workers in lieu of a lost ability to earn wages, the collection of social benefit taxes on the wage-replacement benefits makes little sense."

That argument may make some sense for purposes of FUTA, but not for FICA, which serves an entirely different purpose. Certainly Medicare is completely unrelated to wage replacement. Further, companies may have several reasons for paying SUB pay, including maintaining good relations with the remaining workers (knowing that they may get severance if their employment involuntarily terminates) and attracting employees (who will know that, if they are terminated, they will receive some form of severance). These reasons are not predicated solely upon wage replacement, and the court's assumption that severance serves only this function may be fundamentally flawed.

Further, it has long been clear that the payment of taxes and receipt of benefits are not interrelated. For example, in *United States v. Cleveland Indians Baseball Co.*,[8] the Supreme Court stated that "[a]lthough Social Security taxes are used to pay for Social Security benefits in the aggregate, there is no direct relation between taxes and benefits at the level of an individual employee."[9] As a result, the Court held that there was no need to treat the phrase "wages paid" the same for benefit eligibility purposes and tax purposes.[10] This also undercuts *Quality Stores*' reasoning that it makes no sense to tax payments that are derived from public benefits.

The court in *Quality Stores* makes no mention of the underlying reasons for structuring SUB pay as other than wages to avoid the state unemployment benefit problem that no longer really exists. It makes no mention of the fact that Congress created 501(c)(17) trusts specifically to pay SUB pay as other than wages. It fails to address the meaning of the restrictive language in IRC section 3402(o) that it only applies to Chapter 24 income tax withholding. Nor does it make any meaningful attempt to distinguish dismissal pay from SUB pay. These factors underlie the IRS's reasoning in Revenue Ruling 90-72 that SUB pay must be paid from a separate trust and tied to the receipt of unemployment benefits. The court's dismissal of the Revenue Ruling as not a binding regulation without analysis is susceptible to challenge. It is likely all of these potential issues will continue to be addressed by the IRS in other cases.

Considerations for Employers

Given that there are now two court decisions reaching opposite conclusions, the potential cost to the Treasury of this issue, and the IRS's position as set forth in Revenue Ruling 90-72, it seems almost certain that the IRS will appeal this decision. Further, it is likely

that other courts will weigh in on this issue as other refund claims get tried, making it possible that the issue will have to be decided by the Supreme Court. Of course, the IRS could easily resolve the problem prospectively by promulgating regulations, which both the *CSX* and *Quality Stores* courts pointed out had never been issued, to clearly and unequivocally decouple SUB pay treatment for FICA and income tax withholding purposes.

In light of the current uncertainty, and expecting 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 can, however, file 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 2006 tax year must be filed by April 15, 2010. 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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[1] *In re Quality Stores, Inc.*, 2010 U.S. Dist. LEXIS 15825 (W.D. Mich. 2010).

[2] *CSX Corp. v. United States*, 52 Fed. Cl. 208 (Fed. Cl. 2002).

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

[4] Section 3402(o) states in relevant part:

> (o) Extension of withholding to certain payments other than wages
>
> (1) General rule
>
> For purposes of this chapter (and so much of subtitle F as relates to this chapter) -
>
> (A) 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.
>
> (2) Definitions
>
> (A) Supplemental unemployment compensation benefits
>
> For purposes of paragraph (1), the term "supplemental unemployment compensation benefits" 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.

[5] *Rowan Cos v. United States*, 452 U.S. 247 (1981).

[6] *CSX Corp.*, 518 F.3d at 1334-35.

[7] *See, e.g., Jones v. California Employment Stabilization Com.*, 120 Cal. App. 2d 770 (1953); *Shand v. California Employment Stabilization Com.*, 124 Cal. App. 2d 54 (1954); *Bradshaw v. California Emp. Stab. Com.*, 46 Cal. 2d 608 (1956).

[8] *United States v. Cleveland Indians Baseball Co.*, 532 U.S. 200 (2001).

[9] *Id.* at 212.

[10] *Id.* at 213.