



JONES DAY
COMMENTARY

***QUALITY STORES* PUTS FICA REFUND OPPORTUNITY FOR SEVERANCE PAY BACK ON THE TABLE**

A federal district court, affirming a bankruptcy court's decision, recently held that certain types of severance payments are not "wages" and, therefore, not subject to the taxes imposed on employers and employees under the Federal Insurance Contributions Act ("FICA"). *United States v. Quality Stores, Inc.*, 105 AFTR 2d 2010-533 (W.D. Mich. 2010) ("*Quality Stores*"). *Quality Stores* presents an opportunity to claim refunds for FICA taxes previously paid as well as for reevaluating tax positions going forward. Employers who have made severance payments to employees in calendar year 2006 or later may wish to file protective claims for refund of the employer's and the employees' portion of the FICA tax, based on the rationale of *Quality Stores*. The deadline for filing a claim for refund with respect to payments made in 2006 is April 15, 2010, so taxpayers must move quickly if they want to take advantage of this opportunity.

The tax issues are complex and the precise scope of *Quality Stores* is not clear. It is likely that not all payments made to laid-off employees would be covered. Moreover, the government is likely to appeal

the decision, and the only appellate court that has considered this issue so far denied FICA refunds. Finally, under applicable tax refund procedures, the employer must notify the employees who received the severance payments. Affected employers must, therefore, balance all these considerations as well as administrative costs in determining whether to pursue a refund claim. The discussion below provides additional information. We urge interested employers to consult with their tax advisors for an evaluation of these factors in relation to their specific facts and circumstances.

LEGAL BACKGROUND

Both the employer's and the employee's portions of FICA tax are imposed with respect to "wages." Code Section 3121(a) defines "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. The income tax withholding provisions of Code Section 3401(a)

define “wages” in substantially the same way. Moreover, the Supreme Court has held that Congress intended a uniform definition of “wages” for purposes of FICA and income tax withholding. *Rowan Cos., Inc. v. United States*, 452 U.S. 247 (1981). In response to *Rowan*, Congress amended Code Section 3121(a) to provide that nothing in the income tax withholding regulations that provides for an exclusion from wages for withholding purposes “shall be construed to require a similar exclusion from” wages for FICA purposes.

Code Section 3402(o)(1)(A) provides the general rule that “supplemental unemployment compensation benefits” (“SUBs”) that meet certain requirements are treated “as if” they were payments of wages for income tax withholding purposes. Under Code Section 3402(o)(2)(A), these requirements are that the amounts must be paid: (i) to an employee pursuant to a plan to which the employer is a party; (ii) because of an employee’s involuntary separation from employment (whether or not such separation is temporary); and (iii) resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions. Code Section 3121(a), however, does not expressly exempt SUBs from FICA.

The Internal Revenue Service (“IRS”) held in Rev. Rul. 90-72, 1990-2 C.B. 211, that the definition of “SUBs” under Code Section 3402(o)(2) is not applicable for FICA purposes. Instead, in the IRS’s view, for FICA purposes, SUBs are defined solely through a series of rulings it has issued since 1956. These rulings provide that to be exempt from FICA, SUBs must meet a number of additional conditions, including that the SUBs must be payable based on state unemployment benefits or other compensation allowable under state laws, and they must not be paid in the form of a lump sum.

It is with this legal background that the court in *Quality Stores* considered the FICA taxation of SUBs.

THE *QUALITY STORES* CASE

In connection with its Chapter 11 bankruptcy, Quality Stores closed stores and terminated employees. Quality Stores made severance payments to both executives and rank-and-file employees. The payments did not meet the requirements of Rev. Rul. 90-72 because they were not connected to the receipt of state unemployment compensation. Quality Stores withheld federal income tax and the employees’ share of FICA tax from the severance payments and also paid the employer’s share of FICA tax on the severance payments. It then filed refund claims for overpaid FICA, arguing that because the severance payments are not wages for income tax withholding purposes under Code Section 3402(o)(2), they also do not constitute wages for FICA purposes under *Rowan’s* holding that “wages” has the same meaning for income tax withholding and FICA purposes.

The Federal Circuit, the only court of appeals that had previously considered this issue, had rejected the same argument in *CSX Corp., Inc. v. United States*, 518 F.3d 1328 (Fed. Cir. 2008). The district court in *Quality Stores*, however, declined to follow *CSX Corp.* Instead, the district court concluded that because an amendment to Code Section 3402(o) was required in order to subject SUBs to income tax withholding, it therefore follows that SUBs were not otherwise “wages,” including for purposes of FICA taxation. In further support of its reasoning, the district court analogized severance payments to the wage replacement function of Social Security in concluding that FICA should not apply to the severance benefits at issue. This portion of the opinion could be interpreted to exclude from FICA other types of severance benefits that do not meet the requirements of SUBs under Code Section 3402(o)(2), although it is unclear whether the district court intended its opinion to be read that broadly.

FICA REFUND OPPORTUNITY

Although *Quality Stores* is likely to be appealed, any employer that has made, and paid FICA on, significant severance payments during or after 2006 should consider the *Quality Stores* decision in deciding whether to file protective refund claims for the FICA tax, even if the severance payments do not meet the restrictive IRS SUBs definition. If the severance payments meet the statutory definition under Section 3402(o)(2)(A), it may be worthwhile to consider claims for refund on the authority of *Quality Stores*. Finally, as noted, there is language in *Quality Stores* that could be read to apply even to severance payments that do not meet the statutory SUBs definition; taxpayers may want to consider filing protective refund claims in reliance on this aspect of the decision as well.

For the 2006 calendar year, any FICA refund claims must generally be filed by April 15, 2010. Such refund claims must comply with recently adopted IRS procedures, including a (former) employee notification requirement and the need to collect statements from (former) employees. Finally, given the uncertain future of the *Quality Stores* decision, employers who are anticipating providing severance payments that may qualify as SUBs in 2010 and future years should consult with their tax advisors to determine whether to pay and withhold FICA taxes on those benefits.

In addition, employers should note that the law remains unchanged with respect to severance payments meeting the restrictive IRS definition of SUBs under Rev. Rul. 90-72. Those payments remain exempt from FICA tax. Accordingly, any employer that mistakenly withheld and paid over FICA tax with respect to such payments should consider filing claims for refund, regardless of its evaluation of the *Quality Stores* decision.

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