

Author: Elizabeth T. Dold
edold@groom.com
(202) 861-5406

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New Sixth Circuit Ruling – No FICA for Severance Pay – Poses Quandary for Employers

For years, the courts have struggled with whether or not severance pay should be subject to Social Security taxes ("FICA"), just as any other wages, or be exempt as supplemental unemployment benefits ("SUBs"). The IRS' position on this has been clear for many years following Revenue Ruling 90-72, which requires FICA taxes on severance payments that are not contingent on receipt of state unemployment benefits.

Last month, the 6th Circuit upheld the lower court's 2010 decision in Quality Stores, holding that severance payments were not subject to FICA taxes. *In re Quality Stores, Inc.*, 424 B.R. 237 (W.D. Mich. 2010), *aff'd*, 10-1563, 2012 WL 3871364 (6th Cir. Sept. 7, 2012).

Specifically, in Quality Stores a debtor in bankruptcy closed a number of retail stores and, through its severance plans, paid periodic and lump sum payments to employees due to their involuntary separation from employment that resulted directly from a reduction in force or the discontinuance of a plant or operation. The payments were not connected to the receipt of state unemployment compensation and were not attributable to the rendering of any particular employment service. The severance payments were treated as wages for employment tax purposes, but the employer thereafter claimed a refund of the FICA taxes paid.

The 6th Circuit analysis largely tracks the lower court's decision – (1) the payments are SUBs under Code section 3402(o)(2) and, therefore, exempt from wages for both income tax withholding and FICA purposes, and (2) the 1983 legislative "anti-Rowan" language – *nothing in the regulations prescribed for purposes of chapter 24 (which includes 3402(o)) which provides for an exclusion from "wages" as used in such chapter shall be construed to require a similar exclusion from "wages" in the regulations prescribed for purposes of this chapter (FICA taxes)* – does not govern because Revenue Ruling 90-72 is not in the form of an IRS regulation. Moreover, the Court rejected the IRS' definition of SUBs and following the statute (Code § 3402(o)(2)) determined that only 5 requirements are needed for SUBs: (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.

We now have a split in the courts that may well call for Supreme Court review. The 6th Circuit ruling is in direct conflict with the 2008 decision of the Court of Appeals for the Federal Circuit in CSX that held severance payments are subject to FICA taxes, notwithstanding earlier court decisions to the contrary. CSX Corp. v. United States, 518 F.3d 1328 (Fed. Cir. 2008).

Action Steps

Employers who made substantial severance payments in 2009 (or later) should consider filing protective claims by the **April 15, 2013 deadline** (4/15/2014 for 2010 payments, etc.), but continue to subject such payments to FICA taxes until we hear more from the IRS or the Supreme Court. The process for filing a protective claim is rather straightforward (e.g., Form 941-X for the applicable period) and the claim does not need to be filed until just prior to the running of the statute of limitations. And, to the extent that any of the payments are covered by the 6th Circuit (Kentucky, Ohio, Michigan, and Tennessee), at least a protective claim (if not an actual claim on Form 941-X, though that requires more work – e.g., employee consent and it is too soon to tell if IRS will continue to put up a fight, but the initial "informal" word is that the IRS position has remained unchanged) should be filed for any open tax years.

This analysis may also extend to FUTA taxes by filing protective claims on amended Form 940, which generally has a January 31 filing deadline (e.g., 2009 payments may need to be filed by January 31, 2013). (The analysis similarly impacts taxes under the Railroad Retirement Act.)

Employers should stay tuned as these refund claims may well add up to real dollars in these economically difficult times and we have yet to hear the final word.