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### A Tax & Business Planning and Employee Benefits & Executive Compensation Update

## Court Holds Severance Payments Not Subject to FICA Taxes; Refund Claims Should Be Filed Soon

### Brief Summary of *Quality Stores*

In its recent decision, the United States Court of Appeals for the Sixth Circuit in *U.S. v. Quality Stores, Inc.*, No. 10-1563 (6th Cir., 9/7/2012) held that certain severance payments made to former employees were not subject to tax under the Federal Insurance Contributions Act. For employees that have been laid off, and businesses that have reduced their workforce in recent years, the *Quality Stores* decision could result in significant employment tax refunds depending on the number of

individuals affected and periods of time involved in each situation.

Prior to its bankruptcy petition *Quality Stores* closed numerous stores and distribution centers and consequently terminated approximately 75 corporate employees. These employees received severance payments that were paid incrementally in accordance with the company's normal payroll period. After *Quality Stores* went through bankruptcy, all other remaining stores and distribution centers were also closed and all remaining employees were terminated and additional severance payments were made,

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although all post-petition severance payments were paid in a lump sum. Under the severance plan, the payments were not connected to the receipt of state unemployment compensation and were not attributable to the rendering of any particular employment service. At issue was whether the severance paid under both the pre-petition and post-petition plans was exempt from Social Security and Medicare ("FICA") taxes as a supplemental unemployment benefit ("SUB") plan payout as defined in Internal Revenue Code Section 3402(o)(2).

The IRS' long standing position is that for severance pay to be exempt from wages subject to federal income tax withholding and FICA, it must be paid under an SUB plan and under such plan, severance pay must be linked to the receipt of state unemployment compensation and cannot be paid in a lump sum. Furthermore, the IRS contended that the severance payments constituted wages subject to FICA tax because they were payments made in connection with employment. Accordingly, the IRS' view is that the SUB exception from FICA tax should be read very narrowly.

The court unanimously rejected the IRS' position as being against the intent of a statute enacted by Congress and held that the severance payments made by Quality Stores qualified as SUB payments and, further, did not constitute wages subject to FICA tax. Accordingly, the court concluded Quality Stores and its employees were entitled to FICA tax refund of over \$1 million.

In light of the *Quality Stores* court's holding, many individuals and businesses may be entitled to a refund of overpaid FICA tax.

## What Types of Severance Payments are Covered

The *Quality Stores* court interpreted Code Section 3402(o) to require only five elements to qualify a severance payment as for the SUB exemption from FICA tax. To be considered as a SUB payment otherwise excluded from FICA taxation, the payment must be:

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 condition; and
5. Included in the employee's gross income.

The IRS maintains its position that SUB pay made to former employees should be subject to FICA tax withholding unless the payment meets the five criteria listed above, plus two additional requirements:

6. The payments are linked to the receipt of state unemployment compensation; and
7. The payments are not received in lump sum.



## What Will Happen Next

The decision in *Quality Stores* is contrary to an earlier decision by the Court of Appeals for another Federal Circuit. In *CSX Corp. v. U.S.*, 513 F.3d 1328 (Fed. Cir. 2008), the federal circuit agreed with the restrictive definition of "supplemental unemployment benefit" long utilized by the IRS. Accordingly there is a split among the Circuits that may eventually need to be resolved by the Supreme Court. However, in late October, 2012 the Department of Justice ("DOJ") filed a petition for en banc review of the *Quality Stores* decision by the U.S. Court of Appeals for the Sixth Circuit. This latest petition necessarily delays the deadline for any Supreme Court review (even if the Supreme Court decides to take up the case for further review) while the Sixth Circuit considers the DOJ petition. Many commentators believe that if the Sixth Circuit does not grant rehearing en banc or alternatively issues an en banc opinion that is still favorable to the taxpayer, the government will seek U.S. Supreme Court review. Regardless of what ultimately occurs, final resolution on this matter will likely take several years. An important note in the Department of Justice's petition is that the government believes that that \$120 million is at stake in pending refund suits with over \$1 billion at issue when the IRS takes into account all potential claims, so they believe there is a significant financial reason to continue to pursue an alternate determination and thus it is likely DOJ will continue to push for a final court ruling no matter what the timetable ends up being before final resolution.

## What Steps Should Be Taken

Even with the continued uncertainty and apparent split amongst existing court rulings, while the 6<sup>th</sup> Circuit rehearing petition in *Quality Stores* is pending, employers should consider taking the necessary steps to protect their right to file a claim for FICA refunds on their own behalf as well as on the behalf of employees who

received the SUB pay. Employers may do so by filing "protective refund" claims. A protective refund claim is a relatively simple process whereby a taxpayer files an amended return requesting a refund of tax in the event the law as interpreted by *Quality Stores* is ultimately upheld. By filing such a protective refund claim in this manner, the taxpayer preserves the legal right, even if outside the allowable statute of limitations period, to receive a refund of excess monies previously paid if the litigation ultimately is resolved in a favorable manner.

From a timing perspective, the general statute of limitations period with regard to quarterly employment tax returns filed for a calendar year runs for three years, starting from April 15 of the succeeding year. Thus, the statute of limitations for filing a FICA tax refund claim for the quarters in calendar year 2009 Forms 941 generally runs until April 15, 2013. Hence, these claims must be filed before this upcoming April 15, 2013 deadline if the taxpayer seeks to receive a refund of excess FICA payments during the 2009 tax year. There are key items that must be included in a protective refund claim for it to be valid, including obtaining the consent of employees for refunds of the portion of FICA withheld from their severance payments. Once filed, the protective refund claim will likely be held in abeyance by the IRS while the appeal is pending.



## Conclusion

The *Quality Stores* decision provides taxpayers in the Sixth Circuit with a potential chance to recover FICA taxes attributable to qualifying severance payments. For employers outside of the Sixth Circuit, *Quality Stores* may ultimately be decided in the Supreme Court providing hope that this issue will ultimately be solved in the taxpayer's favor across the United States. In the meantime, any taxpayers that have made severance payments fitting the criteria set forth by the court in

*Quality Stores* discussed above should consider filing a protective refund claim for overpaid FICA taxes before the end of any open tax years that have not already closed due to the passage of any applicable statute of limitations periods.

We recommend that you contact a Polsinelli Shughart attorney or your current tax advisor soon so your particular facts and circumstances may be reviewed in order to assist you with evaluating whether or not you may take advantage of any FICA refunds in light of the pending *Quality Stores* decision.



## For More Information

If you would like to discuss any of the items covered in this e-Alert, or discuss other matters, please contact one of the members of the Polsinelli Shughart PC listed below:

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## About our

### Employee Benefits & Executive Compensation Group

Polsinelli Shughart PC has a deep bench of qualified Employee Benefits attorneys who cover all aspects of plan creation and design, plan compliance and executive compensation agreements. Collectively our attorneys have more than 100 years of combined employee benefits expertise, providing practical, proactive advice, while also striving to develop innovative solutions to all of your employee benefit needs.

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## About

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