

The Bankler Report

September 19, 2012

INTRODUCTION

The Sixth Circuit Court of Appeals states that Severance Payments are NOT SUBJECT to FICA taxes!

US v. Quality Stores, Inc. (CA 6 9/7/2012).

On September 7, 2012 the Sixth Circuit Court of Appeals issued an opinion in US v. Quality Stores, Inc. that stated that severance payments qualified as supplemental unemployment compensation benefits (SUBs). While the Internal Revenue Code treats these payments as wages for income tax withholding purposes, the Court stated that Congress doesn't regard these payments as wages for FICA.

Downsizing is a fact of life in today's challenging business environment and often results in severance payments to departing workers. This new decision should give companies who made such payments and the discharged workers who received them an opportunity to recover FICA taxes paid on the severance payments provided refund claims are not barred by the statute of limitations. Future severance payments also may escape FICA taxes under the authority of this new decision.

Facts of the case.

Quality Stores, Inc. (Quality), which had operated a chain of retail stores went into bankruptcy. During the period preceding the bankruptcy cases (the Pre-petition Period), Quality closed many of its locations and also terminated approximately 75 employees at its corporate office. On Oct. 20, 2001, an involuntary chapter 11 bankruptcy petition was filed against Quality. After the petition date (the Post-petition Period), Quality closed its remaining stores and distribution centers and terminated all of its remaining employees.

Quality made severance payments to employees who were terminated during both the Pre-petition and Post-petition Periods. The Pre-petition Period severance payments were paid on a weekly or semi-weekly basis, in accordance with Quality's normal payroll period. Severance payments for the Post-petition Period were paid in a lump sum. Neither Pre-petition nor Post-petition Period payments were connected to the receipt of state unemployment compensation.

The severance payments were included in the employees' gross income, and Quality reported the severance payments as wages on the W-2 forms issued to employees. Quality 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.

In 2002, Quality filed refund claims with 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.

When the IRS failed to respond to these claims, Quality Stores filed an adversary action in the bankruptcy court, which concluded that the severance payments were not wages for FICA purposes. The district court affirmed the bankruptcy court.

The IRS appealed and the Sixth Circuit affirmed the lower court and noted that the FICA statute does not expressly include or exclude these SUB payments from wages. The court noted that to qualify for SUB payment, it must be:

- A) an amount paid to an employee;
- B) pursuant to an employer's plan;
- C) because of an employee's involuntary separation from employment, whether temporary or permanent;
- D) resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions; and
- E) included in the employee's gross income.

All payments Quality Stores made to its former employees, whether under the Pre- or Post-Petition Plan, satisfied this five-part statutory test to qualify as SUB payments.

Fifth Circuit.

Federal cases in Texas are appealed to the Fifth Circuit Court of Appeals. This Court has not issued an opinion on this issue but the IRS has litigated this issue in the Court of Federal Claims which also held for the taxpayer. The IRS appealed the decision to the Court of Appeals for the Federal Circuit which it won; thereby creating a split in Districts. The IRS has not announced if it will appeal the Sixth Court of Appeals to the Supreme Court.

If you believe that you may qualify for a refund of these FICA taxes, you **MUST** file a CLAIM for refund **WITHIN 3 years** of the filing of the original payroll tax return (941) for that quarter.