SUTHERLAND

LEGAL ALERT

September 20, 2012

The Sixth Circuit Splits From the Federal Circuit and Rules That Severance Payments Are Not Taxable as FICA Wages

On September 7, 2012, the Sixth Circuit held that certain types of severance payments (referred to as supplemental unemployment compensation or "SUB payments") are not taxable wages under FICA. *United States v. Quality Stores, Inc.*, No. 10-1563 (6th Cir. 2012). In so holding, the court declined to follow IRS revenue rulings and also declined to follow the Federal Circuit's contrary decision in *CSX Corp. v. United States*, 518 F.3d 1328 (Fed. Cir. 2008).

Sutherland Observation: Employers that have made severance payments meeting the requirements for SUB payments as set forth in Internal Revenue Code § 3402(o) should file claims for refund for FICA taxes paid with respect to these payments. The statute of limitations for filing claims for refund for timely filed 2009 Forms 941 will expire on April 15, 2013. Claims for refund for years after 2009 should be evaluated after any Supreme Court action in *Quality Stores*. Employers that have already filed claims for refund and have received a notice of disallowance from the IRS (or have signed a Form 2297) should consider filing suit as soon as possible (or, alternatively, seek the IRS's agreement to extend the statute of limitations using Form 907). Under § 6532, suits filed more than two years after the date of the notice of disallowance or Form 2297 will be barred by the statute of limitations unless the IRS consents to extend it. Employers that have filed claims for refund but have not received a notice of disallowance or a signed Form 2297 need not take any action until they receive a notice of disallowance.

It is particularly important for taxpayers in the Sixth Circuit (Kentucky, Michigan, Ohio, and Tennessee) to preserve their rights because of the favorable decision in *Quality Stores*. It can be expected that if the government does not petition the Supreme Court for certiorari or is denied certiorari in *Quality Stores*, it will continue to litigate the issue in other circuits and to attempt to develop adverse precedent in those circuits. The government has until October 22 to ask the Sixth Circuit for rehearing and, assuming a petition for rehearing is not filed, until December 6 to file a certiorari petition.

FICA imposes employment tax on the amount of "wages" paid to employees with respect to their employment. The definition of "wages" provided in FICA does not directly address SUB payments. SUB payments, however, are provided for under § 3402(o), which defines such payments by reference to a 5-part test and classifies them as payments "other than wages" for purposes of income tax withholding. In Rev. Rul. 90-72, 1990-72 C.B. 211, the IRS announced that it would not follow the definition in § 3402(o) for FICA purposes but would instead enforce the IRS's own 8-part test, derived from Rev. Rul. 56-249, 1956-1 C.B. 488, to determine whether the payments qualified as wages for FICA purposes. The payments in *Quality Stores* did not meet the 8-part test (because some benefits were paid in a lump sum, and because all benefits were not linked to the receipt of state unemployment compensation), but did meet the 5-part test of § 3402(o).

Quality Stores paid the FICA tax attributable to the payments made to its laid-off employees, and filed claims for refund. In an adversary proceeding, the Bankruptcy Court for the Western District of Michigan held that the payments were not subject to FICA. The district court affirmed. The Sixth Circuit affirmed the bankruptcy court.

The parties had stipulated and the Sixth Circuit held that the payments made by Quality Stores were SUB payments under the definition of such payments set forth in § 3402(o), which requires that the payments be: (1) paid to an employee; (2) paid pursuant to a plan to which the employer is a party; (3) because of an employee's involuntary separation from employment (whether or not such separation is temporary); (4) paid as a direct result of a reduction in force, the discontinuance of a plant or operation, or other similar conditions; and (5) includible in the employee's gross income.

The Sixth Circuit began its analysis by confirming that neither the FICA statutes[1] nor the regulations expressly include or exclude SUB payments from the definition of "wages" for FICA purposes. Having concluded that the issue was not resolved by the FICA provisions themselves, the Court turned to the Code's income tax withholding provisions in § 3402(o) and asked whether SUB payments qualified as "wages" under that provision. On that issue, the court expressly disagreed with the earlier Federal Circuit decision in *CSX* and held that the legislative history of § 3402(o) (and a related provision, § 501(c)(17)) indicated that Congress did not consider SUB payments to be "wages" for purposes of income tax withholding.

The Sixth Circuit then used the Supreme Court's decision in *Rowan Cos. v. United States*, 452 U.S. 247 (1981) as a "bridge" to apply the § 3402(o) definition to FICA despite its literal limitation to income tax withholding. The *Rowan* decision held that Congress intended "wages" to have the same meaning for both income tax withholding and FICA. The court agreed with the Federal Circuit in *CSX* that, absent regulations, the language of the "decoupling amendment" enacted by the Social Security Amendments of 1983[2] did not actually "decouple" the definition of "wages" for FICA purposes from the definition for income tax withholding purposes. The court rejected the government's argument that the Supreme Court had eroded the *Rowan* holding in *Environmental Defense v. Duke Energy Corp.* 549 U.S. 561 (2007) or *Mayo Found. for Med. Educ. & Research v. United States*, 131 S. Ct. 704 (2011). The court criticized the Federal Circuit in *CSX* for failing to follow *Rowan* and its own precedent in *Anderson v. United States*, 929 F.2d 641 (Fed. Cir. 1991), in refusing to apply the § 3402(o) definition for FICA purposes.

The Sixth Circuit also concluded that the IRS's contrary position as expressed in revenue rulings was not entitled to deference. In support, the court noted that revenue rulings do not have the force of law and are not entitled to greater significance than congressional intent as expressed in § 3402(o).

Sutherland Observation: The decision in *Quality Stores* represents the second circuit split in recent weeks where the other side of the split is a decision of the Federal Circuit. On August 9, the Second Circuit decided *Exxon Mobil Corp. v. Commissioner*, Nos. 11-2814, 11-2817 (2nd Cir. 2012), which split with the Federal Circuit decision in *Fed. Nat'l Mortg. Ass'n v. United States*, 379 F.3d 1303 (Fed. Cir. 2004) regarding "retroactive" interest netting under § 6621(d).

The Supreme Court has historically seemed relatively willing to hear FICA cases, as evidenced by the number of such cases decided in recent years. *See Mayo Found. for Medical Educ. & Research v. United States*, 131 S. Ct. 706 (2011); *United States v. Fior D'Italia*, 536 U.S. 238 (2002); *United States v. Cleveland Indians Baseball Co.*, 532 U.S. 200 (2001).

While Treasury and the IRS are expected to continue to deny these refund claims and litigate the issue, taxpayers with potential refund claims must file those claims prior to the statute of limitations for seeking

[1] Internal Revenue Code §§ 3101, 3102, 3111, and 3121.
[2] Pub. L. No. 98-21, 97 Stat. 65 (1983).

the refunds expires. Those claims must generally be filed within three years of the Form 941 filing or the refund claim will be time barred.

Sutherland Asbill & Brennan LLP is advising clients to timely pursue refund claims and protect their rights in litigation, and is assisting clients in doing so.

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If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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