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Sixth Circuit: Downsizing Payments Are Not FICA-Taxable Wages

Court holds that severance payments paid pursuant to an involuntary reduction in force are exempt from FICA taxes, allowing companies subject to these taxes to file refund claims.

On September 7, the U.S. Court of Appeals for the Sixth Circuit issued the most significant pro-taxpayer payroll tax decision in the last 10 years. Its decision in *United States v. Quality Stores, Inc.*[1] may have a favorable financial impact on millions of unemployed workers and on thousands of businesses that have had to downsize their workforces due to financial hardships in recent years. This decision specifically addresses the application of payroll taxes to downsizing and layoff benefits. Because of the impact on clients' tax filings, including potentially substantial tax savings for both companies and employees, Morgan Lewis has been deeply involved in this issue generally and with this case specifically.[2]

Quality Stores: A Landmark Decision

In *Quality Stores*, the Sixth Circuit held that severance payments paid to former employees pursuant to an involuntary reduction in force are not taxable "wages" for Social Security and Medicare (Federal Insurance Contributions Act or FICA) tax purposes. Instead, such downsizing payments are exempt from FICA taxes provided the payments satisfy the statutory definition for "supplemental unemployment compensation benefits" or SUB-Pay.[3] This statutory test is straightforward, easily understood, and readily applied. By contrast, the complex administrative interpretation adopted by the Internal Revenue Service (IRS)—a multifactor test of undefined terms—is confusing, particularly in light of its fluctuations over the years. In fact, the U.S. Court of Appeals for the Federal Circuit previously misidentified the precise multifactor test that the IRS applies to downsizing payments. *See CSX Corp. v. United States*, 518 F.3d 1328 (Fed. Cir. 2008) (adopting the IRS test and holding that the severance payments at issue were subject to FICA and Railroad Retirement Tax Act (RRTA) taxes). The Sixth Circuit, however, categorically rejected these shifting IRS SUB-Pay rulings as inconsistent with congressional intent.

Although *Quality Stores* itself involves "only" a $1 million refund, its significance stems from the millions of employees who received downsizing payments upon which the IRS imposed both employer and employee FICA taxes. As a result of the Sixth Circuit's decision, many billions of dollars in potential refunds may be available to companies that were forced to downsize their business operations as well as the millions of terminated workers—many of whom remain either unemployed or underemployed. These potential tax refunds would provide welcome relief to these businesses and terminated workers whose long-term unemployment benefits have expired.

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1. *United States v. Quality Stores, Inc.*, No 10-1563 (6th Cir. Sept. 7, 2012), *available at* http://www.ca6.uscourts.gov/opinions.pdf/12a0313p-06.pdf.

2. A Morgan Lewis team—including David R. Fuller, the IRS's former subject matter expert on SUB-Pay issues—provided assistance to the taxpayer and its representatives in the appeal of this case to the Sixth Circuit. We represented the American Payroll Association (APA), the leading advocate for payroll professionals, in its amicus brief and in oral argument before the Sixth Circuit.

3. Supplemental unemployment compensation benefits are defined in the Internal Revenue Code as "amounts which are paid to an employee, pursuant to a plan to which the employer is a party, because of an employee's involuntary separation from employment (whether or not such separation is temporary), resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions, but only to the extent such benefits are includible in the employee's gross income." I.R.C. § 3402(o)(2)(A).

While most advisors assume that the Department of Justice (DOJ) and the IRS will seek review by the U.S. Supreme Court, the government is sending mixed signals regarding whether it will or will not seek such a review. Legitimate reasons exist supporting either approach by the DOJ and IRS. Nevertheless, the IRS has informally advised that, pending further action on this case, the IRS Service Centers will continue to challenge these SUB-Pay refund claims—notwithstanding that five of the six courts that have considered this issue have applied the statutory definition of SUB-Pay.

Next Steps for Past and Future Years

Quality Stores provides important support for filing refund claims for taxes paid on downsizing payments. Prior to the issuance of this important decision, some employers may have questioned the utility of filing refund claims due to conflicting advice from tax advisors in recent years. However, strong legal arguments (now further supported by *Quality Stores*) exist to support the refund of such payments, and employers should consider pursuing such claims. Several of our clients have filed SUB-Pay refund claims and have been successful in obtaining refunds of varying amounts. While the IRS's next steps will undoubtedly impact how each employer should specifically respond to its own unique refund opportunities and the many different choices available to it, there are immediate proactive steps that all employers should consider in the interim to address these refund opportunities for past and future years.

Past Years

FILING REFUND CLAIMS

Employers that have paid downsizing payments, but that have not previously filed refund claims for taxes paid on these payments, should begin to file FICA tax refund claims as soon as administratively practical for all open payroll tax periods (calendar years subsequent to 2008). Contrary to some recommendations that these filings should be delayed until April 15, 2013, employers should file as soon as possible, as the congressional tax-writing committee may propose legislation to revise *Quality Stores* for both severance paid after the date of introduction and for refund claims filed after the date of such a bill's introduction. Whether claims should be filed as "protective" refund claims or more traditional refund claims is an issue that each affected employer should discuss with its tax advisors. While the differences between these types of refund claims are somewhat nuanced, significant reasons exist that these claims should now be filed as traditional refund claims and not as protective claims.

PERFECTING EXISTING REFUND CLAIMS

If an employer previously filed protective refund claims, it should now consider "perfecting" those claims. This consists primarily of data collection to substantiate both the amount and the type of the SUB-Pay claims. Most employers anticipate that their downsizing arrangements will satisfy the statutory definition of SUB-Pay, but some employers that have undertaken the substantiation process were surprised to learn that their existing severance plans also satisfy the far more rigorous IRS administrative definition of SUB-Pay and that their refund claims would not be challenged by the IRS. In one such situation, a client had one of its relevant plans yield a refund in excess of $5 million that the IRS conceded satisfied its administrative definition even though the client initially believed the plan did not fall within the IRS administrative definition.

FILING REFUND SUITS

The Sixth Circuit's decision in *Quality Stores* may be the catalyst for thousands of employers that have not yet filed refund claims (or that have stopped filing refund claims) to file claims for past, current, and future years. A far smaller number of employers with pending or disallowed claims should consider whether and when to commence FICA refund suits. In a limited number of situations, it may be advisable to file FICA refund suits on such downsizing payments.

MONITORING CLAIM DENIALS

Many taxpayers have received letters from the IRS either denying or freezing their FICA tax refund claims. Any denials formally notifying an employer that they have two years to file suit in court should receive special attention. For such situations, employers should formally request that the IRS grant an extension of this deadline for filing suit (on a Form 907, jointly signed by the employer and the IRS). If the extension (on Form 907) is not requested and received, the employer's claim will simply expire, unless the employer files a lawsuit in court to preserve its claim.

Future Years

At least four significant options exist for reducing FICA tax obligations if an employer is considering a significant workforce restructuring in the future. Three of these involve the following SUB-Pay options: (i) filing refund claims based upon the statutory SUB-Pay definition; (ii) modifying existing severance arrangements to fully qualify with the IRS's administrative definition; or (iii) modifying existing severance arrangements to conform with the underlying purpose of the IRS administrative definition—even if all eight of the specific IRS revenue ruling requirements cannot be independently satisfied. As indicated above, many employers are surprised that, with relatively minor modifications to their existing severance arrangements, the IRS is far more likely to concede that downsizing arrangements satisfy the FICA exemption requirements. However, if such modifications are not made, employers should not simply stop withholding and paying FICA taxes on these payments. Instead, such employers should file FICA refund claims.

Conclusion

Five of the six courts that have looked at the SUB-Pay FICA tax exemption for downsizing payments have adopted the statutory definition of SUB-Pay. Those decisions are well reasoned and consistent with the approach that the IRS maintained for almost two decades prior to changing to its current ruling and audit positions. In these harsh economic times, both employers and their terminated employees may benefit from the *Quality Stores* approach regarding the correct definition to apply for purposes of the SUB-Pay FICA tax exemption. A proper understanding of the *Quality Stores* decision and its impact on the applicability of the statutory definition of SUB-Pay versus the IRS's far narrower administrative definition may result in substantial FICA tax refunds.

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If you have any questions or comments on the *Quality Stores* decision, pursuing SUB-Pay refund claims, modifying existing severance arrangements to more readily conform to the IRS administrative position, or any other payroll tax or similar matter, please contact any of the following Morgan Lewis attorneys:

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