
employee benefits lawflash

October 24, 2012

Quality Stores, Inc. Update

Department of Justice files petition for rehearing en banc, challenging the Sixth Circuit's recent decision that severance payments paid pursuant to an involuntary reduction in force are exempt from FICA taxes.

On October 18, the Department of Justice (DOJ) filed a petition for rehearing en banc in *United States v. Quality Stores, Inc.*, No. 10-1563 (6th Cir. Sept. 7, 2012).¹ In *Quality Stores*, the U.S. Court of Appeals for the Sixth Circuit issued the most significant pro-taxpayer payroll tax decision in the last 10 years, holding that severance payments that satisfy the Internal Revenue Code's statutory definition of "supplemental unemployment compensation benefits" or SUB-Pay are not taxable wages for Social Security and Medicare (Federal Insurance Contributions Act or FICA) tax purposes.² Specifically, the Sixth Circuit held that severance payments paid to former employees pursuant to an involuntary reduction in force were SUB-Pay and not taxable "wages" for FICA tax purposes.³

Petition for Rehearing En Banc

Rehearings en banc are only granted in rare cases when the petitioning party establishes the existence of issues that affect the integrity of the circuit's case law (e.g., intracircuit conflicts) or the development of the law (e.g., questions of exceptional importance). Per the Sixth Circuit's Internal Operating Procedures Rule 35(a), "a petition for rehearing en banc is an extraordinary procedure intended to bring to the attention of the entire court a precedent-setting error of exceptional public importance or an opinion that directly conflicts with Supreme Court or Sixth Circuit precedent." As such, rehearings en banc are generally disfavored and ordinarily not ordered. See *Mitts v. Bagley*, 626 F.3d 366, 370 (6th Cir. 2010). They are granted if a majority of the active service circuit judges who are not disqualified agree to grant rehearing.

In support of its petition for rehearing en banc, the government contends that the Sixth Circuit's *Quality Stores* decision conflicts with the holdings in *Social Security Board v. Nierotko*, 327 U.S. 358 (1946); *Appoloni v. United States*, 450 F.3d 185 (6th Cir. 2006); and *Gerbec v. United States*, 164 F.3d 1015 (6th Cir. 1999), and therefore "[c]onsideration by the full court is thus needed to secure and maintain uniformity of [the Sixth Circuit's] decisions."

Timing

As stated in our previous LawFlash, most advisors assumed that the government would seek review of this matter by the U.S. Supreme Court. If the Sixth Circuit does not grant rehearing en banc or issues an en banc opinion that is still favorable to the taxpayer, the government has informally indicated it will still seek Supreme Court review. With the filing of the petition for rehearing en banc, the period within which the government can seek certiorari review by the Supreme Court is suspended through the date of denial of rehearing or, if rehearing is granted, the

1. Read the petition for rehearing en banc at [http://op.bna.com/dt.nsf/id/vmar-8zbt5v/\\$File/qualitystores.pdf](http://op.bna.com/dt.nsf/id/vmar-8zbt5v/$File/qualitystores.pdf).

2. 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).

3. See our September 27, 2012, LawFlash, "Sixth Circuit: Downsizing Payments Are Not FICA-Taxable Wages," at http://www.morganlewis.com/pubs/EB_LF_6thCircuitConfirmsPayrollTaxRefundOpportunity_27sep12.

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subsequent entry of judgment.⁴ See Sup. Ct. R. 13.3. As a result of this suspension, possible review by the Supreme Court (on certiorari or on the merits) could likely be postponed to a future court term.

Conclusion

Because of the extraordinary relief sought, the DOJ faces a substantial hurdle in having its petition for rehearing en banc granted. Nonetheless, the DOJ's request further prolongs final resolution of the question in the *Quality Stores* appeal (i.e., whether SUB-Pay as defined for federal income tax withholding purposes constitutes taxable wages for FICA tax purposes), making it more imperative that employers monitor their pending refund claims.⁵ Specifically, any IRS denials notifying the taxpayer that it has two years to file a refund suit should receive special attention since the employer should request an extension to file suit (on a Form 907, jointly signed by the employer and the IRS) before the expiration of the two-year period.

Contacts

If you have any questions or comments on the *Quality Stores* decision, this recent petition for rehearing en banc, pursuing severance payment 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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4. A petition for a writ of certiorari is timely if filed with the Clerk of the Supreme Court within 90 days of entry of judgment by the lower court.

5. According to the government's petition for rehearing en banc, the Internal Revenue Service (IRS) has suspended action on administrative refund claims, with the total amount of potential exposure on this issue valued at more than \$1 billion. Our calculations, however, indicate that this sum could be substantially higher.

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