

***Quality Stores* Breathes New Life into Tax Refunds for Severance Pay and SUB-Pay**

March 1, 2010

Last week's federal district court decision in *United States v. Quality Stores, Inc.*, 2010 U.S. Dist. LEXIS 15825 (W.D. Mich. Feb. 23, 2010), should generate renewed interest and revive hopes throughout the country for several billion dollars in Federal Insurance Contributions Act (FICA) tax refund claims that are pending review. Those refund claims, filed by hundreds of employers, relate to many types of downsizing payments, severance payments, and nontraditional supplemental unemployment compensation benefit plan (SUB-Pay) payments made to workers who have been involuntarily downsized during the past 10 to 12 years. Many employers that made downsizing payments may be entitled to significant payroll tax refunds, plus interest. Morgan Lewis attorneys have been actively involved with the SUB-Pay refund issue for more than 15 years and have assisted with refund claims in excess of \$1 billion. The *Quality Stores* decision greatly strengthens the refund arguments for the many types of severance, downsizing, and nontraditional SUB-Pay payments.

Background

Today's troubling economic times have caused many employers to turn to SUB-Pay plans—very traditional benefit plans that were commonly used among employers with unionized workforces in the 1950s and 1960s to enhance or supplement state unemployment benefits for terminated workers. As employers that continue to use traditional SUB-Pay plans can attest, a well-drafted SUB-Pay plan can be an attractive alternative to most current severance and termination arrangements. Traditional SUB-Pay plans are designed to coordinate with the employees' state unemployment benefits. If properly designed, the SUB-Pay amounts are not considered wages; therefore, an employee may simultaneously receive both state unemployment benefits and the employer unemployment benefits. Traditional SUB-Pay plans are also used to significantly reduce an employer's actual out-of-pocket severance costs. As a corollary, SUB-Pay plans can offer significant employer and employee FICA tax savings on the downsizing payments paid from the SUB-Pay plan. Terminated employees can especially use such funds during extended periods of unemployment and economic hardship.

While adoption and implementation of a traditional SUB-Pay plan should be thoroughly vetted with labor and tax counsel due to unique legal issues, a simpler alternative to achieving the tax savings (but not the cost offsets or the coordination with state benefits) may be available for employers that involuntarily terminated employees prior to 2010—filing “protective refund claims” for the FICA taxes paid on SUB-Pay. For the past eight years, such employers have routinely filed these claims (which now

collectively total several billion dollars) based on a Court of Federal Claims decision in 2002 that held that severance payments constitute SUB-Pay benefits that are exempt from FICA taxes (and Railroad Retirement Tax Act taxes), provided that three basic statutory requirements of Internal Revenue Code section 3402(o) are met: (i) existence of a plan; (ii) involuntary separation (permanent or temporary); and (iii) there is a reduction in force, plant closing, or other similar condition. *See CSX Corporation, Inc. v. United States*, 52 Fed. Cl. 208 (Apr. 1, 2002). Despite the Federal Circuit’s reversal of the Claims Court’s favorable decision (*CSX Corp. v. United States*, 518 F.3d 1328 (Fed. Cir. 2008)), the dispute over the FICA exemption for nontraditional SUB-Pay continues (traditional SUB-Pay payments remain exempt and are not being challenged by the IRS) due to the well-reasoned approach taken by the Claims Court and the Federal Circuit’s self-described struggles with the issue.

The *Quality Stores* Decision

This week, the Federal District Court further stoked the controversy with its *Quality Stores* decision, adopting the Court of Federal Claims’ approach and specifically rejecting the Federal Circuit’s analysis. The court held that traditional severance payments that satisfy section 3402(o)’s three aforementioned requirements are exempt from FICA taxes.

What Next?

The *Quality Stores* decision will likely be appealed to the U.S. Court of Appeals for the Sixth Circuit. In the meantime, we continue to recommend that employers protect their FICA tax refund rights by filing protective refund claims for 2006 (as well as 2007–09) if substantial termination or severance payments were made to involuntarily terminated employees in those years. In that regard, note that additional important arguments exist that were not briefed or argued in either *CSX* or *Quality Stores*, but that can significantly enhance the refund claims and increase the likelihood of success. The decision about whether and how to “perfect” those claims (by identifying the actual disputed amount and collecting employee acknowledgements/consents) can be made in the ensuing months, but the deadline for filing 2006 protective refund claims expires on Thursday, April 15, 2010. While the timing is short, such protective refund claims are easy to file (typically taking only one or two hours), even with the recent changes to certain FICA refund tax forms and procedures.

<p>DEADLINE: Employers that paid significant termination benefits to involuntarily terminated employees in 2006 should file “protective” refund claims no later than Thursday, April 15, 2010. These protective refund claims can be easily filed in about an hour to preserve any refund rights an employer may have and to preserve the statute of limitations.</p>
--

Morgan Lewis has handled numerous government and private-sector matters addressing both traditional and nontraditional SUB-Pay plans, including working on more than half of the SUB-Pay rulings issued by the IRS in the last 20 years.

If you have any questions about any of the issues discussed in this LawFlash, please contact any of the following Morgan Lewis attorneys:

Washington, D.C.

Mary B. Hevener
David R. Fuller

202.739.5982
202.739.5990

mhevener@morganlewis.com
dfuller@morganlewis.com

Jerry E. Holmes	202.739.3869	jholmes@morganlewis.com
Stanley F. Lechner	202.739.5079	slechner@morganlewis.com

Chicago

Philip A. Miscimarra	312.324.1165	pmiscimarra@morganlewis.com
----------------------	--------------	--

Dallas

Anne Marie Painter	214.466.4121	anmarie.painter@morganlewis.com
--------------------	--------------	--

New York

David McManus	212.309.6824	dmcmanus@morganlewis.com
---------------	--------------	--

Pittsburgh

R. Randall Tracht	412.560.3352	rtracht@morganlewis.com
-------------------	--------------	--

About Morgan, Lewis & Bockius LLP

With 22 offices in the United States, Europe, and Asia, Morgan Lewis provides comprehensive transactional, litigation, labor and employment, and intellectual property legal services to clients of all sizes—from global Fortune 100 companies to just-conceived startups—across all major industries. Our international team of attorneys, patent agents, employee benefits advisors, regulatory scientists, and other specialists—more than 3,000 professionals total—serves clients from locations in Beijing, Boston, Brussels, Chicago, Dallas, Frankfurt, Harrisburg, Houston, Irvine, London, Los Angeles, Miami, Minneapolis, New York, Palo Alto, Paris, Philadelphia, Pittsburgh, Princeton, San Francisco, Tokyo, and Washington, D.C. For more information about Morgan Lewis or its practices, please visit us online at www.morganlewis.com.

IRS Circular 230 Disclosure

To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein. For information about why we are required to include this legend in emails, please see <http://www.morganlewis.com/circular230>.

This LawFlash is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius LLP. It should not be construed as, and does not constitute, legal advice on any specific matter, nor does this message create an attorney-client relationship. These materials may be considered **Attorney Advertising** in some states. Please note that the prior results discussed in the material do not guarantee similar outcomes.

© 2010 Morgan, Lewis & Bockius LLP. All Rights Reserved.