



# PAYROLL CURRENTLY

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## Federal Court Says Severance Payments Were Not FICA Wages

A U.S. District Court in Michigan, rejecting an IRS appeal of a Bankruptcy Court decision and the holding of the Federal Circuit Court of Appeals in *CSX Corp., Inc. v. U.S.* (see [PAYROLL CURRENTLY, Issue No. 6, Vol. 16](#)), has ruled that payments made to employees pursuant to an employer's severance plans were not "wages" for FICA (social security and Medicare) tax purposes [*U.S. v. Quality Stores, Inc.*, No. 1:09-cv-44, 2010 U.S. Dist. LEXIS 15825 (WD Mich., 2-23-10)]. The employer was not liable for FICA taxes on payments to employees upon their termination of employment because of the downsizing and subsequent closing of operations by the employer, even though the payments were not connected to or contingent on the recipients' eligibility for state unemployment compensation benefits. Accordingly, the employer was entitled to a refund.

### **Agricultural supplier provides severance, seeks FICA refund**

Quality Stores, Inc. operated a chain of retail stores specializing in agricultural supplies and related products. In 2001, Quality closed dozens of its stores, several distribution centers, and terminated many of the employees at its corporate office. Then, after filing a bankruptcy petition, Quality closed its remaining stores and distribution centers, and terminated all remaining employees.

**The severance plans.** Quality made payments to employees terminated both before and after the bankruptcy filing pursuant to severance plans maintained by the company.

Under Quality's prepetition plan, senior executives received 12-18 months of severance pay. All other employees received one week of severance pay for each full year of service. These payments were made on Quality's normal payroll cycle.

Under Quality's postpetition plan, officers received 6-12 months of severance pay. Employees who had been employed for at least two years received one week of severance pay for each full year of service up to a maximum of 10 weeks for salaried employees and 5 weeks for hourly employees. Workers who had been employed for less than two years received one week of severance pay, and the employees who were subsequently employed by the companies that purchased Quality's assets did not receive any severance pay. These amounts were paid in a lump sum.

None of the payments under either plan were connected to the receipt of state unemployment compensation, nor were they attributable to the rendering of any particular employment service.

**The FICA tax dispute.** Quality reported the severance payments as wages on the Forms W-2 issued to the employees, withheld federal income tax and the employees' share of FICA tax from the payments, and paid the employer's share of FICA tax with respect to the payments.

In 2002, Quality filed refund claims with the IRS, seeking to recover \$1,000,125 in allegedly overpaid FICA taxes.



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## **SUB pay exception to FICA wages: IRS position**

For purposes of FICA, IRC §3121 defines “wages” as “all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash.” However, the IRS has published guidance providing an exception to FICA taxation for certain payments made by an employer, conditioned on eligibility for and receipt of state unemployment benefits, referred to as “supplemental unemployment compensation benefits,” or “SUB” pay.

In a series of revenue rulings and private letter rulings beginning in 1956, the IRS took the position that SUB payments under particular plans were not wages for FICA purposes. Then in a 1990 revenue ruling, the IRS modified its position and said that SUB pay must be linked to the receipt of state unemployment compensation and must not be received in a lump sum in order to be excludable from the definition of wages for FICA purposes.

### **IRC §3402(o)**

IRC §3402(o), enacted in 1969, provides that “any supplemental unemployment compensation benefit paid to an individual ... shall be treated as if it were a payment of wages by an employer to an employee for a payroll period.” For purposes of this provision, “supplemental unemployment compensation benefits” are defined 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.”

### **Interpreting the statute**

The court said the severance payments in this case were wage replacement benefits and not remuneration for the employees’ services or wages. Therefore, they were not FICA-taxable.

Under §3402(o), any supplemental unemployment compensation is excluded from the definition of “wages” for tax withholding purposes. And the severance payments in this case met the statutory definition of “supplemental unemployment compensation benefits.”

**Rejecting IRS’ position on the treatment of SUB pay.** Although §3402(o) specifically relates to income tax withholding, it applies also to the question of whether SUB payments are wages for FICA tax purposes, said the court. The plain language and legislative histories of the relevant code sections indicate that Congress intended its definition to be interpreted in the same manner for FICA and FUTA as for income tax withholding – “in the interest of simplicity and ease of administration.”

While IRC §3121(a) allows the IRS to issue regulations distinguishing between exclusions in “wages” for income tax withholding and other tax purposes, the court said that no such regulations have ever been issued suggesting different treatment of SUB payments under the FICA and income tax withholding laws. It also noted that IRS revenue rulings do not override the specific provisions of the statute, a repudiation of the IRS’ position in Rev. Rul. 90-72 that SUB payments fit the §3402(o) definition only if



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they are connected to an employee's eligibility for and receipt of state unemployment compensation.

Moreover, "at some point a line is to be drawn on the taxation of employee financial benefits. ... At one end of the spectrum are social security benefits and at the other end of the spectrum are wages/earnings, and at the point on the spectrum where severance payments are intended to serve the same purpose as social security benefits ... the collection of social benefit taxes on the wage replacement benefits makes little sense."

**Rejecting CSX court's reading of the statute.** The court said the Federal Circuit Court's conclusion in the CSX case – that the language in §3402(o) stating that SUB pay "shall be treated as if it were a payment of wages by an employer to an employer for a payroll period" does not necessarily imply that no such payments are in fact wages – strains logic and ignores clear statutory provisions.

The clear import of §3402(o) is that any payment meeting the definition of "supplemental unemployment compensation benefits" is *not* considered to be "wages." Otherwise, the additional statement, "shall be treated as if it were a payment of wages," is not only unnecessary but also meaningless. If SUB pay already falls within the definition of "wages," there is no need to state that it shall be treated as if it were wages.

**COMMENT FROM APA'S TAX COUNSEL** – After the decision in *Quality Stores*, payroll professionals are faced with the same two basic questions they had to answer after the initial CSX decision. First, can payroll professionals simply stop collecting and paying FICA taxes on severance pay? And second, should companies file claims for credit or refund of FICA taxes already paid to the IRS?

Mary B. Hevener, tax counsel to APA and a partner at Morgan, Lewis and Bockius in Washington, DC, cautions payroll professionals not to stop collecting and paying FICA taxes on severance pay, unless the severance is paid under a "supplemental unemployment benefit plan" that complies with the IRS Revenue Rulings the court disregarded in *Quality Stores*. Otherwise, if the *Quality Stores* decision is overturned on appeal, the employer would owe the IRS both the employer and employee portions of FICA taxes. Arguably, the employer also may be required to treat its payment of the employee share of FICA taxes as *additional wages* to the former employee that are subject to income tax withholding, FICA, and FUTA taxes.

However, payroll professionals can and should continue to file refund claims for the FICA taxes they withhold and pay on severance pay. Ms. Hevener notes that many of the claims filed after the first CSX decision was issued have simply been held in abeyance for years. In recent months, however, the IRS has been issuing claim denial letters with respect to many of them. Ms. Hevener advises companies both to appeal the claim denials and to be sure that their refund claims have been filed for all years open under the statute of limitations. There is still time to file a claim for as far back as 2006, although the statute of limitations on FICA claims expires on April 15, 2010.