

IRS Hot Topics

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Sixth Circuit denies review of FICA refund claims decision on severance payments in Quality Stores

The U.S. Court of Appeals for the Sixth Circuit denied an IRS petition for *en banc* review on January 4, 2013 of a key decision in favor of the taxpayer on the tax treatment of supplemental unemployment compensation benefits ("SUB pay"). The IRS had filed its request for rehearing on October 18, 2012 in response to the Sixth Circuit's recent decision on September 7, 2012.

The Sixth Circuit held in favor of the taxpayer in *United States v. Quality Stores, Inc.* that the SUB payments made to former employees were not wages subject to social security and Medicare ("FICA") tax. Accordingly, the taxpayer and its former employees were entitled to a refund of all FICA taxes -- over \$1 million -- paid on the SUB payments.

It is likely that the IRS will continue to challenge the *Quality Stores* decision, and employers must take steps to protect their right to a refund of FICA taxes in the event there is a final determination that SUB payments are not wages for purposes of FICA taxes.

SUB pay

The issue in *Quality Stores* was whether SUB pay, a type of severance payment, is wages for FICA tax purposes. SUB pay is a severance payment made due to an employee's involuntary separation from employment that results directly from a reduction in force. Despite the broad definition of wages under the Internal Revenue Code, Section 3402(o) only treats SUB pay *as if it were wages*, indicating that it is not



wages but will be treated as such for income tax withholding purposes. The disagreement in interpretation between the IRS and Quality Stores arose because although the statute treats SUB pay as if it were wages for federal income tax withholding purposes, there is no corresponding FICA tax provision which applies similar treatment for FICA tax. The absence of similarly inclusive language or a specific exclusion has led to differences in approach between taxpayers and the IRS for income tax and FICA tax withholding.

In the decision rendered on September 7, 2012, the Sixth Circuit unanimously held in favor of the taxpayer that SUB payments are not wages subject to FICA tax. The court concluded that because SUB pay is not wages for purposes of income tax withholding, then the same definition applies and it is not wages for purposes of FICA. Since there is no corresponding provision to subject SUB pay to FICA tax withholding, like with income tax, withholding is not required. The result is that there is now disparate treatment in two of the U.S. Courts of Appeals. Most recently, the Sixth Circuit denied the IRS petition for review of the case by the full court.

What's next?

For the IRS

The IRS and Department of Justice may seek to appeal the decision and petition for certiorari to the United States Supreme Court. The ninety day window for filing an appeal will now

begin to run. Accordingly, the deadline for the IRS and Department of Justice to file a writ for certiorari is April 4, 2013.

Given the decision to seek full court review, it is likely that the IRS will request consideration by the Supreme Court and most certainly will continue to litigate this issue in other jurisdictions if a writ of certiorari (if any) is denied. The IRS could also address this issue on a prospective basis by promulgating regulations, as was noted in both *CSX* and *Quality Stores*. In any event, the dispute may continue for several years.

For employers

Employers need to ensure that the necessary steps have been taken to protect its right to file a claim for FICA on its own behalf as well as on the behalf of employees who received the SUB pay.

1. File protective claims

At a minimum, employers that made SUB payments during 2009 must file protective refund claims by April 15, 2013 for any FICA taxes associated with these SUB payments. A protective claim reserves the employer's claim to a refund in case the *Quality Stores* decision or this issue in general is resolved. A protective claim is relatively simple to file and is completed on Form 941-X, *Adjusted Employer's Quarterly Federal Tax Return or claim for Refund*. To be valid, a protective claim does not have to state a particular dollar amount but must have other information, such as

clearly alerting the IRS of the essential nature of the claim and identifying the contingencies affecting the claim.

2. Monitor the two-year period for filing suit

Employers that filed a protective claim have likely received a Notice of Claim Denial. A taxpayer has two years from the date of the Notice of Claim Denial to file a refund suit in the U.S. District Court or in the U.S. Court of Federal Claims. Alternatively, a taxpayer could file an administrative appeal within 30 days. Most employers take a "wait-and-see approach" on the resolution of the *Quality Stores* decision. Once the expiration of that two year window approaches, it is critical for taxpayers to file Form 907, *Agreement to Extend the Time to Bring Suit*, to preserve its position for either a potential settlement at IRS Appeals or for filing a refund suit.

3. Withhold on future severance payments

All employers that make severance payments in the coming months should continue to withhold and remit the employee and employer portions of FICA tax on severance payments that do not fit the narrow definition described in Revenue Ruling 90-72. Employers failing to withhold the required FICA taxes may be liable for both the employee and employer shares of those taxes and may be subject to penalties. The recommended approach is to continue to withhold and remit FICA taxes while taking the necessary steps to

preserve the company's right to a refund.

4. Maintain employee data

Many businesses adhere to strict data retention and destruction policies. It is possible that the resolution to this FICA matter may take several years. In the interim, plan documentation and employee-level wage data must be maintained and made available to support FICA claims that will need to be perfected before any refunds will be issued. In some instances, this will require coordination with third party service providers.

Conclusion

In summary, the *Quality Stores* decision and denial of the Sixth Circuit for *en banc* review should provide motivation for employers to implement a plan for recovering FICA on SUB pay. For now, most employers should undertake a few straightforward steps -- file protective claims, monitor the 2 year period for filing suit, continue to withhold on future SUB payments, and modify record retention policies.

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