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The Impact of *CSX Corp v. U.S.*: Saving FICA on Severance Payments

Last year, the Court of Federal Claims in *CSX Corporation v. United States* (Fed. Cl., No. 95-858T) (“CSX”) held that severance payments made pursuant to a reduction in force were “supplemental unemployment compensation” and, thus, were not “wages” for purposes of Federal Insurance Contributions Act (“FICA”) taxes. This decision may have a significant impact on employers that paid out significant severance in the last couple of years or are planning to do so. While *CSX* is not a final decision, an overview of the relevant authority and consideration of possible approaches for severance pay is warranted.

Background

Generally, “wages” for federal income tax purposes are defined substantially the same as wages for FICA purposes. The IRS has always viewed severance pay as “wages” under both statutory provisions. However, old IRS revenue rulings provide certain supplemental unemployment compensation benefits (“SUCBs”) are not subject to FICA withholding if they meet a number of requirements, including: eligibility contingent on state unemployment benefits eligibility, on account of layoff by the employer, the amount of severance plus unemployment may not exceed the employee’s base compensation, and payment from a trust or segregated account.

Since 1969, Section 3402(o) of the Code has required employers to withhold *income taxes* from SUCBs, defining “supplemental unemployment compensation benefits” 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.”

Significantly, Congress did not include such a provision in the FICA rules. As a result, SUCBs are generally not considered “wages” for FICA purposes.

CSX Corporation v. United States

In *CSX*, the Court of Federal Claims rejected the IRS’s narrow definition of what qualifies as a SUCB for FICA purposes. Severance payments were made by CSX Corporation under three types of reductions in force: (1) payments to laid-off employees; (2) payments to employees on reduced hour “standby”; and (3) payments to employees who voluntarily terminated for a severance package.

CSX paid the employer’s share of FICA tax and withheld and remitted the employee’s share on the severance payments. It then filed a claim for a refund of the FICA payments, claiming that the payments were SUCBs and, therefore, not subject to FICA. The IRS rejected CSX’s claim, and litigation ensued.

The Court addressed each of the three types of severance pay as follows:

(1) Employees Laid Off: Severance paid in connection with an involuntary separation from employment is not subject to FICA if it is paid in connection with a reduction in force or similar event.

(2) Employee Reduction in Hours: Since these employees were subject to recall on an as-needed basis and remained on CSX’s active service payroll, the court found no unemployment. According to the Court, there must be a bona fide and indefinite cessation of all services in order to avoid FICA taxes.

(3) Employees Volunteering for a Separation Package: Severance paid as part of a voluntary separation of employment is subject to FICA taxes.

CSX relaxed the standards for severance pay to qualify under the FICA exception for SUCBs if it is (1) pursuant to a plan for a reduction in force and (2) paid to employees who have been involuntarily separated from service. CSX does not define what is a “plan” or a “reduction in force”- terms still open to interpretation.

In November 2003, the *CSX* court was still hearing motions for cross summary judgment, and has not yet entered a final judgment. The IRS has not announced its future actions in response to *CSX*.

Employer Options to Save FICA Expense

Given the present uncertainty, employers can choose to pay FICA on all severance payments and wait for the *CSX* outcome. Employers interested in a more aggressive approach, can consider the following:

If Severance Payments Have Already Been Paid

If severance payments for involuntary reduction in force were made in 2000 or later, the employer may file a protective refund claim with the IRS, as did *CSX* Corporation. Employers have three years from April 15th following the calendar year in which a FICA tax payment is made to file a protective claim for a refund. FICA taxes paid on severance payments in 2000 may be claimed until April 15, 2004. A protective refund claim is relatively simple. Until the outcome of *CSX* is known, a protective claim and not a complete refund claim may be a reasonable investment of time and money.

If Severance Payments May Be Paid in the Future

The most aggressive approach would be to implement a reduction in force without collecting or paying FICA taxes. Until *CSX* is finally resolved, there are risks, including an IRS enforcement proceeding and a 10% penalty, plus interest, for failure to pay FICA. The IRS can also impose a 100% criminal penalty for the failure to pay FICA taxes, although the *CSX* case may establish a lack of intent to disobey the law.

A more conservative approach is to draft severance plans that conform, as much as possible, to the IRS's interpretation of what constitutes SUCBs and anticipate filing a refund claim when *CSX* is finally resolved. The more factors from IRS rulings on SUCBs that a severance plan can satisfy, the more likely that the severance pay would be exempt from FICA taxes. Design changes that would bolster an employer's position on FICA exemption include:

- ◆ Condition severance pay on eligibility for state unemployment benefits.
- ◆ Cut off severance pay if the individual obtains another job.
- ◆ Pay severance in installments. Lump sums do not qualify for FICA exemption.
- ◆ Pay severance from a segregated account.
- ◆ State in the plan documents that severance pay is not being issued in exchange for past services.
- ◆ Offset for unemployment compensation to meet the severance "cap" of installments of no more than base compensation.

If you have questions about severance payments and FICA withholdings or refund claims, please contact the Seyfarth Shaw employee benefits attorney with whom you work or any employee benefits group attorney listed on the website at www.seyfarth.com.

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