

One Minute Memo[®]



Severance Payments and FICA - the Saga Continues

On September 7, the Court of Appeals for the Sixth Circuit upheld the decision in *United States v. Quality Stores, Inc.*, finding that severance pay is generally not subject to Social Security and Medicare taxes under the Federal Insurance Contributions Act, or FICA. This decision keeps alive employers' hopes for a refund of the FICA that they have paid on severance, and employers who have not already filed for a refund should consider doing so.

The Story So Far ...

For the most part, the types of compensation that are subject to FICA are the same as the types that are subject to income tax withholding. However, there are a few types of compensation that are subject to withholding but not FICA, and one of these rare exceptions is a plan providing "supplemental unemployment benefits" ("SUB"). Not surprisingly, the IRS has taken a very narrow view of what constitutes SUB, ruling that severance must be coordinated with state unemployment benefits in order to qualify. However, in 2006, CSX Corporation persuaded the United States Court of Federal Claims that SUB includes all severance paid by reason of a reduction in force, plant closing or similar circumstance, and ordered the IRS to refund to CSX the FICA it had paid on payments under its severance plan.

This led many employers to file their own claims for refund, hoping to ride CSX's coattails. However, these hopes were dashed when the Court of Appeals for the Federal Circuit, which hears appeals from specialized courts like the Claims Court, sided with the IRS and reversed the CSX decision.

Hope was revived again when a bankruptcy court in Michigan in the *Quality Stores* case rejected the Federal Circuit's decision in CSX, and held that most severance plans are exempt from FICA; this decision touched off another round of employers filing refund claims. The IRS is now sitting on a large pile of these refund claims.

The *Quality Stores* Decision

The Sixth Circuit in the *Quality Stores* appeal rejected the IRS interpretation and the decision of the Federal Circuit in CSX, holding that any severance pay that is paid by reason of a reduction in force, plant closing or similar circumstances is exempt from FICA. This means there is now what lawyers refer to as a "split in the Circuits", which means that the issue will probably have to be resolved by the Supreme Court, possibly as early as next spring - unless the IRS can persuade Congress to "clarify" the law.

If the Supreme Court rules in favor of the Sixth Circuit, the IRS will then have to repay the FICA paid on severance payments by any employer that has filed a timely claim for refund.

Free Money!

In order to be eligible to receive a refund of the FICA paid on severance pay during a year, the employer generally must file its claim for refund within three years of the following April 15 (regardless of the employer's fiscal year). This means that it is still

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possible to file a claim for refund of FICA paid in 2009 and later, as long as the 2009 claim is filed by April 15, 2013. If the IRS ultimately prevails in court (or Congress), nothing is lost, but if the IRS loses an employer could get a nice refund check from the government. Filing the claim for refund is relatively simple and inexpensive, and no further action needs to be taken until the IRS rules on the claim (although at least one case has suggested that a suit for refund must be filed within six years after the right to a refund “accrues” even if the IRS has not acted on the claim). There have, however, been reports that the IRS started formally denying refund claims after it won the CSX appeal, and once the IRS issues a formal claim denial, the employer has two years to either file a lawsuit or enter into an agreement with the IRS extending the statute of limitations, or the employer will lose its claim. Whether the IRS will continue denying claims now that it has lost the *Quality Stores* appeal remains to be seen.

One question that some employers may be asking in light of *Quality Stores* is whether, instead of paying FICA on their severance plans and then filing for a refund, they should stop paying FICA on severance altogether, particularly if they are located in the Sixth Circuit (Kentucky, Michigan, Ohio and Tennessee). However, the problem with this is that an employer is not only responsible for paying its own share of FICA, but also for withholding the employee’s share. If the courts ultimately rule in favor of the IRS, an employer who has failed to withhold could be stuck paying FICA on behalf of its former employees as well as its own FICA obligations.

This also raises the question of whether an employer who wants to file a refund claim should only file for the refund of its own share of FICA, or whether it should file on behalf of its employees as well. Most employers have filed for a refund of the employer’s share only, and have left their former employees to file their own refund claims if they wish to do so. However, some employers have had their former employees authorize them to file refund claims for both the employer’s and employee’s shares and, if they receive the refund, will have to distribute the former employees’ shares to them.

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