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Employment Taxes

Supreme Court to Consider Whether Severance Payments Subject to FICA

The U.S. Supreme Court granted certiorari to the government in its challenge to a U.S. Court of Appeals for the Sixth Circuit decision that payments a company made to employees as part of a severance program weren't subject to Federal Insurance Contributions Act taxes (*United States v. Quality Stores, Inc.*, U.S., No. 12-01408, cert. granted 10/1/13).

The Sixth Circuit decision created a conflict with the holding by the U.S. Court of Appeals for the Federal Circuit in *CSX Corp. v. United States*, 518 F.3d 1328, 2008 BL 46216 (Fed. Cir. 2008), that the payments were dismissal pay subject to tax (106 DTR K-2, 6/3/13).

"It's not surprising that the government sought certiorari and that the court granted it," Pratik Shah, a partner at Akin Gump Strauss Hauer & Feld LLP in Washington and a former assistant to the U.S. solicitor general, told Bloomberg BNA Oct. 1. "The court is especially interested when there is a split in tax administration. It's particularly compelling when people have to pay a tax in one part of the country and not another part of the country," Shah said.

Ruth Wimer, a partner at McDermott Will & Emery LLP in Washington, said, "no one is surprised." The government's brief said more than \$1 billion in claimed refunds was at stake. Wimer told Bloomberg BNA Oct. 1 that "some people are saying the amount is closer to \$2 billion when you consider" the Federal Insurance Contributions Act tax is 15.3 percent.

Cases Suggested Review. "Both the Sixth and Federal Circuits were almost asking for the Supreme Court to look at it," Douglas Charnas, a partner with McGuire-Woods LLP in Washington, told Bloomberg BNA Oct. 1.

Charnas was referring to the Federal Circuit's statement in *CSX Corp.* that "the correct resolution of the issue is far from obvious," and the Sixth Circuit's comment that "the Supreme Court may ultimately provide us with the correct resolution."

Quality Stores argued in its reply brief, though, that there wasn't a true circuit split because the disagreement was between the Sixth and Federal circuits. Robert Kester, a partner at Goodwin Procter LLP in Boston, told Bloomberg BNA Oct. 1 that taxpayers will respond to the unfavorable Federal Circuit law by staying out of the Claims Court and filing refund claims in federal district courts.

"The Supreme Court likely concluded that further lower court development of the issue wasn't necessary and that it made sense to settle the issue," Kester said.

Sixth Circuit Decision. The Sixth Circuit distinguished between "income" subject to income tax withholding but not FICA and "wages" that are subject to FICA in addition to income tax withholding.

The Sixth Circuit found that the payments made pursuant to a plan to which Quality Stores was a party didn't constitute "wages" under tax code Section 3121(a), the section of FICA defining "wages," because the payments were supplemental unemployment compensation benefits (SUB) payments.

The Sixth Circuit cited tax code Section 3402(o) in the income tax withholding provisions, which expressly provides that SUB payments are subject to federal income tax withholding even though such payments aren't "wages" as defined by tax code Section 3401(a), which provides definitions applicable to withholding provisions.

Charnas said, "if the definition of income wasn't sufficient, there wouldn't be a need for Section 3402(o). The Sixth Circuit breaks down why 3402(o) is there. It's there because Congress thought FICA was broad enough."

"We have to live up to the fiction that Congress knows what it's doing," Charnas said. "Section 3402(o) was added because there was a concern that people wouldn't know that they needed to pay income tax on the severance pay and wouldn't make estimated payments."

Revenue Rulings. Wimer said the Internal Revenue Service could have adopted regulations to clarify that FICA applied to SUB payments but chose to issue revenue rulings instead.

Wimer said the rulings require that for SUB payments to be exempt from FICA, the payments must be linked to receipt of unemployment benefits. Most employers don't end payments just because the former employee got a new job, Wimer said.

Some taxpayers chose to challenge the IRS's interpretation in the revenue rulings that SUB payments were subject to FICA, and the Sixth Circuit agreed with the taxpayers, Wimer said.

Kester said, "the Sixth Circuit outcome was clearly at odds with the IRS position with respect to FICA taxation of severance pay in reduction-in-force situations, and there are many pending claims from employers located not only in the Sixth Circuit but elsewhere that are being held by the IRS pending final resolution of the Quality Stores case."

Possible Outcomes. Shah said, “you can’t read too much into the grant of cert. The court may not necessarily favor the government. Conformity is at issue, and the court may not have preconceived notions.”

“I would emphasize that the grant of review by the Supreme Court isn’t an indication of how it is likely to rule on the merits,” Kester said.

Shah said the taxpayers “have a strong case when I look at the textual and statutory argument in the Sixth Circuit—Section 3402(o) says ‘as if it were a payment of wages.’” Shah also said the Supreme Court “has taken broad construction of ‘wages’ so there could be an argument that the payments are wages.”

Wimer said the FICA definition of wages and the income tax withholding definition of wages “are broad

with no further drill down. There are very good arguments on both sides, but the IRS had the opportunity to clarify and didn’t do so in regulations.”

Wimer said taxpayers could still file protective refund claims for FICA taxes paid on severance for the 2010 through 2012 tax years.

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Text of the docket is at <http://www.supremecourt.gov/Search.aspx?FileName=/docketfiles/12-1408.htm>.