Clients&FriendsMemo

The Sixth Circuit Rules in *United States v. Quality Stores, Inc.* that Severance Payments Paid to Terminated Employees as a Direct Result of a Work Force Reduction Are Not Subject to FICA Tax

September 28, 2012

Introduction

Downsizing is a fact of life in the recent U.S. economy. Over the past several decades, employers have involuntarily terminated large numbers of employees and made severance payments totaling hundreds of millions of dollars to the departing workers. The Internal Revenue Service (the "IRS") and courts agree that severance payments are income to the employees and subject to federal income tax. However, the employment tax statutes, FICA for non-railroad employees and RRTA for railroad employees, impose employer and employee taxation on only one subset of "income": "wages" under FICA and "compensation" under RRTA,[1] both of which are generally defined as remuneration received for services rendered. Courts have generally held that normal severance payments are "wages," sometimes citing for support the legislative history to the Social Security Amendments of 1949 defining dismissal payments (any payment paid by an employer to an employee on account of an employee's involuntary separation from the service of the employer) as wages for FICA. But what about severance payments paid to employees as a direct result of a work force reduction? In 1990 the IRS ruled that lump sum severance payments paid to employees who were involuntarily separated as a direct result of a work force reduction were wages for FICA and compensation for RRTA because they were indistinguishable from dismissal payments.[2] Earlier this month, the Sixth Circuit disagreed, holding that work force reduction

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1 FICA is shorthand for the Federal Insurance Contributions Act. RRTA is shorthand for the Railroad Retirement Tax Act. Both impose employment tax on the employer and the employee. The principal difference between the FICA and RRTA regimes are in the rates of tax. For 2012, the FICA employer tax rate is 6.2% on wages up to $110,100, and the FICA employee tax rate is 4.2% on the same wage base (the 2% reduction in the FICA employee tax rate will expire on January 1, 2013, unless Congress chooses to extend it). In addition, FICA employers and employees are subject to a 1.45% Medicare tax on all earnings without cap. For 2012, these same FICA tax rates and caps are incorporated in the RRTA regime as Tier I taxation. RRTA also incorporates the 1.45% Medicare tax on both employers and employees. In addition, RRTA has a Tier II tax. The 2012 RRTA Tier II tax on employees is 3.9% on $81,900 of wages, and the 2012 RRTA Tier II tax on employers is 12.1% on $81,800 of wages. As seen from these different rates, RRTA taxation is more onerous on railroad employees than FICA taxation on non-railroad employees, and RRTA taxation is significantly more onerous on railroad employers than FICA taxation on non-railroad employers.

2 Rev. Rul. 90-72, 1990-2 C.B. 211.

severance payments are not dismissal payments, but non-wage supplemental unemployment compensation benefits ("SUB payments") that are not subject to FICA tax. The Sixth Circuit reached its decision after careful examination of a half century of IRS pronouncements, the FICA and federal income tax withholding statutes and legislative history, and relevant Supreme Court precedent. In reaching its decision, the Sixth Circuit declined to follow a contrary 2008 Federal Circuit decision that similar work force reduction severance payments were taxable wages under FICA under controlling IRS guidance.

The Sixth Circuit case is *United States v. Quality Stores, Inc.,* No. 10-1563, 2012 WL 3871364, (6th Cir. Sept. 7, 2012) ("*Quality Stores*"), in which a three-judge panel unanimously affirmed the lower court's decision that the severance payments at issue were not subject to FICA tax.[3] The United States has not yet announced whether it will seek a panel or *en banc* rehearing, or U.S. Supreme Court review of the Sixth Circuit's decision by filing a petition for a writ of certiorari.[4] In order to be timely, a petition for a rehearing must be filed within 45 days after entry of judgment, unless a court order shortens or extends the time. In order to be timely, a petition for a writ of certiorari must be filed within 90 days after entry of the judgment, unless the government files a petition for rehearing by the Sixth Circuit, in which case the 90 day period would run from the date of the denial of the petition for rehearing or, if rehearing is granted, from the date of the subsequent entry of judgment.

Factual and Procedural Background

Quality Stores was the largest agricultural implement retailer in the United States, serving farmers, hobby gardeners, skilled trade persons, and do-it-yourself customers. Prior to and pursuant to a bankruptcy reorganization, Quality Stores closed all its 374 stores, all its distribution centers, and terminated the employment of all its employees. Quality Stores made severance payments to those employees whose employment was involuntarily terminated. The government and Quality Stores agreed that all the severance payments resulted directly from a reduction in force or the discontinuance of a plant or operation.

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[3] In 2008, a U.S. bankruptcy court ordered the United States to make refund of the employer and employee FICA taxes that the employer had paid (employer tax) and withheld and remitted (employee tax) to the IRS. *Quality Stores, Inc. v. United States (In re Quality Stores, Inc.)*, 383 B.R. 67 (Bankr. W.D. Mich. 2008). The bankruptcy court decision was appealed to federal district court, which affirmed the bankruptcy court decision in 2010. *United States v. Quality Stores, Inc. (In re Quality Stores, Inc.)*, 424 B.R. 237 (W.D. Mich. 2010). Although the Sixth Circuit affirmed the decision of the federal district court, the court noted that on an appeal from a district court judgment in a case that originated in bankruptcy court, the Sixth Circuit reviews the bankruptcy court's decision directly, without giving any deference to the district court's decision.

[4] On September 14, 2012, IRS deputy division counsel and deputy associate chief counsel (Tax-Exempt and Government Entities) told the American Bar Association Section of Taxation meeting in Boston that the government was still deciding whether to seek a Sixth Circuit rehearing or seek certiorari to the Supreme Court. *Tax Notes Today*, September 17, 2012.

Severance payments were paid under both a Pre-Petition Severance Plan and a Post-Petition Severance Plan. Payments made under neither plan were tied to the receipt of state unemployment benefits, nor were they attributable to the provision of any particular services. Payments under the Pre-Petition Plan were paid periodically under the normal payroll schedule. Payments under the Post-Petition Plan were paid in a lump sum because the affiliated companies were liquidating and it was not feasible to pay the amounts over time. Neither Plan required employees to be unemployed to receive the payments. The Plans covered both management and hourly employees. Under the Pre-Petition Plan, salaried employees received an average of 11.4 weeks of severance pay and hourly employees an average of 4.2 weeks of severance pay. Under the Post-Petition Plan salaried employees received 5.2 weeks of severance pay, while hourly employees received 3.1 weeks of severance pay.

Because the severance payments constituted gross income to the employees for federal income tax purposes, Quality Stores reported the payments as wages on W-2 forms and withheld federal income tax. Quality Stores also paid the employer portion of the FICA tax (approximately $571,000) and withheld and remitted to the government the employee portion of the FICA tax (approximately $429,000). Because Quality Stores did not agree with the IRS's current ruling position that the severance payments constituted wages for FICA purposes, Quality Stores and affiliates (the "Taxpayer") filed claims for refund[5] of both the employer tax and, to the extent that they had obtained written permission from employees to file claims on their behalf, the employee tax as well. In their claims for refund, the Quality Stores companies took the position that the severance payments were not wages but instead constituted SUB payments that were not taxable under FICA. When the IRS neither granted nor denied the refund claims, the Taxpayer filed an adversary action in bankruptcy court in 2005.[6]

The bankruptcy court agreed with the Taxpayer that the severance payments were nontaxable SUB payments under FICA and ordered the IRS to refund the overpaid taxes to the debtors' bankruptcy estate. A central difficulty in the case was that neither the FICA statute nor Treasury regulations published under the statute addressed SUB payments. The bankruptcy court's decision for refund rested on four points: (1) the severance payments satisfied the definition of a SUB payment contained in section 3402(o) of the Internal Revenue Code of 1986, as amended, (the "Code"); (2) a SUB payment as defined in section 3402(o) is a non-wage payment that is only treated for income tax withholding purposes as if it were a payment of wages in order to avoid burdening the

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5 While returns and refund claims with respect to federal income taxes are filed on a consolidated basis, employment tax returns and refund claims are filed on a separate company basis. A Quality Stores holding company and ten affiliates were the debtors. A total of 15 refund claims were filed by four of the affiliates.

6 *Quality Stores, Inc. v. United States (In re Quality Stores, Inc.)*, 383 B.R. 67 (Bankr. W.D. Mich. 2008).

recipient employee with a large income tax liability at the end of the year;[7] (3) the Supreme Court's conclusion in *Rowan Cos. v. United States*, 452 U.S. 247 (1981) that "'Congress intended 'wages' to mean the same thing under FICA . . . and income tax withholding'" (because the definitions of the term in the two statutes are nearly identical) mandates that a non-wage payment for withholding must also be treated as a non-wage payment for FICA when the FICA statute is silent on the subject; and (4) The Social Security Amendments of 1983 did not change this result because those amendments only authorized Treasury to promulgate different exclusions from wages under the two statutes, not different definitions of wages, and, in any event, no regulations have been published. The bankruptcy court predicated its analysis and conclusions largely on a 2002 decision by the United States Court of Federal Claims in *CSX Corp. v. United States*, 52 Fed. Cl. 208 (Fed. Cl. 2002).[8]

Shortly after the bankruptcy court decision, the Federal Circuit reversed the *CSX* decision.[9] The Federal Circuit concluded that the language in the income tax withholding statute that a SUB payment is to be "treated as if it were a payment of wages" did not necessarily mean that all SUB payments as defined in section 3402(o) are non-wage payments. SUB payments could be wages or non-wages, the Federal Circuit reasoned, because in either instance they would be subject to federal income tax withholding, and the statutory language was ambiguous. However, it was clear to the Federal Circuit that Congress's only concern was to solve a withholding problem, and this suggested that "Congress did not intend that" section 3402(o) "be applied outside the context of income tax withholding." Since neither Congress nor Treasury had addressed SUB payments under FICA, the Federal Circuit concluded that SUB payments for employment tax purposes are defined by the IRS's published rulings on the subject. The court noted that under the SUB plan described in the first of these rulings, published in 1956, the payments, among other characteristics, were paid from independent trust funds and their amount was based on the amount of the employee's unemployment compensation benefits and the employee's weekly pay.[10] Under a 1977 ruling, the court noted that the receipt of the SUB payments could not disqualify the recipient from receiving state unemployment benefits.[11] Under the last of these rulings, published in

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[7] Congress wanted to treat SUB payments as wages (without defining them as wages) so that federal income tax would be withheld during the year without also subjecting the payments to FICA tax, which would have been the case if Congress had defined SUB payments as wages.

[8] CSX was represented by David W. Feeney and Burton Spivak of Cadwalader, and the late Stephen N. Shulman.

[9] *CSX Corp. v. United States*, 518 F. 3d 1328 (Fed. Cir. 2008). David W. Feeney, Burton Spivak and the late Stephen N. Shulman also represented CSX on its appeal to the Federal Circuit. The *Quality Stores* bankruptcy case was decided on February 21, 2008. The Federal Circuit decided the *CSX* case on March 6, 2008. The Federal Circuit also held that the payments at issue in the *CSX* case were "compensation" for RRTA to the extent that the payments were paid to railroad employees.

[10] Rev. Rul. 56-249, 1956-1 C.B. 488.

[11] Rev. Rul. 77-347, 1977-2 C.B. 362.

1990,[12] the court noted that a SUB payment could not be received in a lump sum and had to be linked to state unemployment compensation benefits. All in all, the Federal Circuit concluded that payments could not be excluded from taxation under FICA unless they were paid "under a plan having similar characteristics to the one in Rev. Rul. 56-249."

On the basis of the Federal Circuit's *CSX* decision, the government filed a motion for reconsideration of *Quality Stores* with the bankruptcy court.[13] Upon reconsideration, the bankruptcy court ratified its previous decision.[14] The government then appealed to the federal district court for the Western District of Michigan which, despite the contrary Federal Circuit decision, affirmed the bankruptcy court's decision, holding that the "treated as if it were a payment of wages" language in section 3402(o) clearly meant that SUB payments were not wages but were merely being treated as wages to allow federal income tax withholding, a statutory meaning that the court thought was confirmed by legislative history stating that a special withholding rule was necessary precisely because the payments "do not constitute wages or remuneration for services" and would not be subject to withholding without the enactment of a special legislative rule. The *Quality Stores* district court also held that since SUB payments are defined as non-wage payments for purposes of federal income tax withholding, they are also non-wage payments for purposes of FICA under the Supreme Court's decision in *Rowan*,[15] and that the 1983 Social Security Amendments did not change this result. Regarding the Federal Circuit's statutory interpretation that section 3402(o) included both wage and non-wage SUB, the district court stated: "With all due respect to the Federal Circuit, [that interpretation] strains logic and effectively ignores clear statutory language." Accordingly, the court affirmed the bankruptcy court's decision for refund. The United States appealed to the Sixth Circuit. Oral argument was held in October 2011. The Sixth Circuit affirmed the 2010 district court decision in a decision that was decided and filed on September 7, 2012.

The Sixth Circuit Decision in Quality Stores

The Sixth Circuit began its analysis with a reminder that while the term "wages" is defined in the FICA statute, neither that statute nor Treasury regulations expressly include, or exclude, SUB payments within, or from, the definition of wages.[16] However, the Congressional definition of wages

[12] Rev. Rul. 90-72, 1990-2 C.B. 211. This ruling revoked that portion of Revenue Ruling 77-347 that had ruled to the contrary. The 1990 revenue ruling did not affect the payments at issue in the *CSX* case because they were made before the effective date of the ruling.

[13] The motion was filed on May 16, 2008.

[14] The ratification order was dated August 29, 2008.

[15] *Rowan Cos. v. United States*, 452 U. S. 247 (1981).

[16] The definition of wages in FICA is a two-part definition. First "wages" is defined as "all remuneration for employment." I.R.C. §3121(a). Second, employment" is defined as "any service, of whatever nature, performed . . . by an employer for the person employing him." I.R.C. 3121(b).

in the federal income tax withholding statute is nearly identical to the Congressional definition of wages in FICA,[17] the court also reminded, and the federal income withholding statute does contain a definition of a SUB payment. The questions for the court became whether (1) the severance payments at issue satisfied the congressional definition of SUB payments contained in section 3402(o) of the Code, (2) Congress regarded these payments as wages or non-wage payments for purposes of federal income tax withholding, and (3) the federal income tax withholding answer to the second question also applies to FICA.

First, the federal income tax withholding statute defined SUB payments 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."[18] The court gleaned from this definition five statutory requirements. A SUB payment must be: (a) an amount paid to an employee; (b) pursuant to an employer's plan; (c) because of an employee's involuntary separation from employment, whether temporary or permanent; (d) resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions; and (e) included in the employee's gross income. The court held that the severance payments at issue in *Quality Stores* qualified as SUB payments because they satisfied all five statutory requirements. The court also held that there were no other statutory requirements for SUB payment treatment, specifically that the statute does not require SUB payments to be tied to an employee's receipt of state unemployment compensation benefits and does not exclude from SUB treatment one-time payments made in a lump sum.[19] As noted above, both these restrictions – the requirement of a payment's tie to state unemployment benefits and the prohibition against lump sum payments – had been hallmarks of the IRS's ruling policy since at least 1990.[20]

Second, the court held that SUB payments were not wage payments under the income tax withholding statute. Focusing on the statutory words in section 3402(o)(1) that a SUB payment

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[17] The withholding statute defines "wages" as "all remuneration . . . for services performed by an employee for his employer … including the cash value of all remuneration (including benefits) paid in any medium other than cash." I.R.C. § 3401(a).

[18] I.R.C. §3402(o)(2)(A). The statutory definition is repeated in the corresponding Treasury Regulation, §31.3401(a)-1(b)(14)(ii).

[19] The court buttressed its argument with Code section 501(c)(17), enacted in 1960, which provided an income-tax exemption for SUB trusts. The court noted that the definition of a SUB payment contained in this statute "closely mirrors" the definition in section 3402(o). The court also pointed out that Congress was aware that employers had developed a variety of SUB plans, and Congress wished to facilitate SUB plans because they provided worthwhile benefits. Furthermore, while acknowledging that the definition of "service performed by an employee "is broad, the court also relied on the Supreme Court's "particular instruction" in *Coffy* that "SUB pay falls outside the broad statutory meaning of services performed . . . because, by definition, an employee is not eligible for SUB pay until service to the employer has ended and such benefits provide compensation for the lost job." *Coffy v. Republic Steel Corp.*, 447 U.S. 191 (1980).

[20] Rev. Rul. 90-72, 1990-2 C.C. 211.

"shall be treated as if it were a payment of wages by an employer to an employee for a payroll period," the court concluded that "the necessary implication arising from this phrase is that Congress did not consider SUB payments to be 'wages', but allowed their treatment as wages to facilitate federal income tax withholding for taxpayers." To the extent that any argument could be made that these operative words might be ambiguous, the court held the title of the statute[21] and the statute's legislative history[22] removed any potential ambiguity.

Third, the court held that if SUB payments are not wages for federal income tax withholding purposes, then they are also not wages under the nearly identical definition of that term found in the FICA statute. The court based this holding on the application of *Rowan*, the Supreme Court decision that had held that Congress intended the term "wages" to carry the same meaning for purposes of FICA and federal income tax withholding because the wage definitions in both statutes were virtually identical. The court also rejected the government's contention that Congress legislatively superseded *Rowan* when it enacted the "decoupling amendment" as part of the Social Security Amendments of 1983. The government placed heavy stress on legislative history to this act, which states that "the determination whether or not amounts are includible in the Social Security wage base is to be made without regard to whether such amounts are treated as wages for income tax withholding purposes. Accordingly, an employee's 'wages' for Social Security tax purposes may be different from the employee's 'wages' for income tax withholding purposes." The problem with the government's reliance on the legislative history, the court observed, was that Congress actually legislated more narrowly in the 1983 Amendments, only authorizing Treasury to publish regulations adopting different "exclusions" from wages under each statute, not different definitions of wages themselves.[23] Because the language of the "decoupling amendment" was "incongruent with its legislative history," the court concluded that Congress did not statutorily supersede *Rowan* in 1983, and *Rowan* remains good law.[24]

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[21] The title of §3402(o) is "Extension of withholding to certain payments other than wages."

[22] The legislative history states that before the enactment of section 3402(o), SUB payments were not subject to withholding "because they do not constitute wages or remuneration for services." According to the court, "Congress stressed that although these benefits are not wages, since they are generally taxable payments they should be subject to withholding to avoid the final tax payment problem for employees."

[23] The court also pointed out that, to date, Treasury has not published any regulations authorized by the decoupling amendment. Other subsections of the withholding statute allow for withholding with respect to certain payments for annuities and sick pay listed in §3402(o)(1)(B) & (C). The government also argued that it would have been unnecessary for Congress to exclude annuity payments and sick pay from the FICA definition of "wages" if they were already considered non-wages for FICA purposes. The court rejected this argument for the same reason that the lower court in *Quality Stores* and the trial court in the *CSX* case rejected the argument: SUB payments were non-wage payments to start with, and therefore did not require a specific FICA exclusion.

[24] The court also noted that while the Federal Circuit in the *CSX* case "agrees with us" that *Rowan* remains good law," the Federal Circuit nonetheless "confined the congressional definition of SUB pay in I.R.C. §3402(o) to federal income tax withholding only and did not rely on *Rowan* to conclude that the same statutory definition applies to FICA tax. . . . By contrast, to the analysis of the Federal Circuit, we rely on *Rowan* to reach the conclusion that if Congress decided to treat

The Sixth Circuit thus rejected the IRS's and the Federal Circuit's contrary conclusions.

With regard to IRS guidance, the court noted that the IRS's most recent published revenue ruling, Rev. Rul. 90-72, asserted the position that the "definition of SUB pay under section 3402(o) is not applicable for FICA" and that "Sub pay is defined solely through a series of administrative pronouncements published by the Service."[25] The Sixth Circuit rejected the IRS's claim that it, and not Congress, controlled the definition of SUB. The court's short answer to the IRS was that payments that satisfy the congressional definition of section 3402(o) are, for purposes of FICA, nontaxable SUB payments, and not taxable dismissal pay.[26] Its longer answer was that while courts may give deference to longstanding and reasonable revenue rulings, no deference need be given to the IRS's SUB payment revenue rulings because "the IRS has not taken congressional intent fully into account."[27]

With regard to the Federal Circuit's decision in the *CSX* case, the Sixth Circuit concluded that the Federal Circuit had adopted the IRS standards contained in Revenue Rulings 56-249 and 90-72 "rather than the express statutory definition provided by Congress in §3402(o). . . . By contrast, we resolve the tension between statutory enactments and the IRS revenue rulings in favor of the expressed will of the legislature."

Conclusion

Based on the Sixth Circuit's decision in *Quality Stores*, taxpayers in that circuit should strongly consider filing refund claims for payments similar to those described in *Quality Stores*. All other taxpayers should also consider filing refund claims, at least on a protective basis, for similar types of payments for all open years and, where appropriate under all their particular circumstances, consider entering into agreements with the IRS to extend the statute of limitations to permit the preparation and filing of such refund claims. While the IRS will probably not acquiesce to the Sixth Circuit's *Quality Stores* decision, and probably will deny all claims for refund filed outside the Sixth Circuit (and perhaps in the Sixth Circuit as well), a timely filed refund claim is a requirement for later

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SUB payments as if they were 'wages' for purposes of federal income tax withholding, then the same definition must apply to FICA."

[25] The IRS intended its 1990 revenue ruling to restore the distinction that it believed a prior IRS revenue ruling had blurred between SUB pay (a narrow exclusion from wages) and dismissal pay, a broader concept that included severance pay and had long been subject to FICA taxation. The prior ruling was Rev. Rul. 77-347, 1977-2 C.B. 362.

[26] The 1949 Social Amendments, quoted by the court, stated that "a dismissal payment, which is any payment made by an employer on account of involuntary separation of the employee from the service of the employer, will constitute wages . . . irrespective of whether the employer is, or is not, legally required to make such payment."

[27] The court noted that The Supreme Court decision in *Mayo Found. for Med. Educ. & Research v. United States*, 131 S. CT. 704 (2011), dealing with deference the courts owe to a treasury regulation, "adds nothing of significance to our legal analysis."

filing a refund suit either in the United States Court of Federal Claims or the appropriate federal district court. It is important for taxpayers to preserve their rights to file administrative refund claims and refund suits, especially if the government seeks Supreme Court review, the Supreme Court decides to hear the appeal, and the Supreme Court affirms the Sixth Circuit's decision in *Quality Stores*.

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