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## ***US Supreme Court ends controversy over application of FICA tax to severance payments with unanimous decision for the government***

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### ***In brief***

In a unanimous decision, the US Supreme Court on March 25 brought an abrupt end to thousands of existing Federal Insurance Contributions Act (FICA) tax refund claims potentially worth billions of dollars. As far back as 2002, employers had sought refunds of FICA taxes paid on severance payments made to employees terminated as part of down-sizing.

The Court's 8-0 decision in *US v. Quality Stores* ends the debate as to whether broad classes of termination payments are excluded from FICA taxes. The administrative process has terminated for all previously denied refund claims. Further, since a legal basis supporting those claims no longer exists, the IRS will deny all pending claims.

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### ***In detail***

#### ***Background: A long road***

In 2002, the Court of Federal Claims decided a FICA tax refund claim in favor of CSX, concluding that the definition of supplemental unemployment compensation benefits (SUB pay) for income tax withholding purposes also applied for FICA purposes. *CSX v. US*, 52 Fed. Cl. 208 (2002). The definition applied by the Claims Court was significantly more expansive than the definition of SUB pay adopted by the IRS in revenue rulings. The Claims Court decision led to thousands of claims for refund (CSX claims)

of FICA paid on termination payments. The IRS began suspending CSX claims until the Court of Appeals for the Federal Circuit decided the matter.

In April 2008, the Federal Circuit overruled the Claims Court. *CSX v. US*, 518 F.3d 1328 (Fed. Cir. 2008). Because the Federal Circuit decision was not appealed, it appeared that the issue of the proper definition and scope of SUB pay was resolved, and the IRS began denying CSX claims.

Thereafter, at the government's request, a district court chose to review a bankruptcy court decision analyzing the identical

legal issue. *In re: Quality Stores, Inc.*, 424 B.R. 237 (W.D. Mich. 2010). The district court considered the Federal Circuit's decision and expressly came to the opposite conclusion. The district court's decision thus resurrected the long-standing issue regarding the treatment of severance payments that was thought to have been resolved by the Federal Circuit.

The government sought review of the district court's decision in the Sixth Circuit Court of Appeals. A unanimous Sixth Circuit panel, ruling for the taxpayer, *Quality Stores*, rejected the government's

arguments and the Federal Circuit's rationale articulated in *CSX v. U.S. In re: Quality Stores, Inc.*, 693 F.3d 605 (2012). The government asked the Supreme Court to review the Sixth Circuit's decision in light of the split between the Sixth Circuit and the Federal Circuit and the large dollar amount at issue. The Supreme Court granted certiorari on October 1, 2013.

### ***The Supreme Court's decision***

On March 25, the Supreme Court decided the case unanimously in favor of the government. *US v. Quality Stores, Inc.*, 2014 WL 1168968 (U.S. Mar 25, 2014). Central to the dispute were the definition and tax treatment of SUB pay in Internal Revenue Code Section 3402(o), which contains rules for income tax withholding.

The Sixth Circuit had held that the payments are not wages for purposes of FICA. Instead, it gave weight to the definition of SUB pay in Section 3402(o). That provision defines SUB pay for purposes of income tax withholding 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..., resulting directly from a reduction in force, the discontinuance of a plant or

operation, or other similar conditions..."

The Sixth Circuit had concluded that payments meeting the definition of SUB pay were not wages for FICA purposes. The Supreme Court disagreed and concluded that the text of Section 3402(o) (part of Chapter 24 of the IRC, dealing with income tax withholding) does not require that the FICA (Chapter 21 of the IRC) wage definition be interpreted to exclude from 'wages' all payments that would satisfy the definition of SUB in Section 3402(o)(2)(A).

While explicitly not deciding whether the IRS has properly excluded a narrow class of payments from FICA tax in its existing ruling position, the Supreme Court noted that the IRS still provides that severance payments tied to the receipt of state unemployment benefits are exempt from FICA.

In Rev. Rul. 90-72, the IRS concluded that SUB pay, to be excludable from the definition of wages for FICA purposes, not only must meet the requirements of Section 3402(o), but also must be linked to the receipt of state unemployment compensation and cannot be received in a lump sum. Businesses meeting this more narrowly construed definition of SUB

pay may continue to exclude such payments from FICA.

### ***The takeaway***

#### ***Going forward***

Thousands of employers have filed 'protective' FICA tax refund claims, with some claims stretching back as far as 2002. Some employers filed perfected refund claims, stating a specific dollar amount at issue. All existing *CSX* or *Quality Stores* claims no longer have a legal basis for proceeding. No action is required to withdraw existing or pending claims. The IRS has denied or will deny these claims. The IRS Notice of Denial is a final administrative decision that allows the employer two years to seek judicial review.

In some cases, employers have entered into an agreement with the IRS to extend the statute of limitation for filing suit (using a so-called 907 Letter). However, the *Quality Stores* rationale for seeking judicial review of denied claims no longer has merit. Thus, it is anticipated that employers that have right to file a suit in federal court simply will allow the statute of limitations to expire. Supplemental unemployment compensation benefit plans that meet the requirement of Rev. Rul. 90-72 remain exempt from FICA.

### ***Let's talk***

If you have any questions regarding the *Quality Stores* decision or its impact on employers, please contact one of the individuals listed below or a member of your local Tax Controversy and Regulatory Services practice:

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