

# IRS Hot Topics

A Washington National Tax Services (WNTS)  
Publication

October 22, 2012

## Quality Stores generates renewed interest in FICA refund claims on severance payments

### *In brief*

The IRS filed a petition on October 18, 2012 for en banc review by the US Court of Appeals for the Sixth Circuit of a key decision in favor of the taxpayer on the tax treatment of supplemental unemployment compensation benefits (SUB pay). The Sixth Circuit recently held on September 7, 2012 in *United States v. Quality Stores, Inc.* that the SUB payments made to former employees were not wages subject to social security and Medicare (FICA) tax. As a result, Quality Stores and its former employees were entitled to a refund of all FICA taxes—over \$1 million—paid on the SUB payments.

While the decision was favorable for Quality Stores and its employees, it is unclear whether and when other employers that also made SUB payments might realize any benefit

from the decision. What is clear, though, is that the IRS will continue to challenge the *Quality Stores* decision, and employers must take steps to protect their right to recover FICA taxes in the event there is a final determination that SUB payments are not wages for purposes of FICA taxes.

### *The issue*

The disagreement in *Quality Stores* was whether a type of severance payment, SUB pay, is wages for FICA tax purposes. SUB pay is a severance payment made due to an employee's involuntary separation from employment that results directly from a reduction in force.

Despite the broad definition of wages under the Code, Section 3402(o) only treats SUB pay *as if it were wages*, indicating that it is not wages but will



be treated as such for income tax withholding purposes. The policy rationale behind this treatment was that the payment is generally taxable to the recipient and, without withholding. The severance recipient may likely owe additional taxes when filing his or her individual tax return.

Although the statute treats SUB pay as if it were wages for federal income tax withholding purposes, there is no corresponding FICA tax provision which applies similar treatment for FICA tax. Additionally, there is no specific provision in the Code excepting these severance payments from FICA wages. The absence of similarly inclusive language or a specific exclusion has led to differences in approach between taxpayers and the IRS for income tax and FICA tax withholding. The stated IRS position in Revenue Ruling 90-72 is that SUB pay made to former employees should be subject to FICA tax withholding unless the payment meets two additional requirements:

- (1) the payments are linked to the receipt of state unemployment compensation
- (2) the payments are not received in lump sum. Absent those criteria, the IRS would treat the SUB pay as wages FICA tax withholding.

## *Background*

The question of how to treat SUB payments was addressed in 2008 by

the US Court of Appeals for the Federal Circuit. The Federal Circuit held that SUB payments were wages for FICA tax purposes and subject to withholding unless certain exceptions applied. *CSX Corp. v. United States*, 518 F.3d 1328 (Fed. Cir. 2008). The exceptions articulated by the IRS and supported by the decision were those severance payments meeting the requirements described in Revenue Ruling 90-72.

In this most recent case, Quality Stores, Inc. operated a chain of retail stores and experienced a widespread downturn during 1999 through 2002. Quality Stores made severance payments to certain former employees, withheld federal income tax and FICA tax from those payments, and reported the remuneration as wages on the recipients' Forms W-2, *Wage and Tax Statement*.

In September 2002, Quality Stores claimed a FICA tax refund that included the employer and employee portion of FICA tax plus interest paid on these SUB payments. (Quality Stores only sought the employee portion of FICA for the former employees who consented to allow Quality Stores to pursue the request on their behalf.) The IRS did not allow or deny the refund claims. In response, Quality Stores filed an adversary action seeking a refund in the Michigan Bankruptcy Court. *In re: Quality Stores, Inc.*, 383 BR 67 (Bkrtcy. WD Mich. 2008).

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The Bankruptcy Court and more recently upon appeal, the US District Court for the Western District of Michigan, held in favor of Quality Stores, pointing to the reasoning articulated by the US Court of Federal Claims in *CSX Corp. v. United States*. *In re: Quality Stores*, 424 BR 237 (WD Mich. 2010). The IRS appealed.

In the decision rendered on September 7, 2012, the Sixth Circuit unanimously held in favor of the taxpayer that SUB payments are not wages subject to FICA tax. The court concluded that because SUB pay is not wages for purposes of income tax withholding, then the same definition applies and it is not wages for purposes of FICA. Since there is no corresponding provision to subject SUB pay to FICA tax withholding, like with income tax, withholding is not required. The result is that there is now disparate treatment in two of the US Courts of Appeals. Now, the full court for the Sixth Circuit will review the decision in this case.

## *What's next?*

### For the IRS

The *Quality Stores* decision reinvigorated the focus on the SUB pay controversy. In light of the two different opinions reached in the US Court of Appeals for the Federal Circuit and Sixth Circuit, the IRS took steps last week to continue to pursue its position that FICA tax applies to SUB pay. The IRS clearly articulated its opposition to the *Quality Stores* decision by requesting en banc review

by the Sixth Circuit. The petition for full court review notes that \$120 million is at stake in pending refund suits with over \$1 billion at issue when the IRS takes into account all potential claims. The IRS also stated in the petition that it has suspended administration action on refund requests for approximately 800 taxpayers given the uncertainty. Accordingly, the scope of this decision is broader than the Sixth Circuit jurisdiction: Michigan, Ohio, Tennessee, and Kentucky.

If the full court upholds the recent decision in favor of the taxpayer, the IRS and Department of Justice may seek to appeal the decision and petition for certiorari to the United States Supreme Court. Prior to the IRS petition for full court review by the Sixth Circuit, the IRS and the Department of Justice had ninety days from the September 7th decision to petition for certiorari to the United States Supreme Court. The ninety day window for filing an appeal now will not begin to run until the date of the resolution of the rehearing petition in the Sixth Circuit.

Given the decision to seek full court review, it is likely that the IRS will continue to litigate this issue in other jurisdictions if the full panel rules in the Taxpayer's favor and if a writ of certiorari is denied. The IRS could also address this issue on a prospective basis by promulgating regulations, as was noted in both *CSX* and *Quality Stores*. In any event, the dispute may continue for several years.

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### For employers

While the rehearing petition is pending, employers need to ensure that the necessary steps have been taken to protect its right to file a claim for FICA on its own behalf as well as on the behalf of employees who received the SUB pay.

#### 1. File protective claims

At a minimum, employers that made SUB payments during 2009 must file protective refund claims by April 15, 2013 for any FICA taxes associated with these SUB payments. The protective claim is filed on Form 941-X, *Adjusted Employer's Quarterly Federal Tax Return or claim for Refund*, to reserve the employer's claim to a refund in case the Quality Stores decision or this issue in general is resolved. A protective claim is relatively simple to file. It preserves an employer's right to claim a refund when the contingency is resolved. A protective claim does not have to state a particular dollar amount or demand an immediate refund. However, to be valid, a protective claim generally must:

- be in writing and be signed under the penalties of perjury
- include the taxpayer's name, address, employer identification number, and other contact information
- identify and describe the contingencies affecting the claim

- clearly alert the IRS to the essential nature of the claim
  - identify the specific period(s) for which a refund is sought.
2. Monitor the two-year period for filing suit

Employers that filed a protective claim have likely received a Notice of Claim Denial. A taxpayer has two years from the date of the Notice of Claim Denial to file a refund suit in the US District Court or in the US Court of Federal Claims. Additionally, the notice indicates a taxpayer could file an administrative appeal within 30 days. However, most employers chose to take a 'wait-and-see approach' in anticipation of the *Quality Stores* decision. Once the expiration of that two year window approaches, it is essential for taxpayers to file Form 907, *Agreement to Extend the Time to Bring Suit*, to preserve its position for either a potential settlement at IRS Appeals or for filing a refund suit.

#### 3. Withhold on future severance payments

Because of the continuing uncertainty, employers that make severance payments in the coming months, including those in the jurisdiction of the Sixth Circuit, should continue to withhold and remit the employee and employer portions of FICA tax on severance payments that do not fit the narrow definition described in Revenue Ruling 90-72. Employers failing to withhold the required FICA taxes may be liable for both the

employee and employer shares of those taxes and may be subject to penalties. Thus, the recommended approach is to continue to withhold and remit FICA taxes while taking the necessary steps to preserve the company's right to a refund.

#### 4. Maintain employee data

Many businesses adhere to strict data retention and destruction policies. It is possible that the resolution to this FICA matter may take several years. Employers should take steps to ensure that the plan documentation and employee-level wage data is available to support FICA claims that will need

to be perfected before any refunds will be issued. In some instances, this will require coordination with third party service providers.

## Conclusion

In summary, the *Quality Stores* decision should provide motivation for employers to implement a plan for recovering FICA on SUB pay. For now, most employers just need to implement a few simple steps—file protective claims, monitor the two-year period for filing suit, continue to withhold on future SUB payments and modify record retention policies.

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