Labor and Employment Alert: Court of Appeals for the Sixth Circuit Decision *U.S. v. Quality Stores, Inc.* Offers FICA Tax Refund Opportunity for Some Employers

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CLIENT ALERT | 10.30.2012

UPDATE: The Department of Justice (DOJ) filed a petition for rehearing en banc in *United States v. Quality Stores, Inc.*, No. 10-1563 (6th Cir. Sept. 7, 2012). Although the 6th Circuit rarely grants such requests, the September 7, 2012 merits decision is no longer a final decision of the court. If the court denies the petition, the September 7, 2012 decision will be final. If the court grants the petition for rehearing, another decision on the merits will be issued that either affirms or reverses its original decision. Thus, interested taxpayers will necessarily be in a holding pattern until this issue is resolved. If you are a taxpayer with a potential refund claim that has not yet been filed, or with a refund claim that has been denied by the Internal Revenue Service, you should confer with your tax advisor to ensure that relevant statutes of limitation are kept open.

On September 7, 2012 the Court of Appeals for the Sixth Circuit issued its decision in *U.S. v. Quality Stores, Inc.*, 2012 FED App. 0313P, 2012-2 U.S. Tax Cas. (CCH) P50,551, 56 Bankr. Ct. Dec. 267 (6th Cir. 2012). The court affirmed a federal district court decision holding that severance payments meeting the statutory criteria for a "supplemental unemployment benefit" as set forth at Section 3402(o) of the Internal Revenue Code were not properly characterized as "wages" for purposes of the Federal Insurance Corporation Act (FICA) tax, and therefore were not subject to FICA tax. The decision granted the taxpayer employer and employees a combined tax refund of nearly one million dollars.

The IRS has long taken the position that severance payments to terminated workers are "wages" subject to FICA tax, and that a "supplemental unemployment benefits" exception from FICA tax should be read very narrowly. In *Quality Stores*, the taxpayer challenged this longstanding position of the Internal Revenue Service as to supplemental unemployment benefits.

Facts of the Case

Quality Stores was a large retail store chain. The chain was struggling and closed 63 stores and nine distribution centers. In addition to closing stores, the chain also terminated about 75 employees at its corporate offices. In 2001, the chain entered chapter 11 bankruptcy. Thereafter, the chain closed 300 more stores and its distribution warehouses. Finally, it terminated all remaining employees.

Quality Stores developed a severance payment plan whereby the terminated employees received payments based on a formula devised by the company. Quality Stores reported the severance payments as wages on employees' W-2s for both income and FICA tax purposes, performed all withholding, and paid its own tax liability. However, in 2002, it filed refund claims of more than $1 million for overpaid FICA taxes on the severance payments. Quality Stores took the position that the payments fit within the Section 3402(o) definition of "supplemental unemployment benefit" and was therefore not subject to FICA tax. The District Court in Michigan agreed with Quality Stores and held that the severance payments were not properly subject to FICA tax. The Internal Revenue Service appealed that decision to the United States Court of Appeals for the 6th Circuit.

The 6th Circuit's Decision

The 6th Circuit affirmed the decision of the district court granting the refund claim. The 6th Circuit's decision rejected the longstanding administrative interpretation by the IRS requiring that a qualifying supplemental unemployment benefit payment must be conditioned upon the severed employee obtaining state unemployment benefits, and that lump sum severance payments could never qualify. Instead, the court interpreted Section 3402(o) to require only five elements to qualify a severance payment as a "supplemental unemployment benefit" not subject to FICA tax. To be excluded from FICA taxation, the payment must be:

1. An amount paid to an employee;
2. pursuant to an employer's plan;
3. because of an employee's involuntary separation from employment, whether temporary or permanent;
4. resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar condition; and
5. included in the employee's gross income.

The decision in *Quality Stores* was contrary to an earlier decision by the Court of Appeals for the Federal Circuit. In *CSX Corp. v. U.S.*, 513 F.3d 1328 (Fed. Cir.2008), the federal circuit agreed with the restrictive definition of "supplemental unemployment benefit" long utilized by the Internal Revenue Service. It is possible then that Internal Revenue Service will appeal the *Quality Stores* decision to the Supreme Court of United States asking the Court to resolve the split in the circuits.

Whether the Internal Revenue Service successfully appeals *Quality Stores* or not, those taxpayers that have made severance payments fitting the criteria set forth by the court in *Quality Stores* should contact their tax advisor to discuss filing a refund claim for overpaid FICA taxes. If the *Quality Stores* decision is appealed to the Supreme Court, and the Court accepts that appeal, then a taxpayer's pending refund claim would serve to ensure that if the Court ultimately agreed with the 6th Circuit, the statute of limitations would not

bar recovery. Similarly, if the 6th Circuit's decision in *Quality Stores* is not accepted by the Court for review, then *Quality Stores* will be the law for those taxpayers situated in the 6th Circuit.