

Update: March 2010

Tax Intelligence

Severance Pay Held Not Subject to FICA

Situation

In a controversial decision, a sixth circuit District Court held that certain severance payments made outside a qualified supplemental unemployment benefits (SUB) plan were not subject to FICA tax since the severance payments were not *earnings*. [*U.S. v. Quality Stores, Inc.*, 2010 U.S. Dist. LEXIS 15825 (W.D. Mich.), February 23, 2010].

The IRS has long held that severance payments made pursuant to a SUB plan and meeting specific requirements outlined in Revenue Ruling 90-72 [1990-2 C.C. 211] are exempt from FICA tax under Internal Revenue Code Section 3402(o). One of the key requirements in the revenue ruling is that the severance benefits be linked to the receipt of state unemployment benefits.

The Court's ruling in *Quality Stores* indicated the Court believed the IRS-imposed requirements on the payment of severance benefits were not intended by statute under IRC S 3402(o), found that severance payments made by the taxpayer should not have been subjected to FICA, and granted taxpayer's claim for refund.

This is not a new issue to taxpayers. In 2002, a taxpayer, CSX Corp., was successful in getting a court to rule in its favor deciding that severance payments made outside a SUB Plan were also not subject to FICA taxes. The IRS appealed and six years later the decision was overturned in favor of the IRS. [*CSX Corp. v. U.S.*, 518 F.3d. 1328]. We expect that the IRS will also appeal the *Quality Stores* decision.

Solution

While the ultimate outcome of the case is unknown, the decision might present a refund opportunity for taxpayer's when the Court's reasoning is applied to the taxpayer's own facts and circumstances. A *protective refund claim* might be advisable to preserve the right to a refund in the future when the case is finally resolved, and FICA tax refunds may be filed for any open years under the federal statutes. Protective claims for calendar year 2006 must be filed by April 15, 2010.

If an employer made severance payments during the years 2006 through 2009 meeting the court's criteria under *Quality Stores*, a protective refund claim may be appropriate. Generally, the following should be considered in determining whether a protective refund claim should be filed:

1. Were payments made pursuant to a severance plan?
2. Were payments made on account of a reduction in force and involuntary separation?
3. Were the payments subjected to FICA taxes?
4. Was the employer tax paid substantial enough to make the refund claim process worthwhile?
5. Do you believe the decision in *Quality Stores* should be or will likely be upheld on appeals?

There are additional considerations that will ultimately impact a decision to file, but these initial questions should provide an employer insight on the potential opportunity before moving forward.

If a protective refund claim is filed and the *Quality Stores* case is ultimately decided in the taxpayer's favor, employers will need to "perfect" the claims for refunds. Consequently, certain records will need to be retained related to the severance payments to assist in the quantification, perfection, and substantiation of the FICA refund claim.

Value

With respect to protecting employers' interests under the *Quality Stores* decision, TALX can assist in (1) evaluating whether a protective refund claim might be prudent; (2) preparing and filing protective refund claims; (3) identifying/storing the requisite documents; and, (4) preparing and perfecting the FICA refund claim if the *Quality Stores* decision is upheld. For more information, please contact Pete Krieshok at (314) 214-7325 or pkrieshok@talx.com.