

Sixth Circuit Affirms: Certain Severance Payments are Exempt from FICA Tax

2 min read

Sep 27, 2012

In [*United States v. Quality Stores, Inc.*, No. 10-1563 \(Sept. 7, 2012\)](#), an employer operating a chain of retail stores closed a number of facilities prior to entering bankruptcy proceedings. As part of this reduction in force, the employer provided certain severance benefits to terminated employees. The employer treated the severance benefits as income and reported them as wages on Forms W-2, with Federal Insurance Contributions Act (FICA) taxes withheld. After remitting the taxes to the Internal Revenue Service (IRS), the employer filed a claim for refund to recover more than \$1 million in FICA taxes, arguing that the severance payments were not properly treated as “wages” for FICA tax purposes.

The bankruptcy court agreed, reasoning that the payments fell within a special exception for certain payments made by an employer and conditioned on eligibility for, and receipt of, state unemployment benefits (also known as “supplemental unemployment compensation benefits” or “SUB pay”). The IRS challenged the bankruptcy court’s decision, arguing that recent guidance had made clear that SUB pay was exempt from FICA tax only under limited circumstances which were not present in this case.

The District Court rejected the IRS’ reasoning and ruled in favor of the employer. The court found that the severance benefits were properly treated as “supplemental unemployment compensation benefits” and therefore excluded from wages for FICA purposes under a special statutory provision relating to mandatory withholding of income (and not FICA) taxes.

The Sixth Circuit Court of Appeals has now affirmed the holding of the district court stating that Congress’ intent to align the definition of wages between the statutes governing FICA and federal income tax as expressed in the Internal Revenue Code governed over the IRS’s narrow exemption from FICA withholding provided for in Rev. Rul. 90-72 (1990-2 C.B. 211). In so holding, the Sixth Circuit expressly rejected the reasoning from a case decided by the Appeals Court for the Federal Circuit (*CSX Corp. vs. United States*, 518 F.3d 1328 (2008)).

As there is now a split between the circuits that will ultimately need to be resolved by the Supreme Court or Congress, an employer should continue to withhold FICA on the payment of supplemental unemployment compensation benefits to terminated employees unless it is clear the payments qualify for the limited exception contained in Rev. Rul. 90-72. Where an employer has previously paid FICA taxes, an employer may consider filing a

refund claim, or alternatively, file a protective claim to preserve the statute of limitations on employment tax refund claims for open years.

For more information read *United States v. Quality Stores, Inc.*, No. 10-1563 (Sept. 7, 2012).

Hinshaw & Culbertson LLP is a U.S.-based law firm with offices nationwide. The firm's national reputation spans the insurance industry, the financial services sector, professional services, and other highly regulated industries. Hinshaw provides holistic legal solutions—from litigation and dispute resolution, and business advisory and transactional services, to regulatory compliance—for clients of all sizes. Visit www.hinshawlaw.com for more information and follow @Hinshaw on LinkedIn and X.

Topics

Tax, Severance