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Employers May Be Entitled To FICA Tax Refunds On Severance Pay

In a recent opinion, the Court of Appeals for the Sixth Circuit rejected over 20 years of IRS rulings and held that certain severance payments made to employees who are involuntarily terminated as the result of a reduction in force are exempt from FICA taxation.

This ruling is very important for employers who have downsized in recent years as a result of the difficult economic climate. Employers are encouraged to evaluate whether they may be eligible for a refund of FICA taxes paid on severance benefits since 2009 and take the necessary steps to preserve their rights to a refund. Based on pending suits and claims alone, the IRS estimates that there is over \$1 billion currently at issue.

The Sixth Circuit's Ruling. IRS Revenue Ruling 90-72 provides that severance benefits are generally considered "wages" subject to FICA tax *unless* the benefits are made in periodic payments directly linked to an employee's receipt of government unemployment benefits. The IRS's long-held position was affirmed in 2008 by the Court of Appeals for the Federal Circuit in *CSX Corp. v. United States*.

Last month, in *United States v. Quality Stores Inc.*, the Sixth Circuit expressly rejected the IRS's view as to the limited circumstances under which severance benefits are exempt from FICA. The court broadened these circumstances by holding that severance benefits are *not* FICA taxable wages so long as they meet the following requirements:

- The payments are due to an employee's involuntary separation from employment; and
- The payments result directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions.

Who Should Care? Any employer that has paid FICA tax on severance pay since 2009 that fits within the Sixth Circuit's definition may be entitled to a refund plus interest. Employees also pay FICA taxes through payroll tax withholding, so employees may also be entitled to refunds. In addition, the ultimate resolution of this issue may have a drastic effect on the way severance pay plans are designed – if the Sixth Circuit's opinion is upheld, such plans will no longer need to closely track the restrictions of IRS Revenue Ruling 90-72 in order to be exempt from FICA.

What Will the Courts do Next? The decision in *Quality Stores* was made by a three-

judge panel. On October 19, 2012, the government filed a petition for a rehearing of the case by a larger panel of the Sixth Circuit. We do not know at this time whether the Sixth Circuit will agree to rehear the case and, if it does, what the larger panel will decide.

So far, the Sixth Circuit and the Federal Circuit are the only federal appellate courts to rule on this issue and, having ruled differently in *Quality Stores* and *CSX Corp.* respectively, there is currently a "circuit split." This means that, assuming the larger panel of the Sixth Circuit upholds the initial decision, it is unknown how courts in other federal circuits will decide similar cases; and the Supreme Court may have to make the final decision.

Next Steps. In light of this recent ruling and uncertainty regarding the final disposition of the *Quality Stores* case, employers may wish to take the following actions:

- **Evaluate FICA Taxes Paid.** Employers should immediately determine whether and to what extent they have paid FICA taxes on qualifying severance payments made since 2009. If the amount is substantial, they may choose to request a refund from the IRS.
- **File a Refund Claim.** Due to the statute of limitations, **employers must seek a refund by April 15, 2013 for FICA taxes paid in the year 2009** (and by April 15, 2014 as to FICA taxes paid in 2010, etc.). Unfortunately, it is too late for employers to seek a refund for FICA taxes paid in earlier years. In making a refund claim, employers must not only request a refund of the employer portion of FICA, but they must also seek a refund on behalf of the employees to whom the severance payments were made. Employers must make a reasonable effort to get consents and waivers from these employees before receiving a refund.
- **Protective Refund Claims.** Instead of filing the actual refund claim, an employer may instead preserve its rights by filing a *protective* refund claim before the April 15, 2013 deadline. As opposed to filing an actual claim, employers need not undertake the administrative burden of acquiring consent from former employees prior to filing a protective claim.

Protective refund claims are available to taxpayers when the right to a refund is contingent on the outcome of future events, such as the resolution of litigation or changes in tax law (in this case, the resolution of *Quality Stores*). Filing a protective claim is relatively simple – it generally requires completion of an amended FICA tax form (Form 941-X) and a narrative explaining the basis of the refund and the contingency affecting the claim.

- **Sue for a Refund.** Although the IRS has currently suspended action on refund claims within the jurisdiction of the Sixth Circuit, whether the IRS will disallow refund claims filed before the final disposition of the *Quality Stores* case is unknown. If its claim is disallowed, an employer may bring a suit in federal district court where the employer has its principal place of business. Note that an employer has only two years from the date of the letter of disallowance of its refund claim to file a lawsuit.

Contact Information. For more information on the availability or preparation of a FICA tax refund claim, please contact David Putnal (404.888.8836), Andrew Overway (404.888.8858) or Jared Beckerman (404.888.8857).

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