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Handling FICA Withholding on Severance Payments After *Quality Stores*

May 13, 2014

Presenters:

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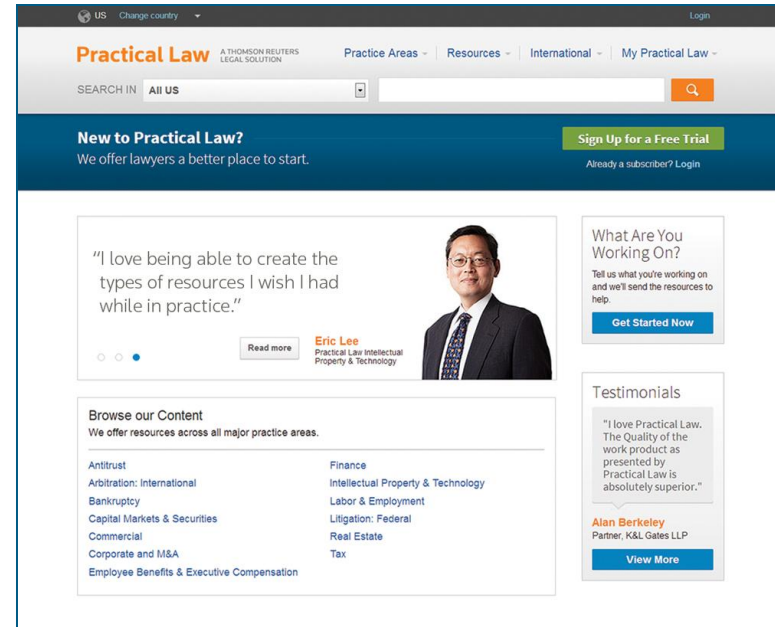
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Background

- Severance payments are generally taxable as “wages” for purposes of Social Security taxation
- IRS revenue rulings allow some “supplemental unemployment compensation benefits” (so-called “SUB” payments), which are paid after severance, nonetheless to be treated as non-wages and thus not taxable under FICA
- The revenue rulings have been inconsistent regarding what requirements need to be met for severance payments to be considered non-taxable SUB payments
- A conflict in the circuits developed, leading a number of employers and employees to file protective claims for refunds, in light of the possibility that severance payments might not be taxable “wages” for Social Security purposes

Facts in *Quality Stores*

- The employer made severance payments to thousands of employees in connection with the employer's bankruptcy proceedings
 - The severance payments were made to employees being involuntarily terminated
 - The payments varied based on the employees' respective seniority
 - The payments were not linked to the receipt of state unemployment benefits
- The employer paid its portion of Social Security taxes on the severance payments and also withheld the employees' portion of such taxes

Claim for Refund

- On behalf of itself and various employees, the employer sought a refund of both its own payments and the amounts withheld from employees
 - Over \$1 million in potential refunds were at issue

The Argument That Severance Payments Are Not “Wages”

- The employer argued that the severance payments should not be considered taxable “wages” for purposes of the statute governing Social Security taxation
- The payments met the definition of SUB payments in a separate section of the IRC governing federal income tax withholding (FITW)
- The IRC indicates that such SUB payments are excluded from the definition of “wages” for FITW purposes
 - The title of statutory subsection in question is “Certain Payments Other Than Wages”
 - FITW statute directs that SUB payments be treated *as if* they were wages (suggesting that they otherwise are not)
- Under Supreme Court precedent, “wages” generally should mean the same thing for purposes of both FITW and Social Security taxation (often referred to as “FICA”), so, if SUB payments are not “wages” under FITW, they arguably should not be “wages” under FICA

Decisions by the Lower Courts in *Quality Stores*

- The bankruptcy court, the district court and the Sixth Circuit all held in favor of the employer, concluding that severance payments of the type at issue are not taxable “wages”
- The lower courts, after reviewing the text of the statute, accepted the employer's arguments that severance payments are not “wages”

Reaction in the Market

- As a result of activity in the lower courts, and in particular the Sixth Circuit decision in *Quality Stores*, some employees who have been paid severance, and their employers, filed protective refund claims with the IRS to preserve their rights to obtain refunds of Social Security taxes, in the event that ultimately it would be determined that severance payments are not “wages”
 - The issue is confined to FICA taxation (and similar questions regarding FUTA wages)
 - Refund claims have been reported to exceed \$1 billion, involving at least 11 unresolved lawsuits and 2,400 pending administrative cases

The Supreme Court's Decision

- The Supreme Court unanimously reversed the Sixth Circuit's *Quality Stores* decision, flatly rejecting the employer's position
- Severance payments such as those at issue in *Quality Stores* are taxable “wages” for purposes of the statute governing Social Security taxation
 - FICA defines “wages” broadly as “all remuneration for employment” – since 1950, FICA has contained no general exception for severance payments
- The Court rejected the contention that the “as if” and “other than wages” language of the income-tax withholding statute compels the conclusion that SUB payments are not wages
 - “As the Federal Circuit explained when construing [the income-tax withholding statute], the statement that ‘all men shall be treated as if they were six feet tall does not imply that no men are six feet tall.’” (citation omitted)

Impact of *Quality Stores*

- For those taxpayers who have all along been treating severance payments as being “wages” for FICA purposes, *Quality Stores* would generally not be expected to have significant practical impact
- For those taxpayers who have filed protective refund claims on the basis of the reasoning of the Sixth Circuit decision, those claims will presumably be rejected (if not withdrawn)
 - There continue to be open issues regarding the proper treatment of severance payments that, unlike the payments in *Quality Stores*, are tied to state unemployment benefits under a so-called “SUB” plan as required by the current version of the IRS revenue ruling
- If there are any taxpayers who have otherwise been proceeding on the basis that severance payments are not “wages” for FICA purposes, those taxpayers should consider reexamining that approach

Impact of *Quality Stores* – Action Steps

- Report severance payments as wages on Form W-2 (generally three-year statute of limitation)
 - Failure to do so raises withholding obligations and related reporting and withholding penalties and interest.
- Treat severance payments as subject to FICA and FUTA taxes, unless they fall within Rev. Rul. 90-72 –
 - Involuntary separation payments
 - Payments linked to state unemployment compensation
 - Periodic payments (not lump sums)
- Stop filing protective claims (Form 941-X) for severance payments, and do not take any action as a result of an IRS denial/dismissal of claim

Questions

Relevant Practical Law Resources Available with a *Free Trial* to Practical Law

- Severance Benefits, Plans and Agreements Toolkit
- Practice Note, Severance Benefits, Plans and Agreements: Overview
- Practice Note, Payroll (FICA) Taxes
- Standard Document, Severance Pay Plan for Employees

About the Speakers

Robert S. Hertzberg, Partner, Pepper Hamilton LLP

Robert S. Hertzberg is a partner with Pepper Hamilton LLP, resident in the Detroit and New York offices. He is co-chair of the firm's Corporate Restructuring and Bankruptcy Practice Group.

Mr. Hertzberg, an accomplished bankruptcy lawyer and fellow of the American College of Bankruptcy and past President of Insol International, has been practicing almost exclusively in the bankruptcy and restructuring field for more than 34 years, representing secured lenders, debtors, debtors-in-possession, trustees, creditors and creditors' committees.

Mr. Hertzberg is a past president of INSOL International (2003-2005), the leading international organization of bankruptcy professionals. He also was a member of the board of INSOL International from 1997 to 2006, and is currently chairman of INSOL's Technical Electronic Newsletter Editorial Board. In addition to INSOL and the American College of Bankruptcy (in which he sat on the Sixth Circuit Admissions Council from 2003-2006), he is active in many other professional organizations, including the Turnaround Management Association, the Commercial Law League of America (past chairman of the Bankruptcy Section) and the American Bankruptcy Institute (past chairman of the Central States Workshop program). Mr. Hertzberg also is a member of the International Insolvency Institute.

Mr. Hertzberg is listed in *The Best Lawyers in America*, the *International Who's Who of Insolvency and Restructuring Lawyers* (USA and International editions) and was selected for inclusion on the 2013 *Michigan Super Lawyers* list. He received the Consumer Bankruptcy Association's Award of Recognition in 2000 for his accomplishments in the bankruptcy field.

Mr. Hertzberg has written extensively on numerous bankruptcy topics and was on the advisory board of the "Globalinsolvency" Web site. He also has lectured throughout Europe, Africa, the Americas and the Far East on bankruptcy and restructuring issues, and participated in several colloquiums at the United Nations that were hosted by UNCITRAL (1999, 2000 and 2007). The colloquiums covered topics including bankruptcy guidelines and secured transactions.

In the community, Mr. Hertzberg has served as chairman of the board of trustees of JVS (Jewish Vocational Services) from 2006 to 2008 and is currently a member of the executive board.

Mr. Hertzberg is admitted to practice in Michigan and New York, and before the United States Supreme Court, the U.S. Court of Appeals for the Sixth Circuit and the U.S. District Courts for the Eastern and Western Districts of Michigan.

About the Speakers

Andrew L. Oringer, Partner, Dechert

Andrew L. Oringer is co-chair of Dechert's ERISA and Executive Compensation Group. He is the Emerging Issues Coordinator for the Employee Benefits Committee of the American Bar Association's Section of Taxation, former co-chair of the Employee Benefits Committee of the New York State Bar Association's Tax Section, and a Fellow of the American College of Employee Benefits Counsel. Mr. Oringer is a member of Practical Law Employee Benefits & Executive Compensation Advisory Board.

Mr. Oringer's practice includes advising clients regarding ERISA and employee benefits generally, including 401(k) and other retirement plans as well as medical and other welfare plans. His advice to clients encompasses all aspects of corporate transactions and initial public offerings in which benefits and compensation issues play a central part. He regularly counsels financial institutions and plan fiduciaries regarding investments, and has been instrumental in designing complex investment structures to address difficult ERISA issues.

Mr. Oringer advises clients with respect to the design and implementation of arrangements relating to executive compensation, including stock option and other equity-based arrangements. His practice extends to the representation of employers and executives in the negotiation of executive employment and termination agreements.

Nationally known for his experience with ERISA and matters relating to executive compensation, Mr. Oringer is a frequent speaker and writer on a wide variety of topics. His written work includes the chapter on Releases in the *Section 409A Handbook*, and the chapter on Investment Funds and ERISA in *ERISA Fiduciary Law*. Publications including *The Wall Street Journal*, *The New York Times*, *Crain's Pensions & Investments*, *Newsday*, *USA Today* and *The Chicago Sun Times* have quoted him in articles on employee benefits issues. He has authored, co-authored or contributed to numerous bar comment letters and reports to regulators on both fiduciary and compensation issues, and has testified at the request of Congress regarding certain proposed Department of Labor regulations.

Mr. Oringer holds leadership roles for the American Bar Association and the New York State Bar Association and is on the advisory boards for a number of leading publications covering ERISA and executive compensation. He also teaches ERISA as an adjunct professor and in other educational settings.

Several major legal directories have recognized Mr. Oringer as a leading lawyer, including *The Best Lawyers in America* (2010-2012), *Chambers USA* (2005-2013), the *Practical Law Company's Labour and Employee Benefits Cross-Border Handbook* (2007, 2010-2012) and *New York Super Lawyers* (2006-2013, including in several years, listing among New York City's Top 100 lawyers across all practice areas).

About the Speakers

Elizabeth Thomas Dold, *Principal, Groom Law Group*

Elizabeth Thomas Dold's practice focuses on Title II of ERISA and other compensation matters, including employment taxes and other reporting and withholding requirements. She covers all types of employee benefits, including qualified plans, IRAs, governmental plans, nonqualified deferred compensation plans, and health and welfare plans. She assists clients in all tax aspects of employee benefits including Internal Revenue Service (IRS) filings, compliance audits, design of retirement products, reviewing marketing materials, nonresident alien reporting/taxation issues, taxation of settlement awards, restorative payments, taxation and reporting of fringe benefits and welfare benefits, and employment taxes.

Ms. Dold is past Chair of the Information Reporting Program Advisory Committee (IRPAC) and the Government Affairs Committee (GAC) General Membership Chair of The American Society of Pension Professionals & Actuaries (ASPPA). Ms. Dold is a frequent speaker and author on a range of employee benefits-related topics and maintains columns in *Taxes – The Tax Magazine* and *the Journal of Pension Benefits*. She is listed in *The Legal 500 US* for Employee Benefits and Executive Compensation. A nationally-recognized expert on employee benefits reporting and withholding issues, she maintains a dedicated newsletter, the "IRS Reporting Corner" (http://www.groom.com/IRS_Reporting_Corner.html), that focuses on these types of issues.

Ms. Dold is a Former Adjunct Professor at Georgetown University Law Center. She received her LL.M. in Taxation from New York University; her J.D., magna cum laude, from Dickinson School of Law and Pennsylvania State University; and her B.S., with highest distinction, from Pennsylvania State University.

Ms. Dold has an interest in Pro Bono activities and inventions. She is the co-founder of linksinpink, which is a non-profit charitable organization to supporting individuals and their families facing a life-threatening illness, including breast cancer.

About the Speakers

Gia Norris, *Editor, Practical Law Employee Benefits & Executive Compensation*

Gia Norris joined Practical Law from Roberts & Holland LLP, where she was an employee benefits and executive compensation attorney. Previously she was an employee benefits and executive compensation attorney at both White & Case LLP and Proskauer Rose LLP. Gia also holds a leadership role on the Employee Benefits Committee of the American Bar Association.