

AN ALERT FROM THE BDO COMPENSATION & BENEFITS TAX PRACTICE

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► SUBJECT

PROTECTIVE FICA CLAIM FOR SEVERANCE PAYMENTS

► SUMMARY

The application of FICA tax to severance pay in connection with certain events such as a reduction in force or plant closing has been hotly contested in the courts for a number of years. With the recent economic decline, many companies have had reductions in force and plant closings and paid severance to terminated employees. Most likely, those companies paid both the employer's and employee's share of FICA on those payments. The Internal Revenue Service has been successful in defending the government's position that such payments are wages subject to FICA tax.

Now, however, the United States District Court for the Western District of Michigan reached a taxpayer-favorable result on the application of the FICA tax to severance payments when it chose not to follow a 2008 ruling by the United States Court of Appeals for the Federal Circuit in *CSX Corp. v. United States*, 518 F.3d 1328 (Fed. Cir. 2008). The court ruled that the bankruptcy court in *United States v. Quality Stores Inc.* correctly determined that payments a company made to employees as part of a company's severance program were not subject to FICA tax. *In re Quality Stores Inc.*, No. 1:09-cv-44 (Feb. 23, 2010).

As background, the Service applies a set of strict standards for a taxpayer to treat severance pay as exempt from FICA tax. See Rev. Rul. 90-72. Thus, under these standards, severance pay is generally considered wages for such purposes. However, section 3402(o) treats the payment of certain supplemental unemployment compensation benefits (referred to as "SUB pay") "as if it were a payment of wages" for income tax withholding purposes.

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Taxpayers have argued that the inference to be drawn from section 3402(o) is that SUB pay is generally not treated as wages for employment tax purposes; otherwise, the “as if it were” language would not have been necessary. There is no corollary provision in section 3121 to exempt such payments from FICA tax but the court in *Quality Stores* applied the standards set forth in section 3402(o) to exempt SUB pay from FICA taxes.

Note that section 3402(o) has three requirements:

1. amounts are paid to an employee pursuant to a **plan**
2. as a result of an **involuntary separation from employment**
3. related directly from a **reduction in force**, the **discontinuance of a plant or operation**, or **other similar conditions**.

We expect that many companies will be able to meet these requirements as a result of their recent severance payments.

We expect that the Service will likely appeal this case. However, because the statute of limitations expires three years after such amounts are reported (for example, April 15, 2010, for the 2006 calendar year) we are recommending that employers file protective refund claims to prevent loss of benefits due to the statute running. Companies should quantify the potential refunds and should file such a claim if such amounts are meaningful.

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