Wages May Not Be Wages: the Sixth Circuit Addresses Supplemental Unemployment Compensation Benefits, Part I.

On September 7, 2012, the Sixth Circuit ruled that supplemental unemployment compensation benefits (so-called SUB payments) are not wages subject to FICA under the Internal Revenue Code. *In re Quality Stores, Inc.*, 2012 U.S. App. LEXIS 18820 (6th Cir. Sept. 7, 2012). The Court elected not to follow the opinion of the Federal Circuit in *CSX Corp. v. United States*, 518 F.3d 1328 (Fed. Cir. 2008), which reached the opposite result.

As part of a financial restructuring and a bankruptcy, Quality Stores and its affiliates closed a number of stores and distribution centers in two waves: an initial group of closures occurred prior to bankruptcy and another set occurred during bankruptcy. Each was accompanied by the elimination of jobs and the termination of employees on a large scale. *In re Quality Stores, Inc.*, 2012 U.S. App. LEXIS 18820, slip op. at *3-*4 (6th Cir. Sept. 7, 2012). Quality Stores made severance payments to its terminated employees, and the payments were not tied to their receipt of unemployment compensation. The number of weeks of severance pay varied based on factors such as position and years of service. *Id.* at *4-*5.

Quality Stores and the IRS took different positions on the appropriate treatment of the payments. The IRS and Quality Stores agreed that the severance payments were the direct result of a reduction in force or the discontinuance of a plant or operation. *Id.* at *3-*4. They also agreed that the payments were reportable as wages subject to withholding for income tax purposes. *Id. at* *6. Quality Stores and the IRS parted company over whether they were also wages for purposes of FICA; although Quality Stores collected and paid the FICA taxes associated with the severance payments, it then sought refunds on its own behalf and on behalf of employees who had authorized it to seek refunds for them. *Id.* at *6-*7. When the IRS rejected the refund claims, Quality Stores initiated a refund case as an adversary proceeding in connection with its bankruptcy case. It was successful in both bankruptcy court and, on appeal, in federal district court; the case reached the Sixth Circuit on the government's appeal.

The Supreme Court touched on SUB payments in *Coffy v. Republic Steel Corp*., 447 U.S. 191 (1980), where it held that the SUB payments could not be compensation for work performed since they were contingent on an employee losing his job. Instead it characterized SUB payments as "a reward for length of service," not "compensation for services actually rendered." 447 U.S. at 205.

Wages for FICA purposes are defined as "all remuneration for employment . . . ." I.R.C. § 3121(a). Employment is then defined as "any service, of whatever nature, performed . . . by an employee for the person employing him . . . ." I.R.C. § 3121(b). While recognizing that the FICA definitions of "wages" and "employment" should be construe broadly, the Sixth Circuit commenced its analysis by noting that it was bound by the Supreme Court's holding in *Coffy* that SUB payments represent compensation for a lost job, not payment for services rendered. 2012 U.S. App. LEXIS 18820, slip op. at * 11 (citing *Coffy*).

To further complicate matters, although Section 3401(a) of the Code defines "wages" for purposes of federal income tax withholding in a way that is essentially identical to the definition in FICA, Congress adopted Section 3402(o), which extended the withholding requirement to "supplemental unemployment compensation benefits." I.R.C. § 3402(o)(1)(A). This section of the Code then defined "supplemental unemployment compensation benefits" as amounts paid

under a plan to which an employer is a party that are paid because an employee had an involuntary separation from employment that resulted directly from a reduction in force or from the discontinuance of a plant or an operation, to the extent they are includable in gross income. *See* I.R.C. § 3402(o)(2)(A). If a payment meets this definition, then it "shall be treated as if it were a payment of wages by an employer to an employee for a payroll period." I.R.C. § 3402(o)(1).

Based upon the parties' stipulation of facts, the Sixth Circuit concluded that the payments at issue were SUB payments within the meaning of Section 3402(o) of the Code. 2012 U.S. App. LEXIS 18820, slip op. at *12-*14. The Sixth Circuit then concluded that the decision of Congress in Section 3402(o)(1) to treat a payment of supplemental unemployment compensation benefits "as if it were a payment of wages" indicated that Congress did not consider SUB payments to be wages: "In our view, the necessary implication of this phrase is that Congress did not consider SUB payments to be 'wages,' but allowed their treatment as wages to facilitate federal income tax withholding for taxpayers." 2012 U.S. App. LEXIS 18820, slip op. at *14. Given that conclusion, as well as the identical definition of "wages" in FICA, the Sixth Circuit held that the bankruptcy court had correctly concluded that the severance payments were not "wages" for purposes of FICA and affirmed the judgment in favor of Quality Stores. *Id.* at *17.

This is a complex opinion on a tricky issue, and the Sixth Circuit explained its reasoning in further detail. I will summarize the balance of the opinion and critique its reasoning in future posts.

Jim Malone is a tax lawyer in Philadelphia.