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Recent FICA Case - Possible Refund Opportunity and Deadline

A recent federal court case may result in a change in payroll tax laws. But to take advantage of the change (if it occurs), employers need to act **before April 15, 2010**.

The new case was issued by the U.S. District Court (Western District of Michigan, Southern Division) in the *Quality Stores, Inc.* case. The case deals with FICA taxes as applied to so-called "supplemental unemployment compensation benefits" or "SUBs" payable under a plan. In general, they are paid to an employee due to the employee's involuntary separation from employment as a result of a reduction in workforce, the discontinuance of a plant or operation, or other similar conditions encountered by the employer.

The current IRS position, as expressed in Revenue Ruling 90-72, is that SUBs are subject to income tax withholding and FICA (Social Security and Medicare) taxes, unless they fit within a very narrow set of circumstances. Specifically, the IRS currently states that in order to be excluded from the definition of "wages" for federal income tax withholding and FICA taxation purpose, SUB pay must be linked to the receipt of state unemployment compensation and must not be received in a lump sum.

However, in the recent *Quality Stores* case, the District Court in Michigan issued a pro-taxpayer decision in this area that is contrary to the current position of the IRS. The District Court determined that SUBs paid in a Chapter 11 bankruptcy context were the functional equivalent of "wage-replacement social benefits" rather than taxable wages. The District Court also noted that, while the federal tax code states that SUBs are subject to income tax withholding "as if" they were payments of wages, there is no such equivalent provision for FICA taxes. As such, the District Court held that SUBs are not subject to FICA taxes and withholding, even where they have no connection to state unemployment compensation and are paid as a lump sum.

The current position of the IRS has not changed, and has been upheld by other courts. Therefore, it is unlikely that the District Court's recent decision gives comfort to employers that they can avoid withholding and paying FICA taxes on SUBs paid in the future due to a workforce reduction (at least in jurisdictions outside the Western District of Michigan). The District Court's decision is likely to face an appeal and a very strong challenge from the IRS. However, it is certainly possible that the District Court's decision will be upheld. As such, clients that paid any significant SUBs in 2006 (due to workforce reductions or plant closures) may wish to immediately file protective refund requests with the IRS prior to April 15, 2010. The reason is that on April 15, 2010, the statute of limitations for FICA tax refunds expires for all FICA taxes paid during 2006. In other words, filing a protective refund request will preserve an employer's ability to obtain a refund of FICA taxes collected and paid during tax year 2006 if the District Court's decision gains traction and becomes settled law.

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