



Court Rules Supplemental Unemployment Compensation Not Subject to Social Security, Medicare Taxes

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In a case from West Michigan, the federal court of appeals in Cincinnati recently ruled that certain payments of supplemental unemployment compensation are not “wages” subject to Social Security or Medicare taxes under the Federal Insurance Contributions Act (FICA). This ruling is significant to employers who have made similar payments and may be eligible for a refund.

Background

The employer made periodic and lump-sum severance payments to employees after the employer went out of business and filed bankruptcy. None of the payments were conditioned on receipt of state unemployment compensation. The employer reported the payments as wages on W-2 forms and withheld income and FICA taxes from them.

At the time, the IRS was applying FICA taxes to all severance payments except payments made in installments (not lump sums) to employees receiving unemployment compensation under state law.

The employer challenged the IRS’s position by filing refund claims to recover more than \$1 million in FICA taxes. The employer argued that FICA does not apply to any severance payment that satisfies the statutory definition of “supplemental unemployment compensation” in section 3402(o) of the Internal Revenue Code. The bankruptcy court agreed with the employer, and both the federal district court and the federal court of appeals agreed with the bankruptcy court.

The Ruling

Section 3402(o) says supplemental unemployment compensation is “treated as if it were a payment of wages by an employer to

an employee for a payroll period.” The court of appeals decided this means the payments are not actually wages, but merely treated as wages to facilitate federal income tax withholding.

The court said the Congressional committee reports and even the title of Section 3402(o) —“Extension of withholding to certain payments other than wages” — supports this conclusion. The court also said section 3402(o) does not distinguish between installment and lump sum payments or require the payments to be conditioned on receipt of state unemployment compensation benefits. In effect, the ruling rejects the additional limitations imposed by the IRS and expands the types of severance payments that are exempt from FICA.

What Employers Should Do Next

The court’s decision applies only to payments that satisfy section 3402(o) and only to payments made in Michigan, Ohio, Kentucky, and Tennessee (the states that are under the court’s jurisdiction). The decision conflicts with the decisions of other federal courts, and may result in a decision by the Supreme Court or in legislation from Congress. So the ultimate resolution is uncertain. For now, however, the court’s decision is the law in these four states.

In the meantime, employers who have made similar payments should consider filing protective claims for refund for FICA taxes paid with respect to the payments. The statute of limitations on refund claims for 2009 taxes will expire on April 15, 2013. Employers who have filed refund claims and have received a notice of disallowance from the IRS or have signed a waiver of notice should consider filing a protective lawsuit as soon as possible, or ask the IRS to extend the statute of limitations.

Varnum Advisory

Employers who have filed refund claims but have not yet received a notice of disallowance or a signed waiver of notice need not take any action until they receive a response from the IRS.

If you think you may have made severance payments that should have been exempt from FICA taxes and would like help filing a refund claim, contact your Varnum attorney or any of Varnum's Labor and Employment attorneys.

