

RECENT TAX DEVELOPMENTS THAT EMPLOYERS NEED TO CONSIDER

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RECENT CASE OPENS DOOR FOR POTENTIAL REFUND CLAIMS OF FICA TAXES PAID RELATED TO SEVERANCE PAYMENTS

A recent decision from the United States District Court for the Western District of Michigan held that certain severance payments made to employees pursuant to an involuntary reduction in force are not “wages” for FICA tax purposes. See United States v. Quality Stores, Inc. et al., 105 AFTR 2d 2010-XXXX (02/23/2010). This is significant because it opens the door for potential refunds of FICA taxes paid on certain severance payments. Although the application of this decision is limited and will likely be appealed by the IRS, employers who have made significant involuntary severance payments to employees between 2006 through 2009, should consider filing a protective refund claim. Filing such a claim for 2006 should be an employer’s most immediate concern because the statute of limitations for 2006 will expire next month.

In Quality Stores, the issue was not whether severance payments were considered taxable income, but rather, whether the payments are considered “wages”. By classifying the payments as “wages”, FICA taxes are applicable. The court in Quality Stores followed the lower court decision in CSX Corporation v. United States, 52 Fed. Cl. 208 (2002). In CSX, the U.S. Court of Federal Claims concluded that involuntary layoff payments are exempt from FICA taxes if these payments qualify as “supplemental unemployment compensation benefits” under Section 3402(o)(2) of the Internal Revenue Code of 1986, as amended (the “Code”). According to the Code, supplemental unemployment compensation benefits must be paid pursuant to a plan, be made due to an involuntary separation (permanent or temporary), and there must be a resulting reduction in force, plant closings, or other similar conditions. In addition to the statutory considerations, the court in CSX noted that although the statute covers income tax withholding,

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not FICA taxes, any statutory exemption from “wages” for involuntary severance benefits must be deemed to extend to FICA taxes. As a result of CSX, thousands of refund claims by employers were made in an effort to recoup the employer and employee portions of FICA taxes paid on all forms of involuntary severance. These claims were largely held in abeyance by the IRS while the appeal was pending. Upon appeal, the lower court’s holding in CSX was reversed and the IRS ultimately disallowed the refund claims. CSX Corporation v. United States, 518 F.3d 1328 (Fed. Cir. 2008).

Although the decision in Quality Stores will likely be appealed to the U.S. Court of Appeals for the 6th Circuit, employers are again faced with the question of whether refund claims should be filed as a protective measure. In deciding whether to take this step, distinctions between the circumstances surrounding the two cases - CSX and Quality Stores - should be considered. Unlike that of the U.S. Court of Appeals for the Federal Circuit, the decision of the U.S. District Court for the Western District of Michigan does not provide precedent beyond Michigan. Even if the U.S. Court of Appeals for the 6th Circuit were to affirm the District Court’s decision, the IRS would likely refuse to follow this decision outside the 6th Circuit. Consequently, taxpayers outside of the 6th Circuit, like those here in New Hampshire who are part of the 1st Circuit, will likely have their refund claims denied; however, if similar successful litigation occurs in the 1st Circuit, only those who have made timely refund filings will benefit.

If you are an employer who made significant involuntary severance payments to prior employees for the years 2006 through 2009, we recommend that you consult your tax counsel to determine whether filing a protective claim is advisable. The refund request for 2006 is the most immediate concern, as the statute of limitations will expire on April 15, 2010. Failure to file a protective FICA tax refund claim will result in a loss of your ability to make the claim in the future, as we wait for further developments and more guidance on how the IRS is expected to respond.

TAX INCENTIVES FOR EMPLOYERS AVAILABLE UNDER THE HIRE ACT

Two new tax benefits are now available to employers hiring workers who were previously unemployed or only working part-time. These provisions are part of the Hiring Incentives to Restore Employment Act (“HIRE Act”) enacted into law last week.

Employers who hire unemployed workers after February 3, 2010 and before January 1, 2011 may qualify for a 6.2 percent payroll tax incentive, in effect exempting them from their share of Social Security taxes on wages paid to these workers after the date of enactment. This reduced tax withholding will have no effect on the employee’s

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future Social Security benefits, and employers still need to withhold the employee's 6.2 percent share of Social Security taxes as well as income taxes. The employer and employee shares of Medicare taxes would also still apply to these wages.

In addition, for each worker retained for at least one year, businesses may claim an additional general business tax credit up to \$1,000 per worker when they file their 2011 income tax returns.

The two tax benefits are helpful to employers who are adding positions to their payrolls. New hires filling existing positions also qualify, but only if the workers they are replacing left voluntarily or for cause. Family members and other relatives do not qualify.

The new law also requires that the employer get a statement from each eligible new hire certifying that he or she was unemployed during the sixty (60) days before beginning work or alternatively, worked fewer than a total of forty (40) hours for someone else during the sixty (60) day period. The IRS is currently developing a form that employees can use to make the required statement.

Businesses, agricultural employers, tax-exempt organizations and public colleges and universities all qualify to claim the payroll tax benefit for eligible newly hired employees. Household employers cannot claim this new tax benefit.

Employers claim the payroll tax benefit on the federal employment tax return that they file (usually quarterly) with the IRS. Eligible employers will be able to claim the new tax incentive on their revised employment tax form for the second quarter of 2010.

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