No. 12-1408

In the Supreme Court of the United States

UNITED STATES OF AMERICA, PETITIONER

v.

QUALITY STORES, INC., ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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The question presented in this case is whether severance payments made by an employer to terminated employees are taxable under the Federal Insurance Contributions Act (FICA), 26 U.S.C. 3101 *et seq.* Respondents do not dispute that the question is recurring and exceptionally important, and they concede (Br. in Opp. 13) that the Sixth and Federal Circuits have answered the question differently. With thousands of refund claims and cases worth a combined total of more than $1 billion currently wending their way through the Internal Revenue Service (IRS) and lower courts, the importance of the issue and the square circuit conflict clearly call for this Court's review.

A. The Question Presented Is Recurring And Exceptionally Important

Respondents do not dispute that the proper tax treatment of severance pay under FICA is a recurring

issue of exceptional importance. According to the IRS, that question is currently pending in at least eleven cases and more than 2400 administrative refund claims, with a total amount at stake of more than $1 billion. The decision below also has significant potential implications with respect to the administration of Social Security and Railroad Retirement Act benefits. See Pet. 25. The importance of the question presented for the public fisc, as well as for employers and employees in the Sixth Circuit, alone warrants this Court's review.

B. The Decision Below Conflicts With Decisions Of This Court And Other Courts Of Appeals

1. Respondents acknowledge that the decision below "diverges from the Federal Circuit's decision" in *CSX Corp.* v. *United States*, 518 F.3d 1328 (2008). Br. in Opp. 16. Respondents contend, however, that the circuit conflict does not warrant this Court's review because taxpayers may seek refunds either "(i) in a federal district court (or bankruptcy court), with an appeal to one of the regional courts of appeals, or (ii) in the Court of Federal Claims, with an appeal to the Federal Circuit." *Id.* at 16-17 (footnote omitted). Respondents argue that, because the Federal Circuit has ruled in the government's favor, taxpayers are likely to file refund suits in the district courts (or bankruptcy courts) rather than in the Court of Federal Claims, thus diminishing the ongoing practical significance of the Federal Circuit's decision. See *id.* at 17.

As explained below, the Sixth Circuit's reasoning is unpersuasive, and there is no reason to assume that other courts of appeals will prefer it to the Federal Circuit's contrary approach in *CSX Corp.* See Part C, *infra*. In any event, the fact that taxpayers who seek to assert refund claims may have a choice of fora is *more*

reason, not less, for this Court's review. Cf. *Yee* v. *City of Escondido*, 503 U.S. 519, 538 (1992) (observing that "[f]orum shopping" is "of particular concern" where plaintiffs may obtain different results in a given jurisdiction by filing suit in either state or federal court).

Respondents also argue (Br. in Opp. 18) that review is not warranted because they cited 1968 Treasury regulations to the Sixth Circuit that were not before the Federal Circuit in *CSX Corp*. In the decision below, however, the Sixth Circuit did not even mention, let alone rely on, those regulations. Those regulations did not relate to the proper tax treatment of severance pay under FICA, but instead concerned the payment of supplemental unemployment compensation benefits by tax-exempt trusts under 26 U.S.C. 501(c)(17). When the regulations were issued in 1968, such supplemental payments—*i.e.*, payments tied to state unemployment benefits—were not treated as "wages" subject to either FICA tax or income-tax withholding. As a result, supplemental unemployment benefit payments did not have to be reported on IRS Form W-2, which is normally used to report wages. But supplemental payments still had to be reported as taxable non-wage income, which meant that taxpayers found themselves subject to substantial tax obligations when they filed their returns. See Pet 16; *CSX Corp.*, 518 F.3d at 1336.

In 1969, at the Treasury Department's suggestion, Congress enacted 26 U.S.C. 3402(*o*) to address that particular problem. Section 3402(*o*) provides that "any supplemental unemployment compensation benefit paid to an individual * * * shall be treated as if it were a payment of wages by an employer to an employee for a payroll period." 26 U.S.C. 3402(*o*)(1)(A). Following Section 3402(*o*)'s enactment, the IRS amended its regulations to

require tax-exempt trusts to report supplemental unemployment benefit payments on Form W-2. See Treas. Reg. § 1.501(c)(17)-2(j) (as amended by 35 Fed. Reg. 17,328 (Nov. 11, 1970)). In other words, once Congress provided that such payments were to be treated as wages for income-tax withholding purposes, the IRS amended its regulations to require the reporting of supplemental unemployment benefit payments as wages. The 1968 regulations are thus entirely consistent with the history of Section 3402(*o*) set forth in the government's petition. See Pet. 16-17.

Respondents further contend that the IRS could "address this issue through regulations." Br. in Opp. 21. But the Sixth Circuit declined to defer to the IRS's Revenue Rulings on the ground that those Rulings were "inconsistent with the intent of Congress as expressed in the statutes and the legislative history." Pet. App. 22a. The Sixth Circuit thus held that, under Section 3402(*o*), "the expressed will of the legislature" is that the severance payments at issue here "are not subject to FICA tax." *Id*. at 28a-29a. As part of its analysis, the Sixth Circuit suggested that the IRS lacked any regulatory authority to treat severance payments as subject to taxation under FICA. See *id*. at 29a ("And where a promulgated Treasury regulation has no power to alter a statute Congress enacted, neither does a revenue ruling."). It is thus not clear that the IRS could resolve the current circuit conflict by issuing regulations.

2. Respondents argue (Br. in Opp. 14-15) that, although the Third and Eighth Circuits have joined the Federal Circuit in holding that various types of severance payments are "wages" for FICA purposes, those decisions are distinguishable because the payments at issue in those cases were made as a result of voluntary

rather than involuntary separation. The text of FICA, however, draws no such distinction. It defines "wages" to include "all remuneration" paid for "any service" performed by an employee—without regard to whether there is a continuing employment relationship or why that relationship may have ceased. 26 U.S.C. 3121(a) and (b) (2006 & Supp. V 2011). Accordingly, the Third and Eighth Circuits (and even the Sixth Circuit in a previous decision) have not viewed the determination whether a severance payment constitutes "wages" for FICA purposes as turning on the voluntary or involuntary nature of an employee's separation. See *University of Pittsburgh* v. *United States*, 507 F.3d 165, 171-174 (3d Cir. 2007); *North Dakota State Univ.* v. *United States*, 255 F.3d 599, 605-608 (8th Cir. 2001); see also *Appoloni* v. *United States*, 450 F.3d 185, 189-194 (6th Cir. 2006), cert. denied, 549 U.S. 1165 (2007).

To be sure, the nature of an employee's separation might be relevant if, as respondents contend, Section 3402(*o*) governed the tax treatment of a severance payment under FICA. As the petition for certiorari explains, however, the Third, Eighth, and Federal Circuits have not treated Section 3402(*o*) as in any way relevant to the determination whether particular payments are FICA "wages." See Pet. 23. Those decisions reinforce the conclusion that this Court's review is necessary to prevent disuniformity in the administration of federal tax laws.[1]

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[1] Respondents contend (Br. in Opp. 15) that the government took a contrary position in *NYSA-ILA Container Royalty Fund* v. *Commissioner*, 847 F.2d 50 (2d Cir. 1988). That is incorrect. As the petition explains (Pet. 11-14), between 1956 and 1990 the IRS issued numerous Revenue Rulings that addressed whether particular payments to terminated employees should be treated as "wages" for both income-

3. Respondents acknowledge that this Court's decision in *Social Security Board* v. *Nierotko*, 327 U.S. 358 (1946), applied the "broad statutory meaning" of the term "wages" in FICA. Br. in Opp. 15 (discussing *Nierotko*'s "broad construction of 'wages' under FICA"). FICA defines "wages" as "all remuneration" paid for "any service, of whatever nature, performed * * * by an employee for the person employing him." 26 U.S.C. 3121(a) and (b) (2006 & Supp. V 2011). This Court in *Nierotko* recognized that FICA's broad definition of "wages" encompasses an award of back pay because such a payment is based on, and made on account of, "the entire employer-employee relationship." 327 U.S. at 366.

Respondents attempt to distinguish *Nierotko* on the ground that back pay is "a type of payment that clearly differs" from the severance payments at issue in this case. Br. in Opp. 15-16. But the amounts of the severance payments at issue in this case depended on particular employees' level of seniority, length of service with the company, and regular rate of pay. Those are all factors that depend on "the entire employer-employee relationship," *Nierotko*, 327 U.S. at 366, and all of them are

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tax withholding and FICA purposes. The IRS concluded that payments made to terminated employees were "wages" unless they were "linked to state unemployment compensation" and "designed to supplement the receipt of state unemployment compensation." Rev. Rul. 90-72, 1990-2 C.B. 211, 212. The government's brief in *NYSA-ILA Container Royalty Fund* set forth that same position: supplemental unemployment benefit payments—as defined by the IRS's Revenue Rulings—are not "wages" for FICA purposes. See Gov't Br. at 16-18, 18 n.*, *NYSA-ILA Container Royalty Fund*, *supra* (No. 87-6267). Under the IRS's longstanding approach, the severance payments at issue here are clearly "wages" for FICA purposes because they are wholly unconnected to state unemployment compensation.

usual factors associated with determining the level of an employee's compensation. The decision below therefore cannot be reconciled with this Court's reasoning in *Nierotko*.

C. The Decision Below Is Incorrect

Respondents argue at length (Br. in Opp. 4-13) that the decision below is correct. Even if respondents' arguments on the merits had greater force, the case would still warrant this Court's review in light of the square circuit conflict and the administrative importance of the question presented. In any event, respondents fail to offer a persuasive defense of the Sixth Circuit's decision.

1. Respondents assert that severance payments are not made in return for "any service, of whatever nature, performed" by an employee, 26 U.S.C. 3121(b) (2006 & Supp. V 2011), but are instead made for "the 'elimination of employment' due to plant shutdowns and similar conditions," Br. in Opp. 4. A severance payment, however, compensates a terminated employee for his *past* service to his employer, regardless of the reason for his termination. In *Otte* v. *United States*, 419 U.S. 43 (1974), this Court recognized that an employer may continue to pay "wages" after an employment relationship has ended. See *id.* at 49-50 (observing that because FICA defines wages as remuneration for services that an employee "performs or *performed*," the statutory language "speaks in the past tense as well as the present and thereby plainly reveals that a continuing employment relationship is not a prerequisite for a payment's qualification as 'wages'") (emphasis added). And even if the severance payments at issue here were viewed exclusively as compensation for loss of future employment, they would still be "wages" under *Nierotko*, which in-

volved compensation for work that the employee was not allowed to perform.

2. As the petition for certiorari explains, the court of appeals did not hold that the severance payments at issue here fall outside FICA's definition of "wages." See Pet. 8, 11. Although respondents defend the Sixth Circuit's textual analysis, they, like the court of appeals, rely on Section 3402(*o*) rather than on FICA. See Br. in Opp. 6.

By its terms, Section 3402(*o*)(1) applies only to Chapter 24 (income-tax withholding) and certain related procedural matters. See Pet. 15-16. FICA is codified at Chapter 21, not Chapter 24. As the Federal Circuit has explained, "Congress's decision to restrict the scope of the rule set forth in [S]ection 3402(*o*) to [C]hapter 24 suggests that Congress did not intend that rule, or any implication that might be drawn from that rule, to be applied outside the context of income tax withholding." *CSX Corp.*, 518 F.3d at 1341. Respondents offer no answer to the Federal Circuit's reasoning; they do not attempt to ground their position in the literal text of Section 3402(*o*)(1); and they do not explain why the court of appeals was justified in looking beyond FICA's definition of "wages" and drawing inferences from Section 3402(*o*).

Section 3402(*o*)(1)(A) provides that "any supplemental unemployment compensation benefit," as that term is defined in Section 3402(*o*)(2)(A), "shall be treated as if it were a payment of wages." Respondents infer (Br. in Opp. 8) that whatever the statute defines as a "supplemental unemployment compensation benefit" cannot itself be wages. That inference ignores the history of Section 3402(*o*), which respondents do not address. See Pet. 16-17. Congress defined the term "supple-

mental unemployment compensation benefit" broadly to include *both* the payments linked to state unemployment compensation that the IRS had historically treated as non-wage income, *and* various types of dismissal payments that the IRS had viewed as "wages," in order to ensure that both types of payments were subject to income-tax withholding. There was no reason for Congress to define the term more narrowly, because mandating withholding for all types of payments—some that were already subject to withholding and some that were not—created no practical difficulties. See Pet. 17-18.

By contrast, respondents' interpretation of Section 3402(*o*)(1)(A) brings that provision into conflict with more than 60 years of IRS practice. See Pet. 18. If Congress had wanted to eliminate FICA withholding from the sorts of dismissal payments that the IRS had historically treated as wages, the language it used in Section 3402(*o*)—which addresses income-tax withholding rather than FICA taxation, and which *expands* the range of payments that are subject to withholding—would have been a remarkably indirect way of accomplishing that result. Respondents offer no reason why Congress would have chosen such a circuitous route. Nor do they identify any evidence that, in subjecting "supplemental unemployment compensation benefit[s]" to income-tax withholding through the enactment of Section 3402(*o*), Congress sought to exempt from FICA taxation any payments that had previously been treated as FICA "wages."

Respondents also rely (Br. in Opp. 8-9) on Section 3402(*o*)(1)(C), which authorizes (but does not require) income-tax withholding from "sick pay which does not constitute wages." 26 U.S.C. 3402(*o*)(1)(C). The limiting language "which does not constitute wages" reflects

Congress's evident understanding that some sick pay was already treated as "wages." Respondents argue that the absence of similar language in Section 3402(*o*)(1)(A) suggests a different congressional understanding with respect to supplemental unemployment compensation benefits.

That inference is unwarranted. Section 3402(*o*)(1)(C)'s special withholding rule applies only "if at the time the payment is made a request that such sick pay be subject to withholding under this chapter is in effect." 26 U.S.C. 3402(*o*)(1)(C); see S. Rep. No. 1033, 96th Cong., 2d Sess. 3 (1980) (explaining that "this section of the bill provides for *voluntary* withholding from payments of sick pay made by a third party") (emphasis added). Given that limitation, the phrase "which does not constitute wages" serves an important purpose, by making clear that no such "request" is necessary to trigger income-tax withholding from sick pay that is *already* treated as "wages." Because Section 3402(*o*)(1)(A) contains no similar limitation, no practical harm results from the provision's application to payments that constituted wages under pre-existing law. See Pet. 17-18.[2]

3. Contrary to respondents' contentions (Br. in Opp. 4, 6), this Court's decision in *Coffy* v. *Republic Steel Corp.*, 447 U.S. 191 (1980), has no bearing on the question presented here. In *Coffy*, the Court held that payments to laid-off employees were "perquisites of seniori-

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[2] In addition, Section 3402(*o*)(1)(C) was added to the statute in 1980, see Act of Dec. 24, 1980, Pub. L. No. 96-601, § 4(a), 94 Stat. 3496, 11 years after Section 3402(*o*)'s original enactment in 1969, see Tax Reform Act of 1969, Pub. L. No. 91-172, § 805(g), 83 Stat. 708; and it therefore sheds little light on Congress's intent in enacting the original provision.

ty" under the Vietnam Era Veterans' Readjustment Assistance Act of 1974, because the payments at issue were "in the nature of a reward for length of service, and [did] not represent deferred short-term compensation for services actually rendered." *Id.* at 205-206. But *Coffy* did not address whether the payments were "wages" for either FICA or income-tax withholding purposes. And *Nierotko* makes clear that a payment may constitute "wages" for those purposes even if it does not compensate an employee for the performance of specific tasks or functions. FICA's expansive definition of "wages" encompasses compensation (like a bonus or severance payment) that accounts more generally for an employee's entire performance over some period of time. See Pet. 10.

4. Respondents' reliance (Br. in Opp. 4-5, 10) on *Rowan Cos.* v. *United States*, 452 U.S. 247 (1981), is likewise misplaced. In *Rowan*, the Court observed that the term "wages" is defined "substantially the same" for both income-tax withholding and FICA purposes, *id.* at 255, and the Court reasoned that the benefits at issue (meals and lodging) should be treated the same for both purposes, see *id.* at 263. That general equivalence is of no help to respondents here, however, since they identify no sound reason to conclude that the severance payments at issue in this case are not "wages" for purposes of income-tax withholding. Respondents' argument depends on the premise that *all* payments encompassed by Section 3402(*o*)(2)(A)'s definition of "supplemental unemployment compensation benefits" must be treated as non-wage payments for all purposes other than income-tax withholding. As the government has explained, and as the Federal Circuit correctly recognized in *CSX Corp.*, 518 F.3d at 1344-1345, the negative inference that

respondents seek to draw from Section 3402(*o*) is not justified by its text, history, and purpose.

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For the foregoing reasons and those stated in the petition for a writ of certiorari, the petition for a writ of certiorari should be granted.

Respectfully submitted.

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AUGUST 2013