Case No. 10-1563

IN THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

In re: Quality Stores, Inc., *et al*., *Debtors*

UNITED STATES OF AMERICA,

Appellant,

v.

QUALITY STORES, INC., *et al*.,

Appellees.

ON APPEAL FROM THE ORDER OF THE UNITED STATES
DISTRICT COURT FOR THE WESTERN DISTRICT OF MICHIGAN

APPELLEES' RESPONSE IN OPPOSITION TO PETITION FOR REHEARING *EN BANC*

Robert S. Hertzberg, Esq.
Pepper Hamilton LLP
Suite 1800, 4000 Town Center
Southfield, MI 48075-1505
(248) 359-7333

Michael H. Reed, Esq.
Pepper Hamilton LLP
3000 Two Logan Square
18th and Arch Streets
Philadelphia, PA 19103
(215) 981-4000
Counsel for Appellees

TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES

Page(s)

CASES

STATUTES

OTHER AUTHORITIES

Page(s)

INTRODUCTION

Pursuant to this Court's December 4, 2012 directive, Appellees Quality Stores, Inc. et al. ("Quality Stores" or "Appellees") respectfully submit this memorandum in opposition to the Petition for Rehearing En Banc filed by Appellant United States (the "Government").

SUMMARY OF ARGUMENT

The Panel found that payments made by Quality Stores to its former employees, which the parties had stipulated met the statutory definition of "supplemental unemployment compensation benefits," did not constitute "wages" subject to FICA taxation. The Panel's comprehensive and well-reasoned decision on this issue of first impression in this Circuit is well supported by the statute, the legislative history and the decisions of the United States Supreme Court. The decision is also completely consistent with the prior decisions of this Court. The Government does not cite any relevant decision of the Supreme Court or this Court that the Panel did not consider, but argues instead that the Panel "misread" or only "perfunctorily acknowledged" decisions of the Supreme Court and this Court. Pet. at 10, 11. On the contrary, the Panel thoroughly reviewed and correctly applied all relevant statutory provisions and precedents of the Supreme Court and this Court and came to the proper result in this case. The Government's argument to the contrary is entirely without merit and the Petition should, accordingly, be denied.

ARGUMENT

I. The Panel Properly Relied Upon *Coffy*

The primary grounds upon which the Government bases its request for the extraordinary relief of an en banc review is the Panel's reliance upon the Supreme Court's decision in *Coffy v. Republic Steel Corp.*, 447 U.S. 191 (1980). The Government asserts that the Panel "failed to address the actual FICA question" because of the Panel's erroneous belief that "*Coffy* establishes that SUB pay is not wages for FICA purposes." Pet. at 8.[1]

The Government's implication that the Panel relied upon *Coffy* to decide the ultimate issue in this case, i.e., whether supplemental unemployment compensation benefits ("SUB payments") constitute wages for FICA purposes, is incorrect and misleading. *Coffy* is the only Supreme Court case that expressly addresses the character of SUB payments and, therefore, appropriately was cited and relied upon by the Panel. However, the Panel's decision in this case ultimately was based upon its construction of the relevant provisions of the Internal Revenue Code ("IRC"), including 26 U.S.C. § 3402(o), legislative history and the binding precedent of the Supreme Court in *Rowan Cos. v. United States*, 452 U.S. 247 (1981).

[1] While on the one hand arguing that *Coffy* is irrelevant (*see* Pet. at 10), the Government later argues that *Coffy* actually supports its argument that SUB payments constitute wages. (*See* Pet. at 11-12).

As the Panel noted, the Supreme Court in *Coffy* held that SUB payments "are contingent on the employee's being thrown out of work; unless the employee is laid off he will never receive SUB payments . . . SUB's are compensation for loss of jobs." Op. at 6, citing and quoting *Coffy*, 447 U.S. at 200. This holding certainly is not inconsistent with *Social Sec. Bd. v. Nierotko*, 327 U.S. 358 (1946), which involved "back pay." *Coffy's* holding that SUB payments constitute non-wages also is consistent with the most relevant statutory provision, 26 U.S.C. § 3402(o), and the legislative history of that provision:

> Moreover, the legislative history of the statute confirms our interpretation. When § 3402(o) was enacted in 1969, Congress recognized that SUB payments "are not subject to [federal income tax] withholding because *they do not constitute wages or remuneration for services*." S. Rep. No. 91-552, at 255-56 (1969), *reprinted in* 1969 U.S.C.C.A.N. 2027, 2305 (emphasis added). Because SUB payments "are generally taxable income to the recipient," however, Congress decided to require federal income tax withholding on SUB payments to alleviate any unexpected income tax burden on employees for the calendar year in which the payments were made. *Id.* Congress stressed "that *although these benefits are not wages*, since they are generally taxable payments they should be subject to withholding to avoid the final tax payment problem for employees." *Id.* (emphasis added). As a result of the enactment of § 3402(o), the "withholding requirements . . . on wages are to apply to these *non-wage* payments." *Id.* at 2306 (emphasis added).

Op. at 9-10. *See also* Op. at 15, n. 4.[2]

II. The Panel's Construction of the Statute Was Correct

The Government's other major complaint is the Panel's alleged failure to recognize that § 3402(o) of the IRC is "limited to income-tax withholding." Pet. at 8. As the Government itself acknowledges, however, the Panel held that its "analytical bridge" for applying the definition found in Chapter 24 (income tax withholding) to Chapter 21 (FICA) of the IRC is the Supreme Court's decision in *Rowan*. Pet. at 7; Op. at 10. The Supreme Court's decision in *Rowan* clearly continues to be good law and binding on this Court. *See* Op. at 10-15; *see also Gerbec v. United States*, 164 F.3d 1015, 1026 n. 14 (6th Cir. 1999). While a subsequent amendment of the Code (the so-called "decoupling amendment") enacted in 1983 authorized the IRS *by regulation* to alter the holding of *Rowan* by providing for varying exclusions from wages for income tax withholding and FICA

[2] That legislative history followed a position that the IRS itself adopted in 1968 in final regulations addressing information reporting requirements which provided that SUB payments must be reported on Forms 1099 as non-wage payments, rather than on Forms W-2 which are used to report wages subject to withholding for both FITW and FICA purposes. Treas. Reg. §§ 1.501(c)(17)-2(j) and 1.6041-2(b), T.D. 6972, 1968-2 C.B. 222, 229 and 239; 33 Fed. Reg. 12889 (September 12, 1968). Regulation § 1.6041-2(b) was amended in 1970 after enactment of IRC § 3402(o)(2) to require reporting on Forms W-2 of SUB payments which are treated as wages for purposes of IRC § 3402(o)(2). T.D. 7068, 1970-2 C.B. 252; 35 Fed. Reg. 17328 (November 11, 1970). The definition of "supplemental unemployment compensation benefits" used in both the 1968 regulations and the current regulations track the definition used by Congress in § 3402(o)(2). *See* T.D. 6972, 1968-2 C.B. at 226. *See also*, Treas. Reg. § 1.501(c)(17)-2(a). The Panel was fully aware of this history.

tax purposes, the IRS has not acted on its authority to promulgate such regulations.[3]

Rowan requires that the definition of wages under FICA be construed *in pari materia* with the definitions in the income tax withholding parts of the Code. The Petition does not challenge the Panel's holding that SUB payments are non-wages for purposes of income tax withholding (although treated as wages pursuant to § 3402(o)(2)). Under *Rowan*, therefore, it follows that SUB payments are also not wages for purposes of FICA taxation.

The Government points out that the Federal Circuit found the statutory design that limits the scope of the definition of SUB payments to Chapter 24 to be a "key factor." Pet. at 8. As the Panel correctly recognized, however, the Federal Circuit, having determined that some SUB payments constitute wages for purposes of both FICA and income tax withholding, did not reconcile its statutory construction with *Rowan* and one of its own prior decisions:

> *Rowan* remains good law, and the Federal Circuit agrees with us on this point. *CSX Corp.*, 518 F.3d at 1344 & n.4. That court, however, confined the congressional definition of SUB pay in IRC § 3402(o) to federal income tax withholding only and did not rely on *Rowan* to conclude that the same statutory definition applies to

[3] Responding to the Panel's direct question to comment on the IRS' failure to issue a regulation clarifying this issue after the decoupling amendment was passed, Government counsel in her oral argument rebuttal stated that it is not possible for the IRS to issue a regulation on every topic that comes up.

> FICA tax. *Id.* at 1340-42, 1345. In doing so, the Federal Circuit appears to have created an inconsistency within its own law. *Id.* at 1344 (observing that *Anderson v. United States*, 929 F.2d 648 (Fed. Cir. 1991), "held that the term 'including benefits' in the definition of wages under FICA must be accorded the same meaning as the identical term used in the income tax statutes.") By contrast to the analysis of the Federal Circuit, we rely on *Rowan* to reach the conclusion that if Congress decided to treat SUB payments as if they were "wages" for purposes of federal income tax withholding, then the same definition must apply under FICA.

Op. at 14-15. *See also Anderson*, 929 F.2d 648, 654 n.10. (Fed. Cir. 1991).

The Government also has never reconciled its statutory construction with *Rowan* or the legislative history of § 3402(o).[4]

III. The Panel Properly Followed and Applied Precedents of the Supreme Court and this Court

The Panel clearly considered and analyzed the impact on this case of the Supreme Court's decision in *Social Sec. Bd. v. Nierotko*, 327 U.S. 358 (1946)

[4] In the Petition, the Government attempts to reconcile its statutory construction with *Rowan* by arguing that Congress expressed its intent to treat SUB payments differently under Chapter 21 by limiting the scope of the definition of SUB payments to Chapter 24. *See* Pet. at 12-14. The absence of a provision expressly addressing SUB payments in Chapter 21, however, says nothing about whether Congress intended to exclude such payments from wages for FICA purposes. The definition was needed in Chapter 24 to facilitate income tax withholding on amounts that Congress recognized were not wages. By not adopting any correlative provision in Chapter 21, Congress respected, and left unchanged, the characterization of SUB payments as non-wages for FICA tax purposes. *See* Op. at 9-10, 15 n.4.

and this Court's prior decisions in *Appoloni v. United States*, 450 F.3d 185 (6th Cir. 2006), *cert. denied*, 549 U.S. 1165 (2007) and *Gerbec*.

The Panel noted *Nierotko*'s broad construction of "wages" under FICA. *See* Op. at 6-7, citing *Nierotko*, 327 U.S. at 365-70. The Panel went on to note, however, that *Coffy*, a more recent decision of the Supreme Court, holds that SUB payments fall outside the broad statutory meaning of wages. Op. at 7.

The Panel also considered this Court's decision in *Appoloni*, noting that it represents an example of this Court's broad and inclusive construction of the FICA definitions. Op. at 7, citing *Appoloni*, 450 F.3d at 190. In *Appoloni*, a divided panel of this Court held that payments by school districts to public school teachers in exchange for relinquishment of the teachers' statutorily granted tenure rights constituted "wages" taxable under FICA. The majority emphasized that it was of great significance to its holding that the school district's purpose "was to induce those at the highest pay scales to voluntarily retire early." 450 F.3d at 196 (emphasis added). By contrast, as the Panel noted, SUB payments involve amounts paid due to an employee's "involuntary separation from employment… resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions." 26 U.S.C. § 3402(o)(2)(A); Op. at 8, 15.

The Panel also considered *Gerbec*. *See* Op. at 15. In *Gerbec* this Court held that, under a settlement of a wrongful discharge class action, damages

paid for non-physical personal injuries were exempt from FICA taxation under the exclusion for "tort or tort-type rights" but damages paid on account of unpaid back wages and future wages were taxable under FICA. The Panel noted that neither SUB payments nor IRC § 3402(o) were examined in that case. *Id.*

After considering all of the potentially relevant prior precedents of this Court, including *Appoloni*, *Gerbec* and *Sheet Metal Works Local 141 Supplemental Unemployment Benefit Trust Fund v. United States*, 64 F.3d 245 (6th Cir. 1995), the Panel concluded that "these prior cases do not impact our analysis here." Op. at 16.

IV. The Treatment of "Dismissal Payments" is Irrelevant

The Government also contends that the Panel's statement that "at the time SUB pay was conceived in the 1950's, all 'dismissal payments' made to employees qualified as FICA 'wages' for purposes of taxation" cannot be reconciled with the Panel's conclusion that "the payments made by Quality Stores to its former employees qualify as SUB payments, not 'dismissal pay.'" Pet. at 14-15, quoting Op. at 17, 20. This assertion is unfounded.

First, as the Government is well aware, the definitions of "dismissal payments" and "SUB payments" are very different. *See* Op. at 16-20; and compare Treas. Reg. § 31.3401(a)-1(b)(4) (defining "dismissal payments") with Treas. Reg. § 31.3401(a)-1(b)(14) (defining "SUB payments"). SUB payments not only

involve an involuntary separation from employment but also require the payments to be made **pursuant to a plan** and in connection with **the closure of a plant or operation or other similar work force reduction**.

Moreover, the treatment of dismissal payments prior to and during the 1950's has nothing to do with the current treatment of SUB payments, which is determined by the statute (i.e., 26 U.S.C. § 3402(o)(2)(A)) enacted in 1969, its legislative history and *Rowan*. Thus, there is no inconsistency or irreconcilability between the statements of the Panel as the Government contends.[5]

The fundamental flaw in the Government's position is that it fails to recognize that, since the early 1950's, SUB payments have been recognized as a special category of non-wages by both Congress, in the codification of the term in § 3402(o) of the IRC and the legislative history of that provision, and the Supreme Court (in *Coffy*).

At most, the Government has shown that it disagrees with the reasoning of the Panel and the Panel has reasoned disagreements with certain aspects of the Federal Circuit's analysis in *CSX*. Such disagreements, however, do

[5]Recognizing the interpretative significance of *Rowan*, the Government, both before the Federal Circuit in *CSX* and before the Panel in this case, unsuccessfully argued that *Rowan* had been legislatively overruled. *See* Op. at 11-12; *CSX*, 518 F.3d at 1343-45.

not constitute legal error, let alone the type of fundamental error that would justify a rehearing en banc or even a panel rehearing.

V. Conclusion

In conclusion, the Panel's decision is fully supported by the statute, the legislative history and the relevant precedents of the Supreme Court and is completely consistent with the prior decisions of this Court. Indeed, ironically, the Government invites this Court to rule in derogation of *Rowan,* a binding decision of the Supreme Court, which, of course, this Court cannot do. Accordingly, Appellees respectfully request that the Petition be denied.

Respectfully submitted,

/s/ Michael H. Reed
ROBERT S. HERTZBERG, ESQ.
Pepper Hamilton LLP
Suite 1800
4000 Town Center
Southfield, MI 48075-1505
(248) 359-7333

MICHAEL H. REED, ESQ.
Pepper Hamilton LLP
3000 Two Logan Square
18th and Arch Streets
Philadelphia, PA 19103
(215) 981-4000

Counsel for Appellees

CERTIFICATE OF SERVICE

It is hereby certified that on December 14, 2012, the foregoing Response to Petition for Rehearing *En Banc* was electronically filed with the Clerk of the Court by using the ECF system. Counsel for the appellant and counsel for the amici curiae are registered ECF users and will be served by the ECF system.

/s/ Michael H. Reed
Michael H. Reed, Esq.
Pepper Hamilton LLP
3000 Two Logan Square
18th and Arch Streets
Philadelphia, PA 19103
(215) 981-4000

Counsel for Appellees