

Message from Our Managing Partner

In this *Update*, we congratulate two Pepper partners for their vital contributions to our community. Michael Staebler was named to the Executive Committee of Ann Arbor SPARK, and Abraham Singer was honored for his work for the Fair Housing Center of Metropolitan Detroit.

We're also pleased to report how Pepper lawyers got a great result for our client, Quality Stores, as well as these new enhancements to Pepper services:

- our Independent Contractor Compliance Practice Group, which can advise and assist clients on an interdisciplinary basis, as Congress moves to make employee misclassification a federal labor law violation
- part of Pepper's International Practice Group, our Italian Desk is designed to serve as a bridge between Italian and U.S. businesses.

And our events and webinars include an episode of the Legal Roadmap to Success podcast series with The Deal: "Distressed M&A Dealmaking," and our "Lease Considerations for Green Buildings" webinar.

We welcome your comments, questions and suggestions.

Thomas P. Wilczak, Managing Partner

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Pepper Lawyers Victorious on Behalf of Quality Stores

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In *Quality Stores, Inc. v. United States*,¹ the United States District Court for the Western District of Michigan held that severance payments made by employers to employees pursuant to an involuntary separation are not subject to FICA taxation. This case, which Pepper handled before the district court, may have far-reaching effects on employers' and employees' need to pay Social Security and Medicare (FICA) taxes. Even if the decision does not overturn current law with regard to FICA taxes, it could lead to further litigation on the issues addressed by the court. Accordingly, taxpayers would be well advised to preserve their refund claims, in some cases immediately, in light of the pending court proceedings.

THE QUALITY STORES BACKGROUND

Quality Stores operated a chain of retail stores, selling agricultural supplies and related goods. In 2001, Quality Stores went into bankruptcy and eventually closed all of its stores and terminated all of its employees. In the period before its bankruptcy petition, Quality Stores closed more than 60 stores, and terminated approximately 75 corporate employees. Under the severance plan in place, these employees received severance payments that were paid out in accordance with the normal payroll period. After the bankruptcy petition was filed, the remaining stores and distribution centers

This publication may contain attorney advertising.

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were closed and all remaining employees of Quality Stores were terminated. These employees also received severance payments; however, these employees received lump-sum payments under a different severance plan. For both the pre-petition and post-petition severance pay plans, payment of the severance was not linked to the receipt of state unemployment benefits. Quality Stores reported these payments as wages on the former employees' W-2s and withheld both federal income tax and FICA from them, and paid the employer's FICA share. However, Quality Stores eventually filed refund claims for both its FICA payments and also on behalf of consenting employees for their shares of the FICA payments. After the bankruptcy court upheld Quality Stores' refund claims, the IRS appealed. Pepper Hamilton lawyers Robert Hertzberg, Mike Reed and Lisa Petkun represented Quality Stores in the district court and wrote the district court brief.

THE QUALITY STORES DECISION

The crux of the *Quality Stores* decision is whether payments made to terminated employees fall within the definition of "wages," and thus are subject to FICA, or into the exception for supplemental unemployment compensation benefits (SUB) payments and thus are exempt. Per the Internal Revenue Code, SUB payments are amounts paid to an employee because of an employee's involuntary separation resulting directly from a reduction in force, discontinuance of a plant or operation, or other similar conditions.²

Under Revenue Ruling 90-72,³ the IRS takes the position that in order for SUB payments to be exempt from the definition of "wages," and thus exempt from federal income tax withholding and FICA, they must be paid under a plan in which severance pay is linked to the receipt of state unemployment compensation and is not paid in a lump sum. In 2008, the Court of Appeals for the Federal Circuit upheld this definition in *CSX Corp. v. United States*,⁴ and in doing so reversed a lower court decision that was decided in favor of the plaintiff on similar grounds as *Quality Stores*.

However, on February 23, 2010, the United States District Court for the Western District of Michigan affirmed the holding of the bankruptcy court that Quality Stores' payments made to its laid-off employees fall within the exception to the definition of "wages" for SUB payments. The court rejected the IRS's argument that the payments were wages subject to FICA. The court reasoned that the plain language of Section 3402(o)⁵ and

the legislative history make it clear that a SUB payment is not a payment of wages, which is why Congress had to treat it "as if it were a payment of wages" for withholding tax purposes. It further noted that SUB payments are intended as a substitute for FICA protection for employees, and thus taxing SUB payments would run counter to the congressional intention to collect FICA so that individuals could receive remedial monetary support under the Social Security Act. Accordingly, the court held that Quality Stores was entitled to refunds for the FICA payments it had made attributable to the SUB payments.

PRESENT IMPACT OF THE DECISION

The *Quality Stores* decision, if followed by other courts, could create significant opportunities for taxpayers and generate billions of dollars in refunds for companies that have been in the unfortunate position of having to close operations or reduce their workforce. However, it is important to keep the immediate impact of the case in perspective.

First, *Quality Stores* is a federal district court decision, in contrast to the *CSX* case, which was decided by the Court of Appeals for the Federal Circuit. At present, the *Quality Stores* decision is at best persuasive authority. By contrast, the *CSX* case has broad precedential authority over all decisions in the Federal Circuit, and thus true national reach. In addition, the IRS may appeal *Quality Stores* to the Sixth Circuit Court of Appeals. Moreover, even if the decision were to be affirmed by the Sixth Circuit, it would then be precedential only in Kentucky, Ohio, Michigan, and Tennessee – the geographical boundaries of the Sixth Circuit.

Second, a number of factors must come together in order for *Quality Stores* to become precedential in other federal circuits. Taxpayers whose refund claims were rejected would need to file lawsuits, and only when a case reached a circuit court and a circuit court made a favorable decision would the case become precedent in that circuit. It is difficult to predict how this process will unfold in the coming months. However, it is likely that many refund suits will be filed all over the country, given that present economic circumstances have forced many companies to conduct broad reductions in force. Under current tax law, all such companies should have paid FICA taxes on SUB payments, and the IRS continues to be unwilling to grant any refund claims. That means that numerous companies could be the standard-bearers to import the *Quality Stores* decision to other circuits.

Finally, the particular facts of *Quality Stores* could limit its applicability to certain types of severance payments. The case only addressed severance that is paid under a plan or system designed to compensate employees because of a reduction in force, office or plant closing, or another similar situation. It did not involve payments made under a voluntary separation, such as an early retirement plan. Accordingly, if other taxpayers take the IRS to court in other jurisdictions, it is quite likely that issues regarding severance payments made to employees under other circumstances and not covered by the *Quality Stores* decision will be litigated.

PEPPER PERSPECTIVE

The learning from the *Quality Stores* decision is that even if a groundswell of companies flood the courts and cause a wholesale reversal in the treatment of severance payments for FICA purposes, this process will take years to reach a national resolution. However, taxpayers only have a three-year statute of limitations in which to seek a refund. The IRS allows taxpayers to file a protective claim that preserves the refund window while a court case regarding the same issue is pending. Protective refund claims

are easy to file, generally requiring only a handful of forms and a general statement of the law upon which the taxpayer is relying. Therefore, taxpayers who made severance payments (and thus FICA payments) between 2006 and 2009 should consider filing protective refund claims to preserve their ability to seek FICA refund payments. Taxpayers that made significant payments in 2006 need to file by April 15, 2010 before the 2006 statute of limitations closes.

ENDNOTES

- 1 No. 1:09-cv-44 (W.D. Michigan, Feb. 23, 2010).
- 2 I.R.C. § 3402(o).
- 3 1990-2 C.B. 211.
- 4 518 F.3d 1328 (Fed. Cir. 2008).
- 5 Unless otherwise stated, all references to “Section” are to the Internal Revenue Code of 1986 (the Code), and all references to “Treas. Reg. Section.” are to the Treasury Regulations promulgated thereunder (the Regulations).



The Deal and Pepper Hamilton’s Legal Roadmap to Success - Distressed M&A Dealmaking

There are a number of hot-button legal topics interesting to dealmakers at the moment. What key legal issues should you be thinking about in the coming months? Hear thoughtful perspectives in this series of incisive podcasts from The Deal and Pepper Hamilton LLP.

The Deal

EPISODE 4: PEPPER HAMILTON ON DISTRESSED M&A DEALMAKING

In this 2010 Legal Roadmap to Success podcast sponsored by Pepper Hamilton LLP, partners Todd A. Feinsmith and James D. Rosener discuss distressed M&A dealmaking with The Deal’s Maria Woehr.

Listen today by visiting

www.thedeal.com/knowledge/knowledge-center/pepper-hamiltons-feinsmith-and-rosener-on-distressed-ma.php.

Congress Moves to Make Employee Misclassification a Federal Labor Law Violation

In Response, Pepper Creates Independent Contractor Compliance Practice Group

RICHARD J. REIBSTEIN | REIBSTEINR@PEPPERLAW.COM

On April 22, 2010, a long-awaited bill addressing the issue of misclassification of employees as independent contractors was introduced by the House (Rep. Lynn Woolsey, D-CA) and Senate (Sen. Sherrod Brown, D-OH). The bills, H.R. 5107 and S. 3254, are called the Employee Misclassification Prevention Act (EMPA). They would amend the federal Fair Labor Standards Act to impose strict recordkeeping and notice requirements on businesses with respect to workers treated as independent contractors, and expose such businesses to fines from \$1,100 up to \$5,000 per employee for each violation of the law.

The purpose of EMPA is to curtail and penalize the practice of many businesses in the United States of misclassifying employees as independent contractors. This practice has reportedly contributed to the “tax gap” at both the federal and state level, as well as a loss of federal and state labor protections for those workers that, by law, should be classified as employees instead of as independent contractors.

EMPA does not prohibit businesses from continuing to use properly classified independent contractors; it only prohibits companies from misclassifying workers as independent contractors when such workers are really employees.

Nonetheless, all businesses would be affected by EMPA, because it imposes upon every company that uses either employees or independent contractors a recordkeeping and a notice requirement. Any business that fails to provide the required notice would be subject to fines, even if its independent contractors are properly classified.

Briefly, if enacted into law as drafted, EMPA would:

- require every company covered by the law to provide a written notice to all workers who perform labor or services informing them that they have been classified as either an employee or “non-employee,” directing them to a Department of Labor Web site for further information about the rights of employees under the law, and informing them to contact the Department of Labor if they have any questions about whether they have been misclassified

PEPPER HAMILTON ATTORNEYS’ NEW BLOG ADDRESSES INDEPENDENT CONTRACTOR COMPLIANCE

Pepper Hamilton’s Independent Contractor Compliance Practice Group leaders have launched a blog at www.independentcontractorcompliance.com, which includes a comprehensive set of legal resources for companies and lawyers seeking information about independent contractor misclassification, and which will track and comment on developments in the law. Richard Reibstein, Lisa Petkun and Andrew Rudolph have been handling worker classification matters for more than 20 years. As part of Pepper’s interdisciplinary practice in this field of law, they address this issue from the labor, tax and employee benefits law perspectives.

- require companies which are now required to keep records of the hours of work and wages of employees to keep comparable records for “non-employees” providing labor or services to the business
- add a new provision making it a “prohibited act” under federal law to fail to accurately classify a worker as an employee (i.e., to misclassify a worker as a non-employee)
- impose upon businesses a penalty from \$1,100 to \$5,000 per worker for a violation of the notice or recordkeeping requirements or for misclassifying an employee as a non-employee, and
- impose triple damages for willful violations of the minimum wage or overtime laws where the employer has misclassified the affected employee.

In addition, EMPA would direct the Secretary of Labor to:

- establish a misclassification Web site that would enable workers to file complaints online and notify them that employees may have greater rights under state or local laws than under federal law
- amend the Social Security Act to establish penalties for misclassifying employees or for paying unreported wages to employees for unemployment compensation purposes
- authorize the Department of Labor to report misclassification information to the IRS, and
- direct the Department of Labor to conduct “targeted audits” of certain industries “with frequent incidence of misclassifying employees as non-employees.”

The proposed legislation also seeks to pierce the corporate veil of corporations, partnerships, and LLCs owned in whole or part by the worker and used to avoid the issuance of Form 1099s.

EMPA is one of two bills introduced in this legislative term that deal with misclassification of employees. In 2009, the House and Senate introduced the Taxpayer Responsibility, Accountability, and Consistency (TRAC) Act of 2009 (S. 2882 and H.R. 3408). If enacted, the TRAC Act would limit the availability of the so-called “safe harbor” provisions in Section 530 of the Revenue Act of 1978, which has been relied on by many businesses to designate workers as independent contractors for federal employment tax purposes. The TRAC Act also would afford workers the right to petition the IRS for a determination of the worker’s status, and increase penalties of up to \$1 million to \$3 million for intentional disregard by taxpayers filing incorrect Form 1099s. Both houses of Congress are expected to reintroduce TRAC Act bills in 2010 that are similar or identical to those bills introduced in 2009.

The introduction of EMPA is consistent with the national labor policy of the Obama administration. The recently released Budget for Fiscal Year 2011 authorized \$25 million to the Department of Labor to target employee misclassification through the hiring of 90 additional investigators and 10 additional lawyers to pursue “a joint proposal that eliminates incentives in law for employers to misclassify their employees” and “enhances the ability of both agencies to penalize employers who misclassify.”

In anticipation of this proposed legislation on employee misclassification, Pepper has created its Independent Contractor Compliance Practice Group (http://www.pepperlaw.com/PracticeArea_preview.aspx?PracticeAreaKey=72). This practice team focuses on the interrelated legal issues involving independent contractors by using an interdisciplinary approach along with unique proprietary tools and techniques to diagnose and enhance compliance with independent contractor laws.

We also have prepared an article (available online at http://www.pepperlaw.com/publications_article.aspx?ArticleKey=1769) that explains steps employers should take now to minimize the risks posed by the use of independent contractors.

Pepper’s Independent Contractor Compliance Practice Group includes more than 25 employment, tax, and employee benefits attorneys working collectively. We have a dual approach: first, to assist organizations that currently use independent contractors to do so in a permissible manner under applicable employment, tax and employee benefits laws and to minimize exposure to liability from such laws; and second, to defend organizations that are subject to misclassification challenges brought in judicial and administrative proceedings and audits by governmental agencies and private lawyers.

Our team members understand that an audit by an unemployment or workers’ compensation agency of a company’s use of independent contractors may also lead to legal challenges in the tax and employee benefits areas, and vice versa. When asked by clients to enhance their legal compliance with independent contractor laws, we examine the issues and propose compliance measures from all three related legal disciplines – tax, employee benefits, and labor/employment law – using our proprietary tools, including “IC diagnostics” based on continually updated legal research.

More information about Pepper’s Independent Contractor Compliance Practice Group may be obtained by contacting any of the group’s co-chairs: Richard J. Reibstein (employment/labor matters) at 212.808.2722 or reibsteinr@pepperlaw.com; Lisa B. Petkun (tax matters) at 215.981.4385 or petkunl@pepperlaw.com; Andrew J. Rudolph (employee benefits matters) at 215.981.4749 or rudolpha@pepperlaw.com; or Bob Ludolph (Detroit office employment/labor matters) at 313.393.7368 or rudolphr@pepperlaw.com.

Michael Staebler Elected to Executive Committee of Ann Arbor SPARK



Michael B. Staebler has been elected to the Executive Committee of Ann Arbor SPARK. Ann Arbor SPARK, a non-profit organization, is the driving force in establishing the Ann Arbor region as a destination for business expansion, retention, and location by identifying and meeting the needs of business at every stage, from startups to large organizations. This is the organization's fifth year

assisting in the creation of economic opportunities throughout the region and state.

Mr. Staebler is a commercial practice partner in the Detroit office of Pepper Hamilton. He leads the firm's SBIC practice and is co-chair of the Fund Services Group. Mr. Staebler concentrates his practice in the formation and operation of Small Business Investment Companies, venture capital and private equity funds, mergers and acquisitions, and corporate finance and governance. He earned his J.D., *cum laude*, from the University of Michigan Law School and his B.A., *magna cum laude*, from Harvard College. He is a member of the Michigan bar.

Abraham Singer Honored by Fair Housing Center of Metropolitan Detroit

Abraham Singer was honored by the Fair Housing Center of Metropolitan Detroit (FHCMD) at its third annual Attorney Appreciation Awards Reception, held on April 22, 2010 at the Detroit Historical Museum. The FHCMD recognized Mr. Singer with its Attorney Appreciation Award for his commitment and work for full compliance with state and federal fair housing laws.

Mr. Singer is a partner with Pepper Hamilton and head of the litigation department in the Detroit office. He is a member of the Commercial Litigation Practice Group and the White Collar and Corporate Investigations Practice Group. Mr. Singer handles a broad-ranging commercial litigation and white-collar criminal defense practice in federal and state trial courts. He represents individuals and business enterprises in all stages of white collar criminal investigations, with particular focus on public corruption investigations, health care fraud, bankruptcy fraud and tax fraud. He concentrates his civil litigation practice on complex business disputes.

The Fair Housing Center of Metropolitan Detroit, a non-profit, tax-exempt, citizen-based organization, was established in 1977 for the purpose of addressing fair housing issues in the metropolitan Detroit area. FHCMD seeks to assure equal access to housing without discrimination based on race, sex, age, color, religion, national origin, familial, marital, sexual orientation or disability status.



Abraham Singer accepts the Attorney Appreciation Award from Emily C. Hall, vice-chairperson of the Fair Housing Center of Metropolitan Detroit.

Pepper Hamilton Announces Formation of Italian Desk as Bridge Between Italian and U.S. Businesses

Continuing its long history of assisting Italian companies and individuals in their business endeavors in the United States, and American companies and individuals investing and conducting business in Italy, Pepper Hamilton LLP has formed its Italian Desk, part of the firm's continued development of its International Practice Group.

The Italian Desk, a multi-disciplinary team of attorneys and professionals, has strong credentials and experience in a variety of practice areas and in many industries, including fashion and retail, manufacturing, food and beverage, pharmaceuticals and life sciences, financial services, technology and energy.

Pepper Hamilton partners Joseph V. Del Raso and Frank J. Cerza, co-chairs of Pepper Hamilton's Italian Practice Group, co-announced the creation of the Italian Desk. "We are very excited about the Italian Desk as a way to provide value to companies in both countries by bringing to bear our legal and business skills, client experience and relationships, and deep understanding of the similarities and differences between the Italian and American cultures," Del Raso said. "This effort is part of Pepper Hamilton's commitment to providing a bridge between Italian business and U.S. opportunities, and vice versa."

Cerza said the members of Pepper Hamilton's Italian Desk are uniquely positioned to serve not only as business lawyers, but also as business advisors. "We certainly have the depth of knowledge of real estate; corporate and securities matters; commercial litigation, arbitration and other forms of dispute resolution; tax; mergers and acquisitions; trade; intellectual property; and regulatory, labor and other matters that Italian companies will encounter as they establish or expand their business in the United States," he added. "In addition, Joe and I also had experience in business, before we were lawyers. So, with the help of a deep Pepper Hamilton bench, the Italian Desk also offers strategic and business planning advice on corporate formation, site selection, distribution, licensing and franchising approaches, tax planning and other areas."

The Italian Desk also advises clients about:

- entry and growth in the U.S. market
- venture capital and private equity
- cross border transactions, such as investments, joint ventures and dispositions of assets or businesses
- facilitating access to private investment funding
- sales of goods and services
- establishment of business operations in Italy
- Foreign Corrupt Practices Act and related compliance and enforcement issues.

Both Del Raso and Cerza pointed out that the benefits the Italian Desk offers to clients are enhanced by the firm's strong relationships with Italian law firms and key commercial and financial institutions as well as federal, state and regional governmental and regulating bodies in the United States and Italy.

Del Raso, a Pepper Hamilton commercial partner, also is president of the National Italian American Foundation and chairman of the board of trustees of The American University of Rome. Cerza, a member of the Board of the Italy-America Chamber of Commerce, Inc. and Honorary Representative of the American Chamber of Commerce in Italy for the State of New York, has lived in Italy and is fluent in Italian.

For more information about Pepper Hamilton's Italian Desk, contact Frank Cerza at 212.808.2741 or cerzaf@pepperlaw.com, or Joseph Del Raso at 215.981.4506 or delrasoj@pepperlaw.com.

WEBINAR

Lease Considerations for Green Buildings

Participants will learn how tenants and landlords can implement sustainability measures and green building practices in leased buildings. It is important that leases identify appropriate standards and address both landlord and tenant responsibilities with respect to these standards. Panelists will focus on these efforts and obligations, and discuss best practices for all parties involved in a green lease.

Panelists

Vicki R. Harding, partner, Pepper Hamilton LLP

Hannah Dowd McPhelin, associate, Pepper Hamilton LLP

Nancy S. Cleveland, Founder and president, Rubicon Crossings

The webinar recording and materials are available online at
www.pepperlaw.com/webinars_update.aspx?ArticleKey=1794

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