

April 23, 2014



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Case in Review: Supreme Court Settles Issue of Whether Severance Benefits Are Taxable under FICA

By Maria Tavano

Last month in an 8-0 decision, the Supreme Court ruled in [United States v. Quality Stores, Inc.](#), 134 S.Ct. 1395 (2014), that severance payments are wages subject to Social Security and Medicare taxes under the Federal Insurance Contributions Act, or FICA.

The Court's decision in *Quality Stores* affirms the IRS's long-held position that severance payments are subject to FICA tax. However, for at least the past 12 years the issue has been somewhat unsettled, as a series of decisions put the federal circuit courts in conflict with each other. As a result, until the Court's decision in *Quality Stores*, the IRS had been fighting off thousands of claims for refunds of FICA taxes paid on severance payments each year.

In 2001, Quality Stores, Inc., once the largest agricultural retailer in the country, filed for involuntary Chapter 11 bankruptcy and, in connection with that bankruptcy, laid off thousands of employees. The former employees received severance payments based on their positions and length of service pursuant to termination plans. Quality Stores reported the severance payments as wages on Form W-2s, paid its share of the FICA taxes, withheld the employees' share of the FICA taxes, and subsequently filed for a refund on behalf of itself as well as approximately 1,850 former employees. After the IRS

took no position on the refund claim, Quality Stores filed for relief in a Michigan bankruptcy court. The bankruptcy court sided with Quality Stores and found that the severance payments did not constitute "wages" under FICA. Both the United States District Court for the Western District of Michigan and the United States Court of Appeals for the Sixth Circuit (covering Kentucky, Indiana, Michigan, and Ohio) affirmed that decision, thereby creating a circuit split and queuing up the issue for a final decision by the United States Supreme Court.

The basis for the Supreme Court's holding is found in both the text and history of certain sections of both FICA and the Internal Revenue Code. FICA defines "wages" as "all remuneration for employment." 26 U.S.C. § 3121(a). In its analysis, the Court concluded severance payments made to terminated employees, based on the plain meaning of the text, fits within FICA's broad definition of wages. The Court further reasoned that specific statutory exemptions to this definition, such as the exemption for disability retirement-related severance payments, reinforce the conclusion that severance payments are generally included as wages under FICA. Otherwise, the Court reasoned, there would be no need for the specific exemptions. The Court also noted that "dismissal payments" were once exempted from the FICA definition of "wages," but that exemption was repealed by Congress in 1950.

The Court turned next to Quality Stores' argument that Section 3402(o) of the Internal Revenue Code, which relates to income-tax withholding, limits the meaning of "wages" under FICA.

The parties stipulated that the separation payments Quality Stores made qualified as "supplemental unemployment compensation benefits" (or "SUB"), under Section 3402. SUB payments are defined as compensation "paid to an employee, pursuant to a plan to which the employer is a party, because of 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." Quality Stores argued that because Section 3402(o) requires SUBs to be treated *as if* they were wages for income tax purposes, it is implicit that such payments are not actually "wages" for income tax withholding purposes. Quality Stores took its argument one step further and reasoned that if severance payments are not wages for income tax purposes, they are not wages under FICA either.

The Court rejected this argument, holding that the text of the statutory provisions cited by Quality Stores did not support its arguments. Further, the Court held, the history behind Section 3402(o) undermined Quality Stores' argument. SUBs originated from labor union demands for guaranteed annual wages for workers. When guaranteed annual wages proved impractical, the labor unions

turned to a different idea: supplementing unemployment compensation. Thus, in the 1950s, major American employers adopted SUB plans in conjunction with their unions. These plans provided laid-off employees with additional payments intended to supplement state unemployment benefits, thereby ensuring workers on short-term layoffs maintained a steady income. This arrangement quickly ran into problems, however, as many states, as is the case today, prevented employees from receiving unemployment benefits if they were still being paid by their employers. Because many states followed the federal definition of "wages," for SUB plans to work at the state level, SUB payments needed to be excluded from the federal definition of "wages." The IRS then issued a series of Revenue Rulings in the 1950s and 1960s holding that SUBs were not wages for purposes of either FICA or income-tax withholding requirements.

Problems persisted, however, because SUBs were nonetheless considered *income*, and without employer withholdings on the payments, employees receiving the SUBs found themselves with a large tax bill at the end of the year.

That is where Section 3402(o) came in. In 1969, Congress enacted Section 3402(o), which requires that *all* severance payments be treated "as if" they were wages for purposes of both FICA and income-tax withholding. Thus, the Court said, Congress responded to the SUB withholding problem by requiring that all severance payments be treated equally: as wages subject to withholding requirements, including under FICA.

Ultimately, the Court held that because the severance payments by Quality Stores were made to employees involuntarily separated from employment based on their positions and length of service and were in no way linked to the receipt of state unemployment benefits, those payments are "wages" under FICA and thus subject to its tax. At the conclusion of its decision, however, the Court left untouched the IRS Revenue Rulings that hold severance payments specifically tied to the receipt of state unemployment benefits are exempt from both income tax withholding and from FICA taxation, and it left for another day (and perhaps hinted at its opinion on) the question of whether those Revenue Rulings are consistent with the requirements of FICA.

For any employers that may have filed for refunds of FICA taxes paid on severance payments, the Court's decision conclusively closes any dispute on the issue. And while the decision left untouched the IRS Revenue Rulings exempting specially structured severance arrangements from the FICA tax, employers utilizing such arrangements should proceed with caution in light of the Court's discussion in *Quality Stores* and the logic underlying its decision.

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