U.S. Supreme Court: Severance Payments are Taxable as Wages for FICA Purposes

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By: John Eagan and Kevin S. Koscil

On March 25, 2014, the U.S. Supreme Court held that severance payments made to employees who were involuntarily terminated are taxable as wages for Federal Insurance Contributions Act (FICA) purposes. The decision in *U.S. v. Quality Stores, Inc.*, No. 12-1408, reversed decisions by the Bankruptcy Court, the U.S. District Court, and the U.S. Court of Appeals for the Sixth Circuit. Based on the Sixth Circuit’s decision, many employers had filed protective refund claims on the basis that severance payments made to employees who were involuntarily terminated were not subject to FICA withholding.

Quality Stores, Inc. and its affiliates made severance payments to employees who were terminated as part of Quality Stores’ Chapter 11 bankruptcy proceeding. Quality Stores treated the severance payments as wages for FICA purposes, but then filed a refund claim with the Internal Revenue Service and claimed that such severance payments were exempt from wages treatment under FICA. Quality Stores successfully argued its position in proceedings before the Bankruptcy Court, the U.S. District Court, and the Sixth Circuit Court of Appeals.

The decisions by the lower courts were based on an analysis of how severance payments are treated for income tax purposes. Under Code Section 3402(o), a severance payment “shall be treated as if it were a payment of wages.” This “as if” language led the lower courts to conclude that severance payments were not to be treated as wages for FICA purposes.

The U.S. Supreme Court held that this conclusion was incorrect. The Court first focused on the general definition of wages for FICA purposes (“remuneration for employment” under Code Section 3121(a)) and held that severance payments are within the scope of wages since they clearly relate to employment. The Court then addressed the “as if” argument for income tax withholding purposes. The Court held that the definition of wages for income tax withholding purposes is very broad and noted that since severance payments are not specifically exempted, such payments “squarely fall within the broad textual definition of wages” for income tax withholding purposes. The Court was also persuaded that that legislative history to the enactment of Code Section 3402(o) indicated that Congress did not intend a wages exemption for severance payments.

Based on the U.S. Supreme Court decision, severance payments made to employees who have been involuntarily terminated are clearly treated as “wages” for FICA purposes. The decision does not, however, have an impact on the IRS’s position that severance payments that are properly tied to the receipt of State unemployment benefits are exempt from FICA tax.
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