

U.S. Supreme Court Rules That Severance Payments Are Wages Subject to FICA Taxes

On March 25, 2014, the U.S. Supreme Court (the Court) in *United States v. Quality Stores, Inc.* unanimously overturned a lower-court decision and held that severance payments made to involuntarily terminated employees are “wages” subject to Federal Insurance Contributions Act (FICA) taxes. The Court largely followed the broad definition of wages (and employment) for FICA purposes under Internal Revenue Code (IRC) Sections 3121(a) and (b) and prior Supreme Court precedents to support its decision.

Background

The issue of whether certain types of severance pay may be excluded from FICA withholding first became a noteworthy topic back in 2002, in *CSX Corp. v. United States*, when the U.S. Court of Federal Claims determined that certain involuntary layoff payments could be exempt from FICA, if those payments qualified as supplemental unemployment compensation benefits (SUB payments) under IRC Section 3402(o)(2). This initial decision prompted many employers to file refund claims for FICA taxes withheld on these types of severance payments, which the Internal Revenue Service (IRS) put on hold while the appeal was pending. In 2008, the U.S. Court of Appeals for the Federal Circuit reversed the lower-court decision in *CSX Corp.* As a result, the IRS disallowed the refund claims for FICA taxes on those benefits that had been held.

On February 23, 2010, this issue was raised again in *United States v. Quality Stores, Inc.*, when the U.S. District Court for the Western District of Michigan affirmed a bankruptcy court’s decision that severance payments made to employees, pursuant to an involuntary reduction in force, were not “wages” for FICA tax purposes. The IRS appealed the ruling to the U.S. Court of Appeals for the Sixth Circuit. On appeal, the U.S. Court of Appeals for the Sixth Circuit held that the severance payments made by Quality Stores, Inc. were properly classified as SUB payments and that such payments were not wages for purposes of FICA tax withholding.

Since there was a split in the circuits regarding whether severance benefits were subject to FICA tax, the *Quality Stores* case was appealed to the U.S. Supreme Court. The Court held that severance payments, including SUB payments, do fall within the definition of “wages” for FICA tax purposes. In its decision, the Court reasoned that severance payments, including SUB payments, are “remuneration for employment” due to the fact that:

- they are made only to employees who have been terminated;
- typically are varied based on job seniority and position; and
- are often used to attract employees

The Court noted that the severance payments made by Quality Stores, Inc. were:

- made to employees terminated against their will;
- were varied based on job seniority; and
- were not linked to the receipt of state unemployment benefits

As a result, such payments constituted “wages” for FICA tax purposes.

The U.S. Supreme Court ruling in *Quality Stores* upholds the IRS’s long-standing position that severance pay – regardless of whether it is paid pursuant to a reduction in force – constitutes wages subject to FICA

withholding. As a result, employers that filed protective refund claims following the Sixth Circuit's earlier decision will not be entitled to a refund of FICA taxes.

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