

CLIENT ALERT: U.S. Supreme Court Rules that Employee Severance Pay Subject to FICA Tax

In *United States v. Quality Stores, Inc.*, the U.S. Supreme Court held unanimously that severance payments made to former employees who were terminated from employment are considered wages and therefore taxable income under the Federal Insurance Contributions Act ("FICA"). Quality Stores, Inc., an agricultural-specialty retailer, filed for Chapter 11 bankruptcy in 2001 and terminated thousands of employees. The company paid severance and withheld taxes as required by FICA, but believing that the payments should not be taxed as wage income, later applied for a refund on behalf of approximately 1,850 affected employees.

FICA funds the benefits provided under the Social Security Act and Medicare through a payroll tax on wages. The term "wages" is broadly defined by FICA as "all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash." FICA defines "employment" as "any service, of whatever nature, performed . . . by an employee for the person employing him." Relying on these definitions, the Court found that the severance payments were remuneration for employment. The opinion compared severance payments to other benefits paid by an employer, as well, noting that they are awarded based on job level and seniority. Additionally, the Court noted that a good severance package attracts employees and helps enforce the employer's positive reputation as a good employer.

FICA contains a "lengthy list" of specific exemptions, including severance payments made in connection with disability retirement. The Court found this distinction persuasive, because such exemption would be unnecessary if severance payments in general were not wages. In reviewing the statutory history of FICA, the Court noted that at one time FICA contained an exemption for dismissal payments, but that provision was later repealed.

Quality Stores argued that severance payments are exempt from taxation under section 3402(o) of the Internal Revenue Code, which states that "supplemental unemployment compensation benefits" ("SUBs") are treated "as if" they are wages. Quality Stores contended that this language means that severance payments fall outside the definition of wages for the purposes of income-tax withholding and is therefore also outside of FICA's definition of wages. The Court disagreed, noting that like FICA, the code broadly defines "wages." The Court clarified that the terms "as if" are consistent with the fact that at least some severance payments are wages. The Court disagreed with Quality Stores' textual argument that the heading of the code section "[e]xtension of withholding to certain payments other than wages" means that severance payments are "other than wages." While pointing out that they can be a useful aid in resolving ambiguity, the relevant heading "falls short of a declaration that all the payments listed in §3402(o) are not wages."

The decision will have a broad impact on FICA taxes on severance payments, but the holding affects only payments made to employees who are terminated involuntarily and whose severance is not linked to state unemployment benefits. Severance payments tied to the receipt of state unemployment benefits are currently exempt from both income-tax withholding and FICA taxation. Employers contemplating entering into severance agreements are well advised to consult with legal and tax professionals to ensure that they are compliant with federal and state tax and employment standards.

Rebecca Waisanen is an attorney with Morgan, Brown & Joy, LLP and may be reached at (617) 523-6666 or at rwaisanen@morganbrown.com. Morgan, Brown & Joy, LLP focuses exclusively on representing employers in employment and labor matters.

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