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SEVERANCE PAYMENTS ARE TAXABLE FICA WAGES

In *U.S. v. Quality Stores, Inc.*, the U.S. Supreme Court ruled that severance payments are taxable as wages under the Federal Insurance Contribution Act (FICA) when made to employees whose employment is involuntarily terminated.

Factual Background

Quality Stores faced financial difficulties in 2001, and eventually entered bankruptcy proceedings. Both before and after filing its bankruptcy petition, the company offered its employees a series of severance packages payable upon the employees' separation from the company. Quality Stores reported the severance payments as wages on W-2 tax forms, paid FICA taxes, and withheld the employees' share of FICA taxes. The company later asked its former employees to allow it to file FICA tax refund claims for them, and eventually filed refund claims for them, and on its own behalf, with the IRS. The IRS did not allow or deny the refund, and Quality Stores initiated a proceeding seeking a FICA tax refund through bankruptcy proceedings.

The bankruptcy court, federal district court, and the Sixth Circuit all ruled in favor of Quality Stores, holding that the severance payments were not subject to FICA taxes because they qualified as supplemental unemployment benefits (SUBs) as defined by the Internal Revenue Code.

Supreme Court's Decision

By a vote of eight to zero (with Justice Kagan recused), the Court held that the definition of "wages" for purposes of FICA includes severance payments made by an employer to its employees because the payments were remuneration for services. The Court analyzed the FICA statutory text (section 3221(a)(13)(A)) and noted that FICA specifically exempts some termination-related payments from the definition of wages. That there are specific enumerated exemptions, the Court reasoned, showed that the severance payments at issue were purposely not exempted.

Further, the Court noted that the specificity of the enumerated exemptions reinforced “the broad nature of FICA’s definition of wages.” The court further dismissed various Code and statutory arguments submitted by the parties arguing exemption should apply.

Employer Implications

Employers that filed FICA tax refunds following workforce reductions, relying on the lower courts’ decisions, will not receive refunds from the IRS. Further, employers who did not withhold FICA taxes when issuing severance payments will have to file amended returns and pay the FICA tax, which may allow employers to avoid penalties from the IRS.

The Supreme Court, however, left open the question of whether all SUB plans are subject to FICA taxes. The IRS’s current administrative position is that certain SUB plans are exempt from FICA, if they are linked to state unemployment benefits. The issue in *Quality Stores* was whether other types of severance payments would fall in the same exemption category. The Supreme Court’s decision implied that, under the relevant statutes, all SUB plans could be subject to FICA, but the Court did not delve into this analysis.

Example of payments that are exempt from FICA taxes include: payments made upon or after the termination of an employee’s employment relationship because of death or retirement for disability, payments on account of disability caused by sickness or accident, payments made under an annuity plan (e.g., health and long-term care insurance), payments under a simplified employee pension plan, and exempt governmental deferred compensation plans. For further guidance on FICA tax exemptions, see 29 U.S.C. § 3121(a).

For a copy of the unanimous opinion authored by Justice Kennedy, see: *United States v. Quality Stores, Inc.*, No. 12-1408 (March 25, 2014).

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