

# SUPREME COURT: SEVERANCE PAYMENTS ARE WAGES SUBJECT TO FICA TAXES

Insights  
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On March 25, 2014 the U.S. Supreme Court unanimously held that a certain type of severance payment known as supplemental unemployment compensation constituted “wages” subject to Federal Insurance Contributions Act (FICA) payroll taxes. The Court’s decision resolves a split of authority between U.S. Courts of Appeals, and affirms the Court’s broad interpretation of “wages” for purposes of both FICA and income tax withholding requirements. *United States v. Quality Stores, Inc.*

## Facts Of The Case

Quality Stores, Inc., an agricultural-specialty retail chain, filed for bankruptcy in 2001. As it neared bankruptcy it laid off a number of its employees and offered them severance packages, based on each employee’s position, rate of compensation, and tenure at the company. Quality Stores remitted about \$1 million in FICA taxes to the IRS based on the severance amounts, but later sought a tax refund in federal bankruptcy court.

In the bankruptcy proceedings, the parties stipulated that the severance packages constituted “supplemental unemployment compensation benefits,” or SUB payments. The bankruptcy court ruled that SUB payments were not “wages” under FICA and accordingly granted Quality Stores’ refund. On appeal, the U.S. Court of Appeals for the 6<sup>th</sup> Circuit affirmed the decision.

## Background

FICA is a tax imposed on employee wages to fund the Social Security and Medicare programs. Employers are required to withhold the tax from their employees’ wages, and then remit the withheld taxes, along with a matching amount paid directly by the employers, to the IRS. Under FICA, “wages” are defined 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.”

FICA itself does not define SUB payments, nor does it expressly state that they are wages. But the Internal Revenue Code, (IRC) in the context of federal tax withholdings, defines SUB payments as:

amounts which are paid to an employee, pursuant to a plan which the employer is a party, because of an employee’s involuntary separation from employment (whether or not such separation is temporary), resulting directly from a reduction in force, the discontinuance of a plan or operation, or other similar conditions, but only to the extent such benefits are includible in the employee’s gross income.

After reviewing the parties’ stipulations from the bankruptcy proceedings, the 6<sup>th</sup> Circuit agreed that Quality Stores’ severance payments were properly classified as SUB payments as defined by the Internal Revenue Code.

The question then turned to whether SUB payments constituted “wages” under FICA (and therefore were subject to FICA taxes). In examining the legislative history, the language of the IRC, and relevant case law, the 6<sup>th</sup> Circuit found that SUB payments were not “wages.”

Accordingly, while SUB payments were payments permitted to be treated as wages for tax withholding purposes (because such payments were subject to personal income taxes), they themselves were not “wages” as defined under the withholding statutes. In light of Supreme Court precedent finding that Congress intended “wages” to carry the same meaning for both federal tax withholding and FICA, the 6<sup>th</sup> Circuit concluded that SUB payments were not wages under FICA, and accordingly affirmed the refund to Quality Stores.

The 6<sup>th</sup> Circuit’s decision was at odds with a 2008 decision of the Court of Appeals for the Federal Circuit, which found that SUB payments were indeed wages under FICA.

On appeal to the U.S. Supreme Court, the government’s argument essentially boiled down to two main components: First, the government argued that the severance payments were remuneration for employment and fit squarely within FICA’s broad definition of wages. Second, the IRC should not be read to narrow FICA’s definition of wages.

The Supreme Court heard oral arguments in the case on January 14.

## **Decision Of The Court**

A unanimous Court found that severance payments (including SUB payments) are “wages” under FICA as they are clearly “remuneration for employment,” given that they are offered only to employees, often vary based on the position or seniority of the employee, and are often used like employee benefits to attract and retain talented employees. The Court also looked to the statutory history of FICA and noted that “dismissal payments” were once expressly exempted from the definition of “wages,” but that exemption was dropped in Congress’ last relevant amendment to the definition in 1950, indicating a congressional intent to treat severance payments as wages.

The Court then turned to whether FICA’s definition of wages was somehow limited by the IRC. The Court pointed out that the income tax withholding statutes also contained a broad definition of wages and that SUB payments were not included in the express exemptions to the definition.

Finally, the Court reviewed the legislative history of the IRC section at issue and found that the language was designed to fix a withholding problem resulting from differential treatment by the IRS and some state unemployment agencies in the 1950s and 1960s regarding severance payments in connection with eligibility for unemployment benefits, rather than some broad congressional decision to exclude SUB payments from wages. To the contrary, the Court was guided by its reasoning in an earlier decision (*Rowan Cos. v. United States*) that Congress intended the definition of wages should be (in general) the same for income tax withholding and FICA tax purposes.

## **Implications For Employers**

SUB payments are “wages” subject to FICA taxes. This was generally the status quo position prior to the Court’s decision, and as a result there will not be the flood of refund requests the government predicted if the Court sided with Quality Stores (the Obama Administration claimed it expected to have to pay over \$1 billion in refunds if it lost).

Less clear is the extent to which this ruling will affect SUB payments generally. If SUB payments constitute “wages,” their receipt by unemployed ex-employees may disqualify them from state unemployment benefits. The Court did not wade into the issue of IRS interpretation of “wages” in this context, and seemed to be limiting its decision to the facts of this particular case, where the SUB payments were not tied to receipt of state unemployment benefits. Accordingly, prior IRS Revenue Rulings determining that SUB payments tied to receipt of state unemployment benefits are exempt from FICA tax and withholding obligations have been left, for the moment at least, intact.

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