A Win for the IRS: Supreme Court Says Severance Payments Are FICA-Taxable Wages

On March 25, the U.S. Supreme Court released a much-anticipated decision with payroll tax implications, ruling unanimously that severance payments are taxable wages under the Federal Insurance Contributions Act (FICA) [*U.S. v. Quality Stores, Inc.*, No. 12-1408 (U.S. Sup. Ct., 3-25-14)]. An earlier decision in the case by the Sixth Circuit of Appeals was reversed. The severance payments involved in this case were made to employees terminated against their will, varied based on job level and length of employment, and were not linked to the receipt of state unemployment benefits.

Note: The American Payroll Association filed a brief on behalf of Quality Stores with the Supreme Court, which was prepared by APA's tax counsel, Mary Hevener and David Fuller of Morgan, Lewis & Bockius.

Background

The severance plans. Quality Stores operated a chain of stores specializing in agricultural supplies and related products. Due to financial hardship, the company closed its stores and distribution centers, and terminated all of its employees. It made downsizing payments to terminated employees pursuant to severance plans that were similar to those maintained by many employers. Executives, salaried employees, and hourly employees received either periodic or lump-sum payments equal to a period of months or weeks based on the employee's position and/or years of service. The payments were not connected to the receipt of state unemployment compensation nor were they attributable to the performance of particular employment services.

The litigation. Quality Stores reported the severance payments as wages on Forms W-2 and withheld and paid both the employees' and the employer's share of FICA taxes on the payments. In 2002, Quality Stores asked 3,100 former employees to allow it to file FICA tax refund claims for them. About 1,850 former employees agreed to allow Quality Stores to pursue FICA refunds. On its own behalf and on behalf of the former employees, Quality Stores filed for a refund of $1,000,125 in FICA taxes.

The bankruptcy court, the district court, and the Sixth Circuit Court of Appeals all held that the FICA taxes should be refunded. The IRS appealed each decision and has finally won the day.

FICA definition of wages

Does the FICA definition of "wages" encompass severance payments? After looking at "the relevant statutory text," the Court said that it does.

● FICA defines "wages" as "all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash" (26 USC §3121(a)).

● The term “employment” encompasses “any service, of whatever nature, performed . . . by an employee for the person employing him” (§3121(b)).

Statutory language. Under this definition, and as a matter of plain meaning, said the Court, severance payments made to terminated employees are "remuneration for employment.” They are, of course, “remuneration,” and “common sense dictates” that employees receive the payments “for employment.”

The payments are made to employees only. It would be “contrary to common usage to describe as a severance payment remuneration provided to someone who has not worked for the employer.” Therefore, severance payments are made in consideration for employment – for a “service ... performed” by “an employee for the person employing him."

Additionally, §3121(a)(13)(A) exempts from taxable wages any severance payments made “because of . . . retirement for disability.” This exemption would be unnecessary if severance payments in general were not within FICA’s definition of “wages.” The Court also noted that the FICA definition of “wages” includes specific exemptions – which reinforce the broad nature of the definition.

Finally, the Court looked at FICA’s statutory history, noting that, in 1939, Congress created an exception from “wages” for “dismissal payments.” The exception was repealed in 1950 and, since then, FICA has contained no exception for severance payments.

Statutory interpretation. The Court long ago interpreted the term “wages” broadly for FICA purposes, stating that the term “service” means “not only work actually done but the entire employer-employee relationship for which compensation is paid to the employee by the employer.” As confirmation of that principle, the Court cited the fact that severance payments often vary, as they did here, according to the function and seniority of the particular employee who is terminated.

“In this respect severance payments are like many other benefits employers offer to employees above and beyond salary payments. Like health and retirement benefits, stock options, or merit-based bonuses, a competitive severance payment package can help attract talented employees.”

In addition, said the Court, employers that downsize in a period of slow business may wish to retain the ability to rehire employees who have been terminated. An employer may seek to retain goodwill by paying its terminated employees well, thus reinforcing its reputation as a worthy employer.

IRC definition of SUB pay

Does the IRC definition of “supplemental unemployment benefits” (SUBs) limit the meaning of “wages” for FICA purposes? Reiterating many of the points made in connection with FICA wages, the Court said that it does not.

26 USC §3402 provides:

“(o) Extension of withholding to certain payments other than wages.

“(1) General rule

"For purposes of this chapter (and so much of subtitle F as relates to this chapter)—

“(A) any supplemental unemployment compensation benefit paid to an individual, ... “shall be treated as if it were a payment of wages by an employer to an employee for a payroll period.”

Arguments rejected. The Court rejected Quality Stores' argument that §3402(o)'s instruction that SUBs be treated "as if" they were wages for purposes of income tax withholding is an indirect way of saying that the definition of wages for income tax withholding does not cover severance payments. On the contrary, said the Court, the definition of wages for income tax withholding purposes is broad: "all remuneration ... for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash" (§3401(a)). And like the definitional section for FICA, it contains a series of specific exemptions that reinforce the broad scope of its definition of wages.

Moreover, severance payments are not exempted, said the Court, and they squarely fall within the broad definition of wages for purposes of income tax withholding under §3401(a), for the same reasons outlined with respect to FICA's similar definition.

The Court also rejected Quality Stores' argument that severance payments must fall outside the definition of wages for income tax withholding – or §3402(o) would be superfluous. On the contrary, said the Court, §3402(o)'s command that all severance payments be treated "as if" they were wages for income tax withholding is entirely consistent with the proposition that at least some severance payments are wages. The statement that "all men shall be treated as if they were six feet tall does not imply that no men are six feet tall."

Regulatory background. The regulatory background against which §3402(o) was enacted illustrates the limited nature of the problem the provision was enacted to address, explained the Court.

SUB plans, as originally conceived in the 1950s, offered "second-level protection against layoff" by supplementing unemployment benefits offered by the states. But for such plans to work, it was necessary to avoid having SUBs defined under federal law as "wages," because some states only provided unemployment benefits if terminated employees were not earning "wages" from their employers.

In "at least partial response" to the prospect of differential treatment of SUBs based on differing state laws, the IRS issued guidance in the 1950s and 1960s taking the position that SUB payments were not "wages" under FICA as well as for purposes of income tax withholding, though the payments still were considered taxable income. As a result, terminated employees faced significant tax liability at the end of the year.

Enactment of §3402(o). In 1969, Congress enacted §3402(o), which provides that all severance payments – that is, both SUBs as well as severance payments that the IRS considered wages – would be "treated as if" they were wages for purposes of income tax withholding. The definition Congress adopted in §3402(o) was not limited to the SUBs that the IRS had deemed exempt from wages under FICA. Not all severance payment plans were tied to state unemployment benefits; and, before §3402(o)'s 1969 enactment, the IRS had ruled that severance payments not linked to state unemployment benefits were wages for purposes of income tax withholding. *Note:* The IRS still provides that severance payments tied to the receipt of state unemployment benefits are exempt not only from income tax withholding but also from FICA taxation.

The problem Congress sought to resolve was the prospect that terminated employees would owe large payments in taxes at the end of the year as a result of the IRS' exemption of certain SUBs from withholding. Congress determined that, whatever position the IRS took with respect to various categories of severance payments, the

problem with withholding could be solved by treating all severance payments as wages requiring withholding.

Statutory interpretation. The Court long ago observed that the definition of wages under FICA was in substance the same as the definition of wages for purposes of income tax withholding. Added to that is the longstanding concern for simplicity and ease of administration, which "instruct" that the meaning of "wages" should be in general the same for income tax withholding and for FICA calculations.

Quality Stores' position – that severance payments should not be subject to FICA taxation but should be deemed wages for purposes of income tax withholding – was rejected as inconsistent with the Court's holding that administrative reasons justify treating severance payments as taxable for both FICA and income tax purposes.

So 'what now' for employers that filed refund claims?

Co-author of APA's Supreme Court brief, APA tax counsel David Fuller, offered his viewpoint on what's in store for those employers that filed FICA refund claims tied to severance pay for terminated employees. He said the Court's decision is the "death knell" for the thousands of FICA tax refund claims filed by employers on behalf of millions of terminated workers. However, a small number of refund claims involve downsizing arrangements that satisfy the IRS's administrative definition and test for what constitutes FICA-exempt SUB pay. To the extent an employer had such an arrangement, the underlying claims will need to be "perfected" or finalized by the employer. For all other SUB Pay refund claims, the IRS has advised that taxpayers should simply let the underlying statute of limitations expire.

Before letting these limitation periods expire, each employer should consult with its own tax advisers on whether to: (a) perfect claims that satisfy the IRS definition of SUB pay, (b) continue to file protective refund claims, Forms 907, *Agreement to Extend the Time to Bring Suit*, or Forms 2297, *Waiver of Statutory Notification of Claim Disallowance*, or (c) simply let the statute of limitations expire.

In addition to these steps for past years, any employer contemplating a future downsizing should consider proactive steps to respond to the Court's concerns expressed in oral argument that an adverse decision might impact the future eligibility of downsized workers to concurrently receive state unemployment benefits and employer-provided termination benefits. Employers considering such future downsizings or restructurings should consult with their tax advisers to consider steps to ensure that their employees can receive both state unemployment benefits and employer termination payments, including seeking to minimize the FICA tax impacts of such payments.