

SCOTUS SPEAKS IN QUALITY STORES: SEVERANCE PAYMENTS ARE SUBJECT TO FICA TAXES

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On March 25, 2014, the United States Supreme Court issued its unanimous (8-0) decision in U.S. v. Quality Stores, 572 U.S. ____ (2014). In its opinion authored by Justice Kennedy, the Court held that the severance payments at issue constituted taxable wages for FICA purposes. The severance payments in question were made to employees in connection with an involuntary termination, were varied based on job seniority and time served, and were not linked to the receipt of state unemployment benefits. In so holding, the Supreme Court reversed the decision of the Sixth Circuit Court of Appeals and resolved a split in the courts. See CSX Corp. v. United States, 518 F. 3d 1328 (Fed. Cir. 2008).

The Court reasoned that severance payments of the type described fit plainly within the definition of “wages” under Section 3121 of the Internal Revenue Code, which defines “wages” for FICA tax purposes broadly as “all remuneration for employment” and defines employment as “any service, of whatever nature, performed by an employee for the person employing him.” According to the Court, common sense dictates that severance payments are remuneration that is received by employees in consideration for employment because severance payments are made only to employees. In addition, the Court noted that the fact that severance payments often vary according to the function and seniority of a particular employee was a further indication that the payments are made to reward employees for their service.

The Supreme Court considered the arguments made by the taxpayer under Code section 3402(o) but found them to be erroneous and concluded that Code section 3402(o), which relates to income tax withholding, does not narrow the term “wages” under FICA to exempt all severance payments. The Court noted that the taxpayer’s position would result in severance payments not being subject to FICA taxation while they would be deemed wages for purposes of income tax withholding. The Court concluded that such a result would be inconsistent with the broad principle set forth by the Supreme Court in Rowan Cos., Inc. v. United States, 452 U.S. 247 (1981) that simplicity of administration and consistency of statutory interpretation instruct that the meaning of “wages” should be in general the same for income-tax withholding and for FICA calculations.

The Court noted in its decision that the IRS still provides, in Rev. Rul. 90-72, that supplemental unemployment benefit (“SUB”) payments tied to the receipt of state unemployment benefits are exempt from income tax withholding and from FICA taxation. Because the severance payments at issue in Quality Stores were not linked to state unemployment benefits, the Court expressly declined to reach the question of whether the IRS’ current exemption is consistent with the broad definition of wages under FICA.

As a result of the Supreme Court’s decision, the IRS will not need to refund an estimated \$1 billion in FICA taxes previously paid in connection with severance payments. Protective claims that have been filed by taxpayers will be denied. Going forward, employers must continue to treat severance payments as “wages” subject to FICA taxes unless they are linked to state unemployment compensation and otherwise qualify for the SUB pay exemption recognized by the IRS under Rev. Rul. 90-72.

See our prior blog posts for additional information regarding this case.

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