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U.S. Supreme Court Finds Severance Pay Subject to FICA Tax

The U.S. Supreme Court held March 25 in *United States v. Quality Stores, Inc.* that severance payments made to employees in connection with an involuntary termination of employment are wages under the Federal Insurance Contributions Act (FICA), as long as the payments are not tied to the receipt of state unemployment benefits.

In October 2001, an involuntary Chapter 11 bankruptcy petition was filed against Quality Stores Inc. Prior to and after the filing of the involuntary bankruptcy petition, Quality Stores terminated thousands of employees. The terminated employees received severance payments under two separate severance plans, neither of which tied the severance payments to the receipt of state unemployment compensation. The amount of each former employee's severance payment was determined based on his or her function and seniority. Quality Stores treated the severance payments as wages. Therefore, it reported the payments on the former employees' Forms W-2, paid the employer's share of FICA tax and withheld the former employees' share of FICA tax.

Thereafter, Quality Stores filed a claim for refund of FICA taxes paid in the amount of $1,000,125 on behalf of itself and some affected former employees. The Internal Revenue Service did not make a determination on the refund. Quality Stores brought a proceeding for the refund in Bankruptcy Court. The Bankruptcy Court granted the refund. The district court and U.S. Court of Appeals for the Sixth Circuit affirmed the Bankruptcy Court's ruling and held that severance payments are not wages for FICA purposes. The United States appealed to the Supreme Court, which reversed the lower courts' decision and held that the severance payments were taxable wages for FICA purposes.

In making its determination, the Supreme Court first looked to the definition of "wages" for FICA tax purposes. FICA defines wages as "all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash." The Court held that severance payments are wages for FICA tax purposes because they were made in consideration for employment. The Court noted that the Internal Revenue Code exempts from taxable wages any severance payment made "because of ... retirement for disability." It reasoned that such an exemption would be superfluous if severance payments were not wages. Furthermore, the Court reviewed the statutory history of the FICA provisions. It pointed out that in 1939, Congress created an exception from wages for "dismissal payments which the employer is not legally required to make." Congress repealed the exception to the definition in 1950, and a similar provision was never reimplemented.

The Court then analyzed whether the withholding tax rules limit the meaning of wages for FICA tax purposes. The Court rejected Quality Stores' argument that severance payments are not included in the definition of wages for income tax withholding purposes (which defines wages in a manner that is similar to FICA) and therefore are also not covered under the FICA withholding rule. It found that severance payments fall within the broad definition of wages for income tax withholding.

In conclusion, the Court ruled that severance payments made in connection with an involuntary termination, which amount varies based on years of service and rank, constitute taxable wages for purposes of FICA as long as the payments are not linked to the receipt of state unemployment benefits.

If you have any questions about the *Quality Stores* decision or any other employee benefits or executive compensation matter, please contact a member of Day Pitney's Employee Benefits and Executive Compensation group.