

Supreme Court Finds that Severance Pay is Wages for Purposes of Payroll Taxes

March 27, 2014

On March 25, 2014, the Supreme Court held in *United States v. Quality Stores, Inc.* that severance payments are taxable wages for FICA purposes. This decision confirms employers' responsibility to treat severance pay as taxable wages.

This case arose after Quality Stores terminated thousands of employees around the time it filed for Chapter 11 bankruptcy. These employees received severance payments under one of two payment schemes: either based upon job grade and management level, or based upon seniority. Additionally, to incentivize some employees to delay their job search so that the company could continue operations, Quality Stores paid severance to certain employees only if those employees worked until a certain date. Quality Stores originally reported the severance payments as wages and paid into FICA, the federal payroll tax imposed on both employees and employers to fund Social Security and Medicare. Thereafter, however, Quality Stores sought a FICA tax refund on behalf of the employees, claiming that the severance payments should not be treated as wages. The IRS neither allowed nor denied the claim, so Quality Stores brought this issue before the Bankruptcy Court. The Bankruptcy Court allowed the refund, and the Sixth Circuit affirmed.

On appeal, the Supreme Court reversed the Sixth Circuit and found that these severance payments were in fact taxable wages under FICA. In reaching its conclusion, the Court considered FICA's definition of the term "wages" as "all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash." FICA defines "employment" to include "any service, of whatever nature, performed . . . by an employees for the person employing him." The court concluded that as a matter of "common sense" severance payments meet this definition because they are "remuneration" and given for "a . . . service performed" by "an employee for a person employing him." Further, the Court noted that precedent dictates that the term "service" includes not just work actually done by the employees but "the entire employer-employee relationship." The Court found that the facts at issue conform to these principles as the severance payment varied (as these sorts of payments typically do) based on each employee's function and seniority. The Court also noted that competitive severance packages can help attract talented employees.

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