



U.S. Supreme Court Subjects Certain Employment Termination Payments to FICA Tax

Hopes that certain severance payments paid by companies to terminated employees could escape application of the Federal Insurance Contributions Act (FICA) tax were dashed when a unanimous U.S. Supreme Court ruled on March 25th that such payments, when not tied to state unemployment benefits, were “wages,” and thus taxable. The ruling for the government will allow the IRS to disallow protective refund claims that numerous companies filed after a federal circuit court held that termination payments were not subject to FICA tax.

Dispute over the Nature of the Payments

Quality Stores, Inc. filed Chapter 11 bankruptcy, and in the process made severance payments to over 3,000 employees who were involuntarily laid off. The company initially treated the termination payments as wages and withheld applicable FICA taxes. But later, the company decided that the payments should not have been subject to FICA and so requested a refund on behalf of its employees for the FICA taxes withheld and on its own behalf for associated employer contributions. Quality Stores obtained summary judgment on the issue from the Bankruptcy Court, which held that the severance payments were not wages under FICA. The federal district court and the Sixth Circuit agreed with that conclusion.¹

The fight over the applicability of FICA (26 U.S.C. §3101 *et seq.*) to the severance payments centers on the fact that the termination plan adopted by Quality Stores did not require that the payments be tied to the receipt of state unemployment insurance, instead basing the amount of the severance package given to each employee on several factors, such as job seniority, and time served with the company. The company took the position that its supplemental unemployment compensation benefits (SUBs) were not wages for

¹ Pub. L. No. 112-240, 126 Stat. 2313 (2013).

income tax withholding purposes, and likewise did not count as wages for FICA. Congress had added SUBs to the income tax withholding regime in Code section 3402(o) to avoid taxpayers having large unpaid tax bills when their returns were filed. The subsection heading said the withholding requirement was for “certain payments other than wages.” Thus, Quality Stores said that if SUBs did not fall squarely within the income tax definition of withholdable wages, as arguably indicated by the clarifying enactment of section 3402(o), they should not be considered wages for FICA either.

Circuits Split on Wage Characterization

On appeal by the government, the Sixth Circuit held in the underlying Quality Stores litigation that the FICA statute was ambiguous on the inclusion of SUB payments.² The court turned to legislative history to determine whether Congress intended for SUB pay to be wages for purposes of federal income tax withholding, and determined that those payments do not qualify as wages under FICA.

Other circuits, however, have come to the opposite conclusion. For example, in *CSX Corp. v. United States*,³ the Federal Circuit agreed with the government that SUBs paid as part of a workforce reduction were wages for purposes of FICA.

The disagreement among the circuit courts led the Supreme Court to grant *certiorari* to resolve the conflict.

Supreme Court Finds Statute Confers Broad Definition of Wages

Looking at the statutory text, the Supreme Court found it significant that Code section 3121(a) employs a broad definition of wages, as “all remuneration for employment.” Writing for the Court, Justice Kennedy explained that “as a matter of plain meaning, severance payments made to terminated employees” by Quality Stores fell within this sweeping definition, because the amount of the payments was based on an employee’s seniority and length of service. Observing that the FICA statute provides a long list of items not considered to be wages, the Court inferred that “the specificity of these exemptions reinforces the broad nature of FICA’s definition of wages.” Moreover, Congress’ amendment of the Code in 1950 to repeal a specific exception from wages for dismissal pay, indicated in the Court’s view, that the general FICA definition covered SUB payments.

In addressing the company’s argument that section 3402(o)’s treatment of SUBs as something other than wages meant those payments could not be subject to FICA, the Court concluded that the government had a better interpretation of the statute. Treating severance payments “as if” they were wages for income tax withholding “is in all respects consistent with the proposition that at least some severance payments are wages,” the Court held. The Court put little weight in the subsection’s heading, noting that captions can be useful in resolving statutory ambiguity, but stating that no ambiguity existed in this circumstance.

In its decision, the Court also looked to *Rowan v. United States*,⁴ where it had held that the remarkable similarity in the definition of “wages” between FICA and the income tax withholding sections of the Code provided strong evidence of congressional intent to read the provisions as having a common purpose because of the similar subject matter. Consequently, the Court reiterated “that simplicity of

² *United States v. Quality Stores*, 693 F.3d 605 (6th Cir. 2012)

³ 518 F.3d 1328 (2008).

⁴ 452 U.S. 247 (1981).

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.”

Key Takeaways

It is now clear that SUBs must be treated as wages and are subject to FICA. Going forward, the IRS will undoubtedly deny refund claims filed by companies who relied on the Sixth Circuit’s interpretation of section 3402(o). The issue was one of high stakes for the government, which had told the Court that total refund claims on the issue exceeded \$1 billion.

However, the Court reserved judgment about the treatment of severance payments that (unlike those at issue in this case) are tied to state unemployment benefits. The IRS has ruled that such payments are exempt from both FICA and income tax withholding.⁵ The IRS has not revoked those rulings.

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⁵ See Rev. Rul. 90-72, 1990-2 C.B. 211.

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