



Employee Benefits and Compensation

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Supreme Court Holds Severance Payments Are Subject to FICA Taxes

This week, the Supreme Court put to rest the long-standing controversy regarding the tax treatment of severance payments. The unanimous 8–0 decision by the U.S. Supreme Court in *United States v. Quality Stores, Inc.*, a case on appeal from the U.S. Court of Appeals for the Sixth Circuit, resolves a circuit court split and affirms the position held by the Internal Revenue Service (IRS) that severance payments received by employees are subject to taxation under the Federal Insurance Contributions Act.

BACKGROUND

The Federal Insurance Contributions Act tax, commonly referred to as the “FICA” tax, is assessed on employee wages to fund the federal Social Security and Medicare programs. Both the employer and the employee pay a share of the tax. “Wages” for FICA purposes are defined as “all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium....”

In 2001, an involuntary Chapter 11 bankruptcy petition was filed against Quality Stores, Inc., a large agricultural retailer. Quality Stores closed its stores and distribution centers and terminated the employment of all of its employees. Severance payments were made to those employees affected by the involuntary reduction in force pursuant to two severance plans. Quality Stores paid the employer portion of the FICA tax and withheld and remitted to the government the employee portion of the FICA tax. Because Quality Stores did not agree with the IRS that the severance payments constituted wages for FICA purposes, Quality Stores filed claims for a refund. When the IRS neither granted nor denied the refund claims, Quality Stores filed an adversary action in bankruptcy court. The bankruptcy court hearing the Chapter 11 petition held that severance payments paid to former employees pursuant to an involuntary reduction in force are *not* taxable wages subject to FICA taxes. This decision was affirmed by the Sixth Circuit.

Despite conflicting court decisions, the IRS has continuously maintained that severance payments are subject to FICA taxation.

THE SUPREME COURT’S DECISION

In the decision released this week, the Supreme Court held that severance payments fall within the broad definition of wages for purposes of FICA. The Court reasoned that severance payments are similar to other benefits offered to employees above and beyond base pay, and such severance payments are not supplemental unemployment compensation otherwise exempt from FICA taxation.

The decision is a welcome relief for the IRS, as it will prevent substantial FICA tax refunds that would have resulted if the Court had found severance payments to be exempt from FICA taxes. As highlighted in its petition for *certiorari* with the Court, the previous uncertainty of the proper tax treatment of these payments has resulted in 11 substantially similar cases pending and more than 2,400 protective refund claims, with a total amount at stake of more than \$1 billion.

If you have any questions about this case and its impact, please contact any of the following attorneys in Robinson & Cole's [Employee Benefits and Compensation Practice Group](#):

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