
Severance Pay as Part of an Employment Settlement - Do You Have to Withhold FICA?

By Richard M. Mitchell

Your former employee has sued, alleging involuntary termination as a result of unfair employment practices. Of course, reinstatement with back wages is a potential remedy. Frankly, however, you do not want the employee back, nor does the employee particularly want to return. You agree to a severance package to resolve the matter.

Do these future, unearned payments constitute “wages” for purposes of the Federal Insurance Contributions Act (“FICA”)? The United States Supreme Court, resolving a split amongst the Circuits, has declared that they do, meaning that FICA withholding must be considered when a claim is resolved using severance payments.

In *United States v. Quality Stores, Inc.*, 134 S.Ct. 1395, 188 L.Ed.2 413 (2014), Quality Stores filed for Chapter 11 bankruptcy protection. It provided severance payments to many of its terminated employees, which the parties stipulated were the result of a reduction in work force. The amount of severance pay depended upon the number of years an employee was with the company. Quality Stores reported the severance payments as wages on the employees’ W-2 tax forms, paid the employer’s required share of FICA taxes, and withheld the employees’ share of those taxes. It then sought, and obtained, consent from approximately 1,800 former employees to allow Quality Stores to pursue FICA tax refunds, claiming these did not constitute “wages” pursuant to FICA.

The United States Bankruptcy Court granted summary judgment in favor of Quality Stores, holding that severance payments do not constitute “wages” under FICA and are, therefore, not subject to the attendant withholding and taxes. The government appealed to the Sixth Circuit Court of Appeals, which affirmed the Bankruptcy Court. In granting certiorari, the Supreme Court noted that other circuits had concluded that at least some severance payments constituted wages subject to FICA tax and, thus, there was a split between circuits.

In order to resolve the issue, the Court undertook a two-step analysis. The first question was whether FICA's definition of "wages" included severance payments. 26 U.S.C. § 3121(a) 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 a reading of the plain language of this section indicated that severance payments made to terminated employees are "remuneration for employment." In the case of Quality Stores, the Court noted that the severance payments were staggered in accordance with years of employment, which supported this concept. The Court further noted that FICA specifically exempts certain termination-related payments from its definition of "wages." These may include payments made to employees resulting from medical disabilities. The Court held that these specific exemptions reinforced the fact that the payments made in the case of Quality Stores constituted "wages" within the meaning of FICA. As such, they should be subject not only to income tax withholding, but also FICA tax withholding.

The Court then turned to the issue of whether Section 3402(o) of the Internal Revenue Code limited the meaning of "wages" for FICA purposes. That subsection addresses income tax withholding relative to certain payments made to employees. Prior to proceeding before the Sixth Circuit, the parties stipulated that the payments at issue constituted "supplemental unemployment benefits" ("SUBs"). Section 3402(o) addresses such payments, stating in relevant part:

*(o) Extension of withholding to certain payments **other than wages.** [A]ny supplemental unemployment compensation benefit paid to an individual...shall be treated **as if** it were a payment of wages by an employer to an employee for a payroll period. (emphasis added).*

Quality Stores argued that the statutory language mandating that SUBs were

“other than wages,” but should be treated “as if” they were wages, constituted an indirect mandate that the definition of “wages” for income tax withholding did not include severance payments. It further argued that, if severance payments did not constitute “wages” within the meaning of this definition, they could not possibly constitute wages for purposes of FICA. The Supreme Court disagreed with the Bankruptcy Court and Sixth Circuit on these points.

The Court began by examining the legislative history of Section 3402(o) of the Internal Revenue Code. It noted that Congress adopted this subsection to address a very specific problem. Prior to its enactment, employees who were paid SUBs were subject to potentially substantial income tax liability at the end of a tax year. Section 3402(o) mandated that such payments should be subject to income tax withholding in order to avoid this dilemma.

The Court then went on to state that the Internal Revenue Code definition of “wages” should be read broadly to include severance pay. It further noted that the provision, similar to FICA, included specific exemptions. These include payment for domestic services in a private home, and services rendered to a foreign government. The Court noted the lack of an exemption for severance payments. Consequently, consistent with its broad reading of the statute, the Court held that Section 3402 did not limit a broad reading of FICA’s definition of “wages.”

Noting that the payments at issue were staggered according to years of service and made to employees who were terminated against their will, the Court held that they constituted “wages” for both income tax withholding and FICA purposes.

The Moral of the Story

While Quality Stores did not involve settlement of litigation arising from allegations of wrongful discharge, its impact on such disputes is important. Often the resolution of an employment dispute involves buying out the employee, especially when that employee is close to retirement age. If this is the mechanism the parties use to achieve their peace, the employer should keep in mind that these payments will be classified as wages for FICA purposes and so treated in consummating settlement of litigation.

