

Supreme Court Holds that Severance Payments for Departing Employees are Subject to Payroll Taxes

Labor & Employment Law Update

By Sara Zorich on March 28, 2014

On March 25, 2014, the Supreme Court in *United States v. Quality Stores, U.S.*, No. 12-1408, 2014 WL 11168968, 3/25/14) overturned the Sixth Circuit and unanimously held severance payments made to terminated workers were subject to payroll taxes including the Federal Insurance Contributions because the payments constituted “wages” and were in connection to services employees provided to the employer.

The defendant, Quality Stores, had made severance payments to employees who were voluntarily terminated prior to a Chapter 11 bankruptcy. Quality Stores paid and withheld taxes subject to the Federal Insurance Contributions Act (FICA) but later believed the payments should not have been taxed and sought a refund from the U.S. government on behalf of itself and the 1,850 employees for which payments and withholdings had been made. The Sixth Circuit held that the severance payments were not wages under FICA and thus, Quality Stores and the employees were not responsible for FICA taxes.

The U.S. Supreme Court reviewed the matter and overturned the Sixth Circuit’s decision. The High Court held that that term “wages” is interpreted very broadly under FICA. The Court determined the severance payments were being paid for the employee’s “service” which is not only the work actually done but constitutes the entire employer-employee relationship. Thus, under FICA’s broad definition of wages, Quality Stores’ severance agreements were taxable as wages under FICA. The Court recognized there is an exemption to taxable wages for certain severance plans that are tied to the receipt of state unemployment benefits. However, the Court found that the severance plans at issue varied based on employee seniority and time served, and were not linked to the receipt of state unemployment benefits so they were taxable wages. It should be noted that the Court addressed the distinction for severance payments and plans that are tied to the receipt of state unemployment benefits which are exempt from income-tax withholding and FICA taxation, and made no comment on such plans since they were not at issue in this matter.

Based on this ruling, employers must be careful when drafting severance agreements and understand that the definition of such wages will be interpreted broadly when determining whether such wages are taxable under the law.

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