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Got Severance Pay? Supreme Court Will Decide How It's Taxed

If your employer pays you severance when you terminate employment or later because you sue, is it for “rendering services?” Clearly it is pay and is subject to income tax and withholding. But as you aren’t actually rendering services for it, the question is whether it is **also** subject to payroll tax.



Predictably, the IRS says it is, but not everyone agrees. Tax rates are high, so significant money can turn on this issue. FICA consists of Social Security tax and Medicare tax.

Employers pay Social Security tax of 6.2% and employees also pay 6.2%, or 12.4% total. Add to that the 1.45% employers pay for Medicare and another 1.45% for the employee. With over 15% of pay at stake, employers and employees both care whether severance pay is subject to FICA.

There are two conflicting cases, [United States v. Quality Stores, Inc.](#) and [CSX Corp. v. United States](#). Fortunately, the Supreme Court has [granted certiorari](#) and will decide once and for all. See [United States v. Quality Stores, Inc.](#)

Severance pay is sometimes defined as gap pay to cover a period after the employee finishes rendering services. The definition is important, and significant tax dollars hang in the balance. The law is strangely muddled and the IRS is pushing its agenda hard.

Severance can be paid for a variety of reasons. It may be company policy, required by state or federal law, or paid pursuant to an agreement between the company and the former employee. It could be paid willingly or only after a lawsuit.

And the courts have reached differing decisions. In 2002, the Court of Federal Claims considered severance pay made in downsizing programs implemented by CSX. The court ruled it was **not** wages under the Social Security (FICA) tax. See [*CSX Corp. v. United States*, 52 Fed. Cl. 208 \(Apr. 1, 2002\)](#).

In 2008, the Court of Appeals for the Federal Circuit reversed and held that the severance pay **was** subject to FICA after all. See [*CSX Corp. v. United States*, 518 F.3d 1328 \(Mar. 6, 2008\)](#). Then in 2012, the Court of Appeals for the Sixth Circuit reached the opposite result. Quality Stores was in a Chapter 11 bankruptcy and made severance payments to terminated employees. In [*United States v. Quality Stores*](#), the Sixth Circuit said severance pay was **not** wages.

Quality Stores treated the payments as wages, withholding federal income and employment tax and paying it to the IRS. Later, the company claimed a refund. The Bankruptcy Court ruled the severance payments were not wages for FICA purposes. The district court affirmed and then the Sixth Circuit affirmed too. Now, the Supreme Court will decide.

Who will win, the IRS or companies and employees? The IRS thinks the Federal Circuit was correct in *CSX Corp.* Taxpayers, on the other hand, are generally more persuaded by the Sixth Circuit's ruling in *Quality Stores*. But even before the Supreme Court decided to weigh in, the IRS has pushed its agenda.

Reports say that the IRS has suspended action on administrative refund claims totaling \$127 million from approximately 800 taxpayers within the Sixth Circuit. The Sixth Circuit includes Kentucky, Michigan, Ohio, and Tennessee. More troubling still, the IRS has been disallowing refund claims filed by employers elsewhere.

The IRS hopes the Supreme Court will reverse *Quality Stores*, making *CSX Corp.* the law of the land. Meanwhile, there can be important statutes of limitation running. If you are impacted by this and the dollars are significant, get some advice to protect your rights.

You can reach me at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.