Forbes

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TAXES 9/27/2017

Here's How IRS Taxes Severance Pay

You may get severance pay when you quit your job, are laid off, or fired. You also might get severance later if you sue and settle. Whether or not your pay is labeled "severance," and regardless of when it is paid, the IRS generally views severance like any other pay. It's taxed as wages, so is subject to withholding and employment taxes. If your employer hands you a severance check as you walk out the door, you may well expect it to have all the payroll deductions you're used to seeing on your regular paycheck.

But payroll deductions may be a big surprise if you've sued, and several years later are settling. You might be expecting a big check without tax withholding. Many people are surprised that a former employer can withhold taxes when you no longer work for them. How can a payment be "wages" subject to withholding, you might ask, if you haven't been an employee for years? If you sue for wrongful termination and settle many years later, isn't there a time limit?

As it turns out, timing doesn't matter. Whether you get a gross check for the full amount or one with payroll tax deductions depends on several variables. They include how careful your employer is about its tax obligations, and how it agrees to resolve your case. Most employment disputes are settled, and it is common to split a settlement between severance (treated as wages) and non-wage income. The employer might agree that some of the settlement is pay for discrimination, emotional distress, or other non-wage income. The severance pay is subject to withholding and employment taxes. The rest would be paid on a gross check with no withholding and reported on a Form 1099. This is one of the many things to know about taxes on legal settlements.

There are two parts to the tax puzzle, income tax withholding and employment taxes. Income tax withholding is simply the employer deducting tax money according to withholding tables, and sending it to the IRS under your Social Security number. Then, in January of the following year, the company will issue you an IRS Form W-2 showing your total income and the taxes withheld. While you might regard the income tax withholding part of the equation as mere timing, the employment tax gets expensive. The employer and employee each pay half the employment tax.

For some years, there was a controversy in the courts over whether all severance pay should be subject to employment taxes. Arguably, severance pay isn't for services that have been rendered, but for services that *will never be* rendered. Even so, the IRS position is that any severance pay is subject to employment taxes, and in 2014, the Supreme Court agreed, reversing a key taxpayer win in the Sixth Circuit Court of Appeals. What's more, the Court voted 8-0 in favor of the IRS.

The Court ruled that severance is subject to tax under the Federal Insurance Contributions Act tax. 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 up to the wage base of $127,200, and 2.9% thereafter, employers and employees both care. Severance pay is sometimes defined as gap pay to cover a period after the employee finishes rendering services. Severance can be paid by company policy, required by state or federal law, or by agreement.

It could be paid willingly or only after a lawsuit. It's best and safest to assume that any pay labeled as "severance" will face employment taxes. The same is true for pay that looks like it might be severance, regardless of how it is labeled.

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.