

Justices to Decide Severance Tax Treatments

By Robert W. Wood

The U.S. Supreme Court has agreed to decide whether severance pay to workers who have been laid off is subject to federal payroll tax. Is that a big deal? You might not think so. Yet the Obama administration has warned that this little tax case could affect \$1 billion in tax refund claims. There are said to be more than 2,400 refund claims pending on this issue and more are expected.

What's more, severance is paid in many contexts, not just to laid off workers. And payroll taxes, after all, do add up. The fuss is not over income taxes. If your employer gives you severance pay — when you terminate employment or later because you sue — is it a payment for services?

In some ways the answer is yes, but in other ways no. Severance pay is really after you *finish* performing services. Severance pay is subject to income tax and to withholding by the employer. The question is whether it is *also* subject to payroll taxes like Social Security tax. You might assume so, and that's certainly what the Internal Revenue Service thinks.

But with rates as high as they are, not everyone agrees. FICA — the Federal Insurance Contributions Act tax — consists of the Social Security tax and the Medicare tax. The tax rate for Social Security is 6.2 percent for the employer and 6.2 percent for the employee, or 12.4 percent total. The rate for Medicare is 1.45 percent for the employer and 1.45 percent for the employee, or 2.9 percent total.

So at over 15 percent, employers and employees both care whether severance pay is only subject to income tax or is *also* subject to FICA. There are two conflicting cases, *United States v. Quality Stores, Inc.*, 693 F.2d 605 (6th Cir. Sept. 7, 2012), and *CSX Corp. v. United States*, 518 F.3d 1328 (Fed. Cir. 2008). The Supreme Court has granted certiorari and will decide.

Severance pay is gap pay to cover some period of time after the employee finishes rendering services. Severance can be paid for a variety of reasons. Severance 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 after a lawsuit.

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 FICA. See *CSX Corp. v. U.S.*, 52 Fed. Cl. 208 (Apr. 1, 2002). However, in 2008, the Federal U.S. Circuit Court of Appeals reversed and held that the severance pay *was* subject to FICA after all. See *CSX Corp. v. U.S.*, 518 F.3d 1328 (Mar. 6, 2008).

Then, in 2012, the 6th U.S. Circuit Court of Appeals reached the opposite result. Quality Stores entered a Chapter 11 bankruptcy in 2001 and closed all 300 of its stores. Thousands of workers were laid off and received severance on which the company paid and withheld FICA taxes. Thus, Quality Stores treated the payments as wages, withholding federal income and employment taxes and paying the IRS.

In 2002, though, Quality Stores claimed an IRS refund for just over \$1 million in FICA taxes. Roughly half was paid by the company and half was withheld from the severance pay. This was not pay for services and therefore was not subject to FICA, said the refund suit.

The bankruptcy court concluded that the severance payments were not wages for FICA purposes. The district court affirmed and then the 6th Circuit affirmed too, ruling that severance pay was *not* wages. So is severance pay wages or not?

It depends on who you believe. The IRS thinks the Federal Circuit was correct in *CSX Corp.* Taxpayers, on the other hand, are generally more persuaded by the 6th Circuit's ruling in *Quality Stores*. And there are many people waiting in the wings on this issue.

The case has implications for many companies that paid taxes on severance to workers laid off in the 2007-2009 recession. Because Quality Stores was in bankruptcy, creditors stand to get some money back if the Supreme Court upholds the 6th Circuit. Now it's up to the Supremes to decide.

In the meantime, the IRS has suspended action on administrative refund claims totaling \$127 million from approximately 800 taxpayers within the 6th Circuit. The 6th Circuit includes Kentucky, Michigan, Ohio and Tennessee. More troubling, the IRS has been disallowing refund claims filed by employers even *outside* the 6th Circuit. The IRS needs the money, and getting it back can be tough.

The IRS hopes the Supreme Court will reverse the *Quality Stores* case, making *CSX Corp.* the law of the land. Many companies have claimed refunds that could be paid if Quality Stores prevails. If you are impacted by this and the dollars are significant, get some advice to protect your rights.

To give them added gravitas (and perhaps even admissibility), think about having them signed under penalties of perjury. Consider all these items early on as you are negotiating the settlement of the case. Documents prepared at tax return time — or even worse, at audit time — are never as persuasive.



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