



Robert W. Wood

THE TAX LAWYER

TAXES | 3/25/2014

Supreme Court Rules Severance Pay Is Taxable Wages

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

Predictably, the IRS says it is, and [now the Supreme Court says so too](#), reversing a [key taxpayer win in the Sixth Circuit Court of Appeals](#). The case was widely watched and could have triggered a wave of payroll tax refund requests had it gone the other way. The two conflicting cases were [United States v. Quality Stores, Inc.](#) and [CSX Corp. v. United States](#).

But now the IRS has won and Quality Stores lost. What’s more, the [Court voted 8-0](#) in favor of the IRS. [Justice Elena Kagan](#) did not participate. Although only about \$1 million was at stake in the case, experts said refund claims might have risen to \$1 billion.



United States Supreme Court building in Washington D.C. (Photo credit: Wikipedia)

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, 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.

Even before the Supreme Court decision, the IRS has pushed its agenda. The IRS [suspended action](#) on administrative refund claims totaling \$127 million from approximately 800 taxpayers even though they were within the Sixth Circuit that was bound by the *Quality Stores* decision. The [Sixth Circuit](#) includes Kentucky, Michigan, Ohio, and Tennessee.

More troubling still, the IRS has been disallowing refund claims filed by employers elsewhere. The tax treatment of severance is now clear.

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.