

# PUBLICATION

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## No Refunds: Supreme Court Settles Circuit Split over Severance Payment Taxation

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In its ruling on *United States v. Quality Stores, Inc.*, No. 12-1408 (U.S. Mar. 25, 2014), the United States Supreme Court put to rest a decade-old battle over whether severance payments made to employees are taxable as wages under the Federal Insurance Contributions Acts (FICA), which is a payroll tax used to fund Social Security and parts of Medicare. Employers and employees both pay 6.2 percent of up to \$113,700 in Social Security taxes, and both pay 1.45 percent of total wages to Medicare.

In 2001, Quality Stores, Inc. declared Chapter 11 bankruptcy, shuttering its stores and laying off its approximately 3,100 workers. The company paid many of its workers severance pay and, at the time, reported the payments as wages, paid the employer portion of the FICA taxes, and withheld the employee's portion from the payments.

Despite their actions, however, Quality Stores did not agree that the payments were wages, and sought a refund of approximately \$1 million from the IRS for itself and its employees. The IRS neither allowed nor denied the refund, so the company initiated proceedings in the Bankruptcy Court, which granted summary judgment in the company's favor. The District Court and the United States Court of Appeals for the Sixth Circuit affirmed the Bankruptcy Court's decision, holding that severance payments are not "wages" under FICA. The Sixth Circuit's opinion created a circuit split, with the Federal Circuit, Third Circuit and Eighth Circuit having already held that severance payments were "wages" under FICA. The IRS then took a writ to the Supreme Court.

In a unanimous decision,\* the Supreme Court rejected Quality Stores' argument that the severance payments were not wages, stating that FICA's broad definition of wages as "remuneration for employment" very clearly encompassed such payments. Quality Stores had argued that text of Section 3402(o) of the Revenue Code, which stated that "supplemental unemployment benefits" shall be treated "as if" they were wages, meant that the payments were not wages. The Court rejected the company's textual argument, holding that Section 3402(o) did not operate to exclude the severance payments from FICA, but instead was consistent with the IRS's position that some supplemental unemployment benefits were wages, while others were not. The Court stressed that the definition of "wages" must generally be the same for both income tax withholding and FICA taxation. Thus, the Court determined that the severance payments made by Quality Stores to its employees were properly taxed under FICA. Also, as the issue was not before it, the Supreme Court left in place a separate, limited exclusion based on Revenue Ruling 90-72, which excludes severance pay linked to receipt of state unemployment benefits.

Given the IRS's wide latitude in the Revenue Code, this might seem like a run-of-the-mill case. However, many employers and employees awaited the outcome of this case, and the IRS anticipated that a decision affirming the Sixth Circuit could have resulted in tax refund claims against the government for more than \$1 billion. Now that this question has been resolved, employers have clear guidance about their tax withholding obligations in the event of layoffs or terminations involving severance pay.

\* Justice Elena Kagan recused herself from the case because of her involvement in the litigation as Solicitor General prior to taking the bench.

