

The Bankler Report

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INTRODUCTION

The US Supreme Court will decide whether severance pay is subject to FICA tax. Employers who paid taxes on severance benefits in 2010 must file a “protective claim for refund” by 4/15/14 in order to preserve a claim.

Background.

“Wages” and “compensation” are subject to both Federal Income Tax withholding as well as FICA taxes (currently 7.65% of the applicable wage base) paid by both the employee and the employer. In numerous rulings and publications, the IRS has consistently held that severance payments were “wages” subject to FICA taxes.

However, in 2002, the Court of Federal Claims held that severance pay was not subject to FICA taxes (CSX Corp v US [CT of Fed Cl 4/1/02]). In 2008, the Court of Appeals for the Federal Circuit reversed and held that severance pay was subject to FICA taxes (CSX Corp v US [CA FC 3/6/08]).

Taxpayer wins! Quality Stores, Inc. Facts

Quality Stores, Inc. operated a chain of retail stores and subsequently filed bankruptcy. Quality closed all of its locations, corporate offices, and distribution centers. Payments to employees were made under severance plans because of the employees involuntary separation from employment, which resulted directly from a reduction in force or the discontinuance of a plant or operation. The payments were not connected to the receipt of state unemployment compensation and were not attributable to the rendering of any particular employment service.

The severance payments were included in the employees’ gross income and Quality reported the severance payments as wages on the W-2 form issued to employees. Quality withheld federal income tax and the employees’ share of FICA tax from the severance payments, and also paid the employer’s share of FICA tax.

When the IRS did not allow the refund claims, Quality Stores filed an action in the bankruptcy court, which ruled that the severance payments were not wages for FICA purposes. The district court affirmed the bankruptcy court.

US Court of Appeals for the 6th Circuit.

The US Court of Appeals for the 6th Circuit (Kentucky, Michigan, Ohio, and Tennessee) in September 2012, basically stated that severance payments were Supplemental Unemployment Benefits (“SUB”) payments exempt from FICA.

To qualify as SUB, a payment must be: (1) an amount paid to an employee; (2) pursuant to an employer's plan; (3) because of an employee's involuntary separation from employment, whether temporary or permanent; (4) resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions; and (5) included in the employee's gross income. All payments that Quality Stores made to its former employees satisfied this five-part statutory test.

Protective refund claim strategy.

The Supreme Court has announced that it will hear this case, due to a conflict between circuits, but a ruling is not expected until sometime in the summer. The statute of limitations for filing a claim for refund for payroll taxes timely reported and paid in 2010 is 4/15/14. Taxpayers should file IRS Form 941-X to preserve a claim should the Supreme Court rule favorably.

Please feel free to contact me should you have any questions or need assistance.