

October 8, 2012

6th Circuit Court of Appeals Holds That Severance Pay Is Not Wages Subject To FICA Tax

Congress imposed the Federal Insurance Contribution Act (FICA) tax on employee “wages” to fund Social Security and Medicare programs. The current FICA tax rate is 13.3%, of which 7.65% is paid by the employer and 5.65% by the employee.

In United States of America v. Quality Stores, Inc., decided September 7, 2012, the 6th Circuit Court of Appeals ruled that severance payments made by the employer to involuntarily terminated employees due to a reduction in the workforce are not subject to FICA tax.

As a result of an involuntary bankruptcy petition, Quality Stores ultimately closed all of its stores and terminated all of its employees. The involuntarily terminated employees received severance pay. Quality Stores reported the severance payments to the Internal Revenue Service (IRS) as “wages” on the employees’ W-2 forms and withheld income tax and the employees’ share of the FICA tax. It also paid its share of the FICA tax.

Quality Stores, however, did not agree with the IRS that the severance payments were “wages” for FICA purposes. It filed a refund claim for the FICA tax paid by it and by those employees who consented to Quality Stores seeking a refund on their behalf.

The Court noted that the Internal Revenue Code provides that payments made to an employee because of the employee’s involuntary separation from employment is a Supplemental Unemployment Benefit (SUB) and not “wages.” And, while such SUB payments are “income” subject to income tax and income tax withholding, SUB payments do not constitute “wages” under FICA. The Court granted a refund of \$1,000,125 for \$571.127 FICA tax paid by Quality Stores and \$428,998 for FICA tax paid by those employees who sought a refund.

The 6th Circuit Court of Appeals’ decision is, however, in direct conflict with a prior decision of the Federal Circuit Court of Appeals. Accordingly, the IRS may appeal to the Supreme Court or may urge Congress to amend the tax code to resolve the conflict.

Employers (and their employees) who have paid the FICA tax on severance pay or who hereafter make severance payments to involuntarily terminated employees due to a reduction in force should consider the costs and benefits of filing refund claims. Until the aforementioned conflict is resolved, we recommend that employers continue to withhold and pay the FICA tax and consider seeking a refund.

For further information, please contact your Butzel Long attorney or the authors of this Client Alert.

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