NO FICA CONTRIBUTIONS FOR SEVERANCE PLAN PAYMENTS!

By Laura B. Hoguet

Usually, when an employee receives severance under an employer plan, the company treats the severance payments as "wages" subject to withholding for both income tax and FICA. A recent Sixth Circuit case says, however, that there should be no withholding from severance for FICA. *In re Quality Stores, Inc.*, No. 10-1563, 2012 WL 3871364 (6th Cir. Sept. 7, 2012). This result, unless set aside by the Supreme Court or changed legislatively, will put at least some money in employee pockets.

The *Quality Stores* decision arose from a long slide into liquidation of a Midwest retailer in the course of which the company adopted two severance plans, one before and the other after bankruptcy filing, that provided for payments to employees based on rank and length of service. The company withheld income tax from the payments and paid employer contributions to FICA, but sued, with more than 1000 former employees, for refunds of the FICA contributions on the ground they were a "supplemental unemployment benefit" and therefore not "wages" under the law. The Sixth Circuit agreed, affirming the district and bankruptcy courts below, and ordered the refunds. The reasoning that led to this conclusion is convoluted (see below), but would seem to apply to many different employer severance arrangements.

FICA taxes, as we all know, were enacted by Congress to support Social Security and, later, Medicare. The employer collects the employee's share from wages as they are paid and pays a matching tax on the wages paid to the employee. "Wages" for FICA purposes include "all remuneration for employment…." I.R.C. §3121(a). "Employment" as broadly defined in the statute includes "not only work actually done but the entire employer-employee relationship…," *Social Security v. Nierotko*, 327 U.S. 358, 365-66 (1946).

The argument that severance payments are not "wages" under this broad definition derives from another line of Supreme Court cases that deal with Supplemental Unemployment Benefit (SUB) plans. SUB plans were adopted by some employers in the 1950's in response to union concern that the benefits available to jobless workers under state unemployment insurance schemes were much less than the workers' wages. SUB plans were supposed to fill this gap, by providing a supplement to laid-off workers. The Supreme Court in earlier cases said that SUB payments "cannot be compensation for work performed….for they are contingent on the employee's being thrown out of work; unless the employee is laid off, he will never receive SUB payments. In this sense, SUB's are analogous to severance payments; they are 'compensation for loss of jobs.'" *Coffy v. Republic Steel Corp.*, 447 U.S. 191, 200 (1980) quoting *Accardi v. Pa. R.R. Co.*, 383 U.S. 225, 230 (1966). The Sixth Circuit pointed to *Coffy* and *Accardi* as Supreme Court holdings on the meaning of "wages" without mentioning that both cases arose in the context, unrelated to the tax code, of protecting veterans' rights under the Vietnam Era Veterans' Readjustment Act of 1974 (*Coffy*) and the Selective Training and Service Act of 1940 (*Accardi*). The Sixth Circuit's decision does not, in any event, rest on the Court's language in these cases, but on the bit of statutory history explained in the next paragraph.

The FICA legislation and regulations that implement it say nothing about SUB plans, but the language that imposes the FICA tax is virtually identical to the definition of "wages" for federal income tax purposes, I.R.C. §3401(a). In the income tax statute, however, Congress added a section expressly to extend withholding to certain payments "other than" wages, specifically:

> amounts which are paid to an employee, pursuant to a plan to which the employee is a party, because of an employee's involuntary separation from employment (whether or not such separation is temporary), resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar condition, but only to the extent that such benefits are includible in the employee's gross income." I.R.C. §3402(o).

SUB payments, then, and any other payments that fit this definition, are subject to income tax withholding even though Congress considers that they are not "wages." According to the company, the employees and the courts in the *Quality Stores* case, since Congress did not add a provision such as §3402(o) to FICA's definition of "wages," these payments are not "wages" for FICA purposes and FICA contributions should not be deducted from them even though income tax is withheld. To nail down this result, the Sixth Circuit had to jump the hurdle of *Rowan v. United States*, 452 U.S. 247 (1981), which concluded that Congress meant "wages" to be the same thing for income tax withholding purposes as for FICA. The court brushed aside the Government's argument that in 1983 Congress had expressly "decoupled" FICA contributions from federal tax withholding, saying that the "decoupling amendment" applied only to inconsistent regulations, not to the statutes themselves. And, the court said, its result was consistent with *Rowan* because its treatment of FICA wages was not really different from wages for tax purposes: "Congress imposed federal income tax withholding on SUB payments because they qualify as gross income, not because they are "wages." Reading the definitions of "wages" found in the FICA and federal income tax statutes consistently, SUB payments do not constitute "wages" under either statutory scheme." *In re Quality Stores, Inc.*, No. 10-1563, 2012 WL 3871364 (6th Cir. Sept. 7, 2012).

The Supreme Court in the *Coffy* case analogized SUB payments to severance payments to support its reasoning that the payments were not compensation for services performed but were, rather, payments made because work was no longer available. The severance payments in the *Quality Stores* case fit this definition, according to the court, because they were paid by the employer pursuant to a plan to employees who had lost their jobs because the company shut down. This idea, and the definition of payments "other than wages" in I.R.C. §3402(o), seems broad enough to encompass any employer severance plan or policy that is written down and provides for the payment of severance to employees who lose their jobs due to changes in the employer's business, whether the change amounts to a plant closing or the simple elimination of an individual's position.

What about the employee whose severance is paid, not pursuant to a "plan," but rather pursuant to a negotiated agreement in which the payment is made in exchange for a release of claims? The employee and employer could certainly argue in this case that the payment is not "wages" for FICA purposes because, like the payments in *Coffy*, it is not made for working, but rather for "not working." Employment lawyers should, no doubt, keep their eyes peeled for this

case, which may well be already pending somewhere in the legal system. It may also be that the IRS will seek to appeal the *Quality Stores* decision to the Supreme Court, or that the Service will ask Congress to close the FICA "loophole" by conforming the statute's definition of "wages" to the Internal Revenue Code's definition. In the meantime, attorneys dealing with severance issues can try to remember to advise clients not to make FICA contributions in respect of these payments.