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***To Tax or Not to Tax, That is the Question:  
The Supreme Court Takes Up Case to Consider Whether Severance  
Agreements are Subject to FICA Taxes***

Last month, the United States Supreme Court agreed to consider whether severance payments made to terminated employees are subject to FICA taxes (Social Security and Medicare taxes). In *United States v. Quality Stores, Inc.*, No. 10-1563 (6th Cir. Sept. 7, 2012), the 6<sup>th</sup> Circuit Court of Appeals affirmed a lower court's ruling that severance payments were not considered wages, thus, they were not subject to FICA taxes. Based on this ruling, the Internal Revenue Service requested review.

The facts of the case are simple. The employer, Quality Stores, made severance payments to various terminated employees and all payroll taxes, including FICA, were withheld from each employee's paycheck. Because an employee's FICA taxes are matched by the employer, both the employer and the employee paid the tax amount. After the employer made the payment, it filed for a tax refund on the premise that the severance payments were supplemental unemployment benefits (SUB), and as such, were not wages subject to FICA.

The lower court and 6<sup>th</sup> Circuit Court of Appeals agreed with the employer and found that the severance payments were SUB payments because such payments were not remuneration for services under FICA but instead were payments related to the elimination of employment, i.e. termination. Thus, these severance payments were not subject to FICA taxes even though they were taxable under the income tax. On appeal, the IRS argued that the employer's severance payments were not exempt from FICA taxes because, among other reasons, Congress had not specifically provided an explicit FICA tax exclusion under IRC section 3121(a).

Currently there is a circuit split regarding whether severance payments are subject to FICA taxes. In *CSX Corp. v. United States*, 518 F. 3d 1328 (Fed. Cir. 2008), the Federal Circuit Court of Appeals found that severance payments are subject to FICA taxes. Thus, by granting cert in this case, the Supreme Court has an opportunity to clarify this important question so that employers are not left guessing as to the tax implications for future settlement payments.

This will be an important case for employers to monitor because of the potential tax exposure involved. The Supreme Court's review allows employers and employees who have received severance payments to file for and receive refunds for any FICA taxes that were paid.

The earliest current open year for filing a refund claim with the IRS is for 2010 (tax year), except for filing extensions already granted by the IRS. Until this case is decided by the Supreme Court, the IRS had indicated that it would likely grant extensions to file suit to collect on pending refund claims for employers and employees. Depending on the outcome of this case, if the decision is affirmed, billions of dollars of FICA refunds could be issued by the IRS. If an employer has made any severance payments and withheld FICA taxes in the process during the tax year of 2010 or later, it should examine those plans and determine if it should file a protective refund claim with the IRS. Until a decision is given by the Supreme Court, employers should maintain their current practices and withhold FICA taxes on severance payments.

For more information regarding severance agreements, please contact Robert Seybert at [rseybert@baylorevnen.com](mailto:rseybert@baylorevnen.com) or any of the firm's employment lawyers at 402-475-1075.