

FERRAIUOLI LLC

Taxes and Employee Benefits

April 14, 2014

Notice to Clients and Friends

U.S. Supreme Court Rules that Certain Severance Payments are Subject to FICA Taxes

On March 25, 2014, the U.S. Supreme Court (the “U.S. Supreme Court”) decided in [*United States v. Quality Stores, Inc.*](#)¹, that certain severance payments to involuntarily terminated employees are subject to Federal Insurance Contribution Act (“FICA”) taxes (i.e., Social Security and Medicare taxes).

Background: With this decision the U.S. Supreme Court resolves a circuit split between the U.S. Court of Appeals for the Federal Circuit (which held in *CSX Corp. v. U.S.*² that the severance pay involved was subject to FICA) and the U.S. Court of Appeals for the Sixth Circuit (which reached a contrary decision in *U.S. v. Quality Stores*³).

Decision: In *Quality Stores*, severance payments were made to employees who were involuntarily terminated. The employer paid and withheld FICA taxes, but later sought refunds arguing that the severance payments made to the employees were exempt “supplemental unemployment compensation benefits” or SUBs. On their interpretation of Section 3402(o)(2) of the U.S. Internal Revenue Code (the “US Code”), SUB payments fell outside the definition of “wages” for income-tax withholding purposes, and in turn, are not covered by FICA’s definition of wages. The Sixth Circuit agreed. However, the U.S. Supreme Court revoked and concluded that Section 3121(a) of the US Code defines FICA “wages” broadly as all remuneration made in connection to the employer/employee relationship. Accordingly, the severance payments at issue in this case (which were made pursuant to a plan that did not tie payments to the receipt of state unemployment insurance or benefits) were not exempt from FICA tax⁴.

Implications: This decision questions the validity of the Puerto Rico’s Supreme Court decision in *Alvira v. SK & F Laboratories*⁵, where it was determined that a discharge compensation under Puerto Rico’s Wrongful Discharge Act⁶ was not subject to FICA. Now on, all employers shall consider this case law and account for (i) the employer’s share of FICA taxes, (ii) FICA tax withholding for the employee’s share, and (iii) the applicable reporting requirements for such payments when providing severance payments in Puerto Rico.

¹ (2014, Sup Ct) 113 AFTR 2d

² 518 F.3d 1328 (Fed. Cir. 2008)

³ 693 F.3d 605 (6th Cir. 2012)

⁴ The Supreme Court notes that severance payments tied to the receipt of state unemployment benefits are exempt for income-tax withholding and from FICA.

⁵ 142 D.P.R. 803 (1997)

⁶ Law No. 80 of May 30, 1976, as amended