Certain Severance Payments Held Not to Constitute "Wages" for Purposes of FICA
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Introduction

Under the Federal Insurance Contributions Act ("FICA"), employers not only have to withhold FICA taxes from their employees' wages, but also are required to pay an equal amount as an employment tax. Internal Revenue Code ("IRC") §§ 3102, 3111, 26 U.S.C. §§ 3102, 3111. FICA taxes are imposed on all "wages" (up to a statutory cap) received by an employee "with respect to employment." IRC § 3101. Therefore, if severance pay is classified as "wages" for purposes of FICA, not only is the value to the former employee of each dollar of severance pay reduced by 7.65% (the current rate of contribution), but also the employer has to pay an additional 7.65% employment tax. Obviously, when an employer engages in a reduction in force in which those who are laid off are provided with severance pay, it can make a substantial difference whether or not the severance pay is "wages" for purposes of FICA, both in the value of the severance pay to its recipients, and in the cost to the employer of providing the severance pay.

In CSX Corp, Inc. v. United States, 52 Fed. Cl. 208 (2002), the Federal Court of Claims (the court to which taxpayer appeals are made) recently ruled that certain payments made to employees who were laid off due to a reduction in force were not "wages" for purposes of FICA, and therefore FICA taxes were not due on them, because these payments could be characterized as "supplemental unemployment compensation." It follows that any employer contemplating a reduction in force that entails severance payments would do well to examine whether the conditions of eligibility for the payments and the circumstances in which they are to be made are such that they qualify for treatment as "supplemental unemployment compensation." If so, substantial tax savings may be available.

The Facts In CSX

The CSX case evolved from a reduction in force embracing 33% of the employer's management work force and 39% of the union work force. Many of these employees were placed in layoff status, thereby becoming eligible for severance benefits equal to a specified percentage of average monthly compensation for a given period of time. A second group of these employees (the "guaranteed extraboards") lost their jobs but, pursuant to agreements with their unions, remained subject to recall on an as-needed basis, essentially constituting an emergency work force; these employees remained on the active payroll and were guaranteed a certain minimum amount of compensation per pay period. A third group of employees consisted of those who had accepted offers of termination pay in return for a voluntary resignation.
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The employer paid the employer's share of employment tax and withheld (and remitted to the IRS) the employee's share of FICA contributions on all pay received by all three groups of these employees in connection with the reduction in force. It then filed claims for refunds on its own behalf and on behalf of all employees who consented to its filing on their behalf. The IRS disallowed the claims, and the employer sued in the U.S. Court of Federal Claims.

The Court's Reasoning

The court's decision began with the observation that the definition of "wages" for purposes of FICA is basically the same as the definition of "wages" for purposes of IRC provisions that require withholding of income taxes: "all remuneration . . . for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash," 26 U.S.C. § 3401(a). The court then observed that 26 U.S. C. § 3402(o), entitled, "Extension of withholding to certain payments other than wages," provides in subdivision (1)(A) that "any supplemental unemployment compensation benefit paid to an individual . . . shall be treated as if it were a payment of wages by an employer to an employee for a payroll period." The court ultimately agreed with the employer's contention that by implication, under § 3402(o), "supplemental unemployment compensation" is not "wages" for purposes of FICA requirements, even though such compensation is to be treated as though it was "wages" for purposes of withholding income tax.

Thus, whether any of the payments at issue in CSX were "wages" for purposes of FICA turned on whether they constituted "supplemental unemployment compensation." The court based its determinations in this regard on the definition contained in 26 U.S.C. § 3402(o)(2), which provides that "supplemental unemployment compensation" consists of "amounts which are paid to an employee, pursuant to a plan to which the employer 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 conditions . . . ." (Emphasis added.)

The court concluded that since all three groups of employees at issue had received payments in furtherance of the employer's decision to reduce the size of its operations, the first prong of the definition - payments "resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions" -- was met in each instance. The only question, in the court's view, was whether the payments were made "because of an employee's involuntary separation from employment."
The court readily found that the payments to laid off employees were "supplemental unemployment compensation," and therefore were not subject to FICA taxes. The IRS argued that these payments should not be regarded as meeting the definition because the employees at issue remained on the payroll while they received severance benefits and therefore did not experience a "separation from employment." But the court rejected this contention, reasoning that "employment" is defined as the performance of "any service" by an employee for an employer, 26 U.S.C. §§ 3401(d), 3121(b), and therefore that a "separation from employment" refers to the discontinuance of the employee's rendering of services, not to a discontinuance of the employee-employer relationship in its entirety.

However, the court rejected the employer's contentions as to the other two groups of employees. The employees on the "guaranteed extraboards," whose jobs were eliminated but who were subject to recall on a standby basis, received their benefits in return for the performance of services. The dispute centered on the amounts they received while on standby, i.e., the guaranteed minimum. The court rejected the employer's contention that such payments were in the nature of "supplemental unemployment compensation" because they were paid in consequence of an involuntary separation. Finding that "these employees may have been underemployed but they were not unemployed," the court ruled that their standby pay was "wages," and not "supplemental unemployment compensation." Therefore, their pay was subject to FICA withholdings and employment taxes.

Finally, the court readily rejected the employer’s contention that the severance pay provided to employees who opted to resign in return for such compensation should be deemed "supplemental unemployment compensation" and not FICA "wages." In the court’s view, the fact that the employees had opted for the severance pay voluntarily -- acknowledging in writing that their resignations were a voluntary action taken in response to the employer’s offer of a severance payment -- precluded any finding that they could meet the "involuntary separation from employment" prong of the definition of "supplemental unemployment compensation."

In so holding, the court rejected the employer’s contention that the elections were, in effect, forced choices, "prompted by the on-going threat of job loss that the workers faced because of the [employer’s] unrelenting efforts to downsize operations." The court drew a distinction between: (1) employees who had been laid off already, and then elected to accept a separation payment, and (2) employees who had not yet actually been laid off and who elected separation in lieu of remaining in their existing positions.
With respect to the first of these subgroups, the court stated that the laid off employee who elects a separation payment, releasing all rights to future employment, cannot be said to have voluntarily separated from employment; such an employee’s election "to permanently relinquish his or her status as an employee after having been involuntarily separated from employment in the first instance does not alter the character of the initial separation: it remains involuntary." The payments to such an employee, the court opined, would be eligible for treatment as "supplemental unemployment compensation."

But the employee who opts for a separation payment without first having been laid off makes a voluntary choice, "even if it was not the attractiveness of the separation payment that persuaded the employee to act but rather the possibility of a layoff or the dislocation of a forced transfer." Where the decision originates with the employee, the court would regard the separation as voluntary notwithstanding that the employee was motivated by a desire to avoid economic uncertainty, such as concern over a possible future layoff. In these circumstances, the payments would not be eligible for treatment as "supplemental unemployment compensation."

Conclusions

The CSX decision offers employers a means of accomplishing significant savings when they implement reductions in force that offer employees being laid off the option of severance benefits in exchange for a release of claims. This case makes it fairly clear that when an employee who has been laid off accepts severance benefits in connection with the layoff, the severance pay may not constitute "wages" for purposes of FICA withholdings or employer-paid employment taxes, at least where (a) the loss of employment indisputably is involuntary and results from a layoff, a plant shutdown, or similar event, and (b) where the severance compensation is paid pursuant to a plan to which the employer is a party, such as a collectively bargained agreement to provide severance pay to employees who are laid off pursuant to a reduction in force. The severance pay would, however, be subject to withholdings for income taxes.

CSX does cast doubt on whether severance pay received on account of an employee’s election to opt into a voluntary separation incentive program could lawfully be treated as "supplemental unemployment compensation," but it nonetheless signals that conducting an analysis of the nature of the severance pay provided in connection with a reduction in force program, as well as the circumstances in which it is available, may result in substantial tax savings.
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The CSX case also highlights the importance generally of analyzing whether payments other than severance pay that are not made to compensate for services rendered present opportunities for tax savings. For example, in appropriate circumstances, signing bonuses, payments made in consideration of the ratification of a collective bargaining agreement, payments made to cancel an employment contract for a term, and payments made to relinquish seniority or tenure rights all may constitute non-wage payments not subject to employment taxes, albeit for reasons not related to the "supplemental unemployment compensation" issue analyzed in CSX. Similarly, in the litigation context, many elements of settlement amounts (and damage awards) may be treated as non-wage payments not subject to employment taxes, so long as the agreement (or the court's judgment) treats those payments in a manner that preserves their non-wage status; e.g., payments for attorneys' fees, pre-judgment interest, liquidated damages, payments to relinquish contract rights, or punitive damages.