EMPLOYMENT LAW

Tax Implications When an Employee Is Terminated

Severance payments are taxable wages for FICA purposes; but are some severance agreements really settlements?

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The United States Supreme Court recently clarified employers' obligations with respect to FICA withholdings from severance payments, holding that such payments are taxable wages under the Federal Insurance Contributions Act, 26 U.S.C. § 3101, et seq. The court had granted certiorari in U.S. v. Quality Stores, 134 S.Ct. 1395 (2014), due to a split in authority among various circuit courts.

Attorneys who represent clients in various employment-related disputes often must consider the tax implications of severance payments and settlement agreements. Although Quality Stores presents a narrow issue, as will be discussed in more detail below, the issue it did not address was what impact, if any, it would have on the following, albeit relatively common scenario in the employment law world: Employer terminates Employee for performance-related issues but offers a severance agreement, the primary purpose of which is to obtain a release of the right to sue. Employee counters by raising allegations of wrongful employment practices, e.g., discrimination, whistleblowing, etc. The parties negotiate the terms of the agreement, and ultimately a document is signed providing Employee with "severance" or some other monetary compensation in consideration for the waiver of legal claims. In this scenario, then, is the severance agreement really a settlement agreement, and would these payments constitute "wages" under the Quality Stores decision?

In Quality Stores, the employer, which was going through bankruptcy proceedings, terminated thousands of employees. During the termination process, the employer created two termination plans, which calculated severance payments based on factors such as job grade, management level and years of service. Quality Stores initially reported all severance payments as wages on W-2 forms, paid its respective portion of FICA taxes and withheld the employees' shares of the FICA taxes. Thereafter, the employer sought a refund of more than $1 million on behalf of itself and those employees who consented to allowing Quality Stores to seek the refund on their behalf. The bankruptcy court granted summary judgment to the employer, which was affirmed by both the district court and the Court of Appeals for the Sixth Circuit.

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The primary issue was whether the severance payments were "wages," as defined by FICA. FICA defines "wages" as "all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash." 26 U.S.C. § 3121(a). "Employment" includes "any service, of whatever nature performed by an employee for the person employing him." 26 U.S.C. § 3121(b). Because the court has already interpreted "service" to include "not only work actually done but the entire employer-employee relationship," the court concluded that the severance payments fell plainly within FICA's definition of "wages." Quality Stores, 134 S.Ct. at 1399-1401.

However, the employer's argument turned on the fact that the severance payments concededly were "supplemental unemployment compensation benefits," or SUBs, as defined by the income tax withholding provisions of the tax code. The general rule for income tax withholding is that a SUB "shall be treated as if it were a payment of wages...." 26 U.S.C. § 3402(o) (emphasis added). Boiled down to its most basic form, the employer argued that the income tax withholding provision was a limitation on FICA's definition of "wages" because "as if wages" effectively meant "not actually wages," thus taking the payments outside the scope of FICA's definition of "wages."

In rejecting this argument, the court reviewed the legislative history behind § 3402(o), which was enacted to allow employers to pay SUBs that otherwise would have precluded an employee from collecting state unemployment benefits. Because some state plans make unemployment benefits available only to those who are not collecting "wages," excluding SUBs from the definition of "wages" allowed employers to pay the benefits without the employees risking their eligibility for unemployment compensation. However, the SUBs still were considered taxable income, but because they were not subject to withholdings, recipients were getting hit with large tax liabilities at year end. To solve the problem, Congress enacted §3402(o) so that income taxes could be withheld from the SUBs even though they were not "wages."

Given the narrow problem Congress sought to resolve with the enactment of § 3402(o), the court in Quality Stores concluded that § 3402(o) did not limit FICA's definition of "wages," so that the subject severance payments were subject to FICA withholdings.

On rare occasions, at least some portion of damages in wrongful termination cases keyed to personal injury damages may avoid taxation pursuant to 26 U.S.C. § 104(a)(2), which excludes from gross income damages paid for personal injury or sickness. 26 U.S.C. §104(a)(2). However, to fall within this exclusion, the amount received must be obtained "through prosecution of a legal suit or action, or through a settlement agreement entered into in lieu of prosecution." 26 C.F.R. § 1.104-1(c). In light of the Quality Stores holding, however, would the agreement from the aforementioned scenario qualify as a "settlement agreement entered into in lieu of prosecution"? Whether employment-related damages are paid "for personal injury or sickness" is a topic unto itself and will not be discussed here.

It goes without saying that the label a lawyer places on a document is not necessarily dispositive of its legal implications. Normally, a severance agreement is seen as a document that ends an employment relationship, while a settlement agreement ends an actual or threatened lawsuit.
However, in the case where a terminated employee makes allegations of wrongful employment practices in the course of negotiating severance, the lines may blur.

Various circuits have held that severance agreements that include waivers of rights are still treated as "wages" for FICA purposes. See, e.g., Univ. of Pittsburgh v. U.S., 507 F.3d 165 (3d Cir. 2007); Abrahamsen v. U.S., 228 F.3d 1360 (Fed. Cir. 2000); Taggi v. U.S., 35 F.3d 93 (2d Cir. 1994). In each of those cases, the underlying plans calculated severance based on factors such as years of services and salary, but also required the waiver of various rights. But again, those cases involved formal plans that were established as exit incentives. Each court reached a similar conclusion that despite the legal rights employees were required to waive or forgo, the severance primarily was intended to compensate the employees for the employee-employer relationship, and thus constituted "wages."

Returning to the aforementioned scenario, however, the primary purpose of the agreement is not to pay consideration for the employment relationship, but to pay consideration to avoid litigation and obtain from the employee a release of the right to sue. Under this scenario, then, does the negotiated severance qualify as "a settlement agreement entered into in lieu of prosecution," even though a complaint was never filed?

While different circuits have developed different standards, courts seem generally to agree that for settlement payments to be excludable, a bona fide dispute must exist at the time of the settlement. The Sixth Circuit has determined that an employee mentioning during the severance negotiation process that he would pursue whatever legal remedies were available to him would suffice to give rise to a bona fide dispute. Greer v. U.S., 207 F.3d 322, 327 (6th Cir. 2000). The Second Circuit has held, however, that while an actual lawsuit may not be necessary, there must have been a specific allegation of tort-like claims made during the settlement negotiations that was resolved as part of the final agreement. Taggi, 35 F.3d at 95-6. It does not appear as though the Third Circuit has addressed the issue head-on.

Putting this into practice, plaintiffs lawyers who wish to avoid tax liability for at least a portion of a severance payment must raise any bona fide disputes that arise from the employment relationship or as a result of the termination during the negotiation process (keeping in mind that to be excludable, the bona fide dispute must be on account of personal injuries or illness). Those claims should be not only alleged with specificity, but also included with equal specificity in any final agreement between the employer and employee. While including a bona fide claim as part of the negotiation process may not guarantee exclusion under § 104(a)(2), simply arguing for more severance without any connection to a dispute that exists at the time will all but guarantee that the payments will be taxable as "wages."

From the employer's perspective, employers should continue to withhold income taxes and FICA from all severance payments that are the result of an employer's plan, or offered to a terminated employee for the sole purpose of receiving a waiver of rights to sue. Only upon the employee raising allegations of a bona fide claim should the employer ever consider not withholding taxes on the entire amount of severance.
On a final note, it is important to remember that the parties' allocation of damages in a settlement agreement may not be binding where the allocation departs greatly from the underlying allegations. Courts recognize that "written allocations may be driven by tax considerations and not reflect the true value of settled claims," in which case they are tasked with the duty of "looking beyond" the parties' language and analyzing the underlying claims to determine the appropriate allocation. *Francisco v. U.S.*, 267 F.3d 303, 321-22 (3d Cir. 2001).

Perhaps the most practical practice pointer is—educate your clients and keep their expectations with respect to their potential tax liability realistic.

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