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MEMORANDUM FOR ROBERT WESTHOVEN

FROM: Jerry E. Holmes
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SUBJECT: Severance Payments Subject to FICA Tax

The years 1999 and 2000, to date, have produced no less than six lower court opinions holding that severance payments are taxable income and wages subject to FICA tax. These decisions deal with payments made in the course of the layoffs and downsizing of the 1980s and 90s and confirm the Service's position on the application of FICA tax to severance payments.

Taxpayers in general have argued two theories: (1) that the payments were entirely excludible from income under section 104(a)(2) as damages on account of personal injuries or sickness, and (2) that the payments were nonqualified deferred compensation to which FICA tax applied in the year the compensation was earned, not in the year it was received. Section 3121(v)(2).

CASE SUMMARIES

Associated Electric Cooperative, Inc. v. U.S., 42 Fed. Cl. 867 (1999), appeal docketed, No. 99-5058 (Fed. Cir. March 8, 1999), held that payments received by employees under a voluntary "early-out plan" were wages for FICA purposes. The workers were coal miners and members of the United Mineworkers Union (UMWU) whose employer decided to close its strip mine and buy a cheaper and cleaner burning form of coal. The workers could receive two different types of payments: (1) an involuntary severance payment equal to one month's compensation for each year of service or (2) a voluntary severance package consisting of a payment equal to the involuntary severance payment plus one year's compensation. The voluntary severance package was designed to encourage employees to resign at an earlier date and to avoid union problems. (In the course of the negotiations, the UMWU relinquished the right to strike when its contract expired.) The plaintiff paid FICA tax on the early-out payments and filed for a refund.

The Court of Federal Claims held that the payments were "wages" on account of "employment" for FICA purposes. It based its decision on the Supreme Court case Social Security Board v. Nierotko, 327 U.S. 358, 365-66 (1946), dealing with the application of FICA to back pay for wrongful termination. In Nierotko the Supreme Court found that back pay was for "services" in the employer-employee relationship, even though strictly speaking it was for a period in which the individual did not work. It

concluded that service performed for the employer "means not only work actually done but the entire employer-employee relationship for which compensation is paid to the employee by the employer." The court in Associated Electric Cooperative rejected the taxpayer's contention that the payments were excludible under section 104(a)(2) as damages on account of personal injuries or sickness.

Two cases dealing with downsizing payments to former IBM employees similarly held that the payments were subject to income and FICA tax. The employees had accepted lump-sum payments calculated on the basis of years of service and salary at termination. They were required to sign a Release and Covenant Not to Sue in exchange for the payment. Abrahamsen v. U.S., 44 Fed. Cl. 260 (1999); Abbott v. U.S., 76 F. Supp. 2d 236 (N.D.N.Y. 1999), appeal docketed, No. 00-6029 (2d Cir. Feb. 15, 2000). The release stated that the employees released rights to sue for discrimination under various statutes. Nevertheless the courts were not persuaded that the payments met the standard of being "received on account of personal injuries." The reason was that the amount of the payments was based upon salary and years of service, measures of employee compensation.

Other cases dealing solely with the FICA tax treatment of severance payments reached similar holdings. Greenwald v. U.S., 85 AFTR 2d ¶2000-407 (S.D.N.Y. 1999) (holding severance payment due to involuntary termination subject to FICA); McCorkill v. U.S., 32 F. Supp. 2d 46 (D. Conn. 1999) (holding severance payment subject to FICA, as based upon employment relationship).

In Cohen v. U.S., 63 F. Supp. 2d 1131 (C.D. Cal. 1999), the district court held that a severance payment received over a period of five years was wages subject to FICA tax. FICA applied when the amounts were paid to the employee, and would not be attributed to the years in which the pay was earned. The amounts, further, were not nonqualified deferred compensation subject to the special timing rule of Code section 3121(v)(2).

LEGAL THEORIES

SECTION 104(a)(2): Despite the fact that IBM's former employees signed a release and covenant not to sue, the courts rejected arguments that the payments were excludible from income under section 104(a)(2) as damages on account of personal injuries or sickness.

The leading case in this area, Commissioner v. Schleier, 515 U.S. 323 (1995), establishes two standards for section 104(a)(2) treatment. (1) The payments must be for tort or tort-type damages, and (2) the damages must be "received on account of personal injuries," i.e., the damages must be attributable to the injury. Typically a tort-like suit involves a broad range of compensatory damages for intangible harms associated with personal injury, such as lost wages, medical expenses, and emotional distress, as well as punitive damages. Mayberry v. U.S., 151 F.3d 855 (8th Cir. 1998).

In these cases IBM faced a risk of tort suits, but the plaintiffs did not bring or threaten tort suits. On the other hand, the fact that the payments were calculated on

the basis of years of service and salary suggested that they were compensation for services.

Note that, effective for tax years beginning after December 31, 1996, Congress amended section 104(a)(2) to limit the exclusion to amounts received on account of personal physical injuries or physical sickness.

SECTION 3121(v)(2): An alternative theory argued in the Cohen case was that the payments were nonqualified deferred compensation. Under this theory, the payments would have been excluded from FICA, though not from income tax.

Section 3121(v)(2) provides that amounts deferred under a nonqualified deferred compensation plan are taken into account for FICA purposes as of the later of (1) when the services are performed, or (2) when there is no substantial risk of forfeiture of the rights to the amount. Generally this provision is beneficial to employees receiving deferred compensation. If their earnings exceeded the wage and benefit base in the year the services were performed, no additional FICA tax is due when risk of forfeiture lapses.

The court in Cohen easily rejected the deferred compensation theory. It found no evidence of a "plan or other arrangement for deferral of compensation." Section 3121(v)(2)(C). The regulations define deferral of compensation as giving the employee a legally binding right during a calendar year to compensation that has not been actually or constructively received. Section 31.3121(v)(2)-1(a)(3)(i). Furthermore, under the regulations, welfare benefits, i.e., "[v]acation benefits, sick leave, compensatory time, disability pay, severance pay, and death benefits do not result from the deferral of compensation for purposes of section 3121(v)(2), even if those benefits constitute wages within the meaning of section 3121(a)." Section 31.3121(v)(2)-1(a)(4)(iv). The court was satisfied that the payments were for severance in exchange for early retirement.

CONCLUSION

In these cases, there was no written plan or other arrangement for deferral of compensation. The payments were clearly designed either to induce employees to retire early or to settle potential claims arising from dismissal. The amounts were based upon salary and years of service, factors indicative of compensation. The courts were persuaded by these factors that the amounts were bona fide severance payments. Cases in which there are written plans which, in the government's view, do not give rise to severance pay will form the basis for a further article.