



## FICA Treatment of Severance Pay Clarified

*A recent federal appeals court decision affirmed the IRS' position on the FICA treatment of severance payments, overturning a controversial lower court decision. Employers now have a clear roadmap as to how to structure severance arrangements that are exempt from FICA taxation.*

### Background

Severance payments to an employee who is involuntarily terminated are taxable income to the employee, and are generally subject to income tax withholding. However, these payments are subject to FICA withholding only if they are "dismissal" payments. If they are "supplemental unemployment benefit" (SUB) payments, they are exempt from FICA.

**BUCK COMMENT.** *At the current FICA rate of 7.65% for the employee, and another 7.65% for the employer, the treatment of severance pay as an exempt SUB payment can represent significant savings for an employer that is downsizing its workforce.*

Unfortunately, the Internal Revenue Code does not make a clear distinction between dismissal and SUB payments. The IRS has developed its interpretation in a series of administrative pronouncements dating back to the 1950s and culminating in Revenue Ruling 90-72.

### SUB Payments

Under Revenue Ruling 90-72, a severance payment will be a SUB payment if it is made to an employee involuntarily separated from service under a plan designed to supplement the receipt of state unemployment compensation. A plan that pays a lump sum severance benefit is not a SUB plan because the total benefit is not related to the actual period of unemployment. Whether a trust is required will depend on specific state unemployment insurance law. Absent a state requirement, the IRS does not require that payments be made from a SUB trust.

### CSX Litigation

CSX Corporation established various programs designed to provide financial help to displaced employees in connection with a workforce reduction. These programs included payment to employees who left involuntarily as well as voluntarily and to those who remained on call and on the active payroll. Some employees received severance benefits based on their length of service, rather than the period of unemployment. CSX took the

position that all of this financial assistance was provided under a SUB plan, and so was exempt from FICA. This position was based on its interpretation of the complex provisions of the Internal Revenue Code, and not on the IRS administrative rulings.

The Court of Federal Claims agreed in part with CSX and determined that the benefits paid after involuntary termination of employment were SUB benefits, and so were not wages for purposes of FICA taxation, despite the fact that these benefits failed to meet the standards of the IRS administrative rulings. Benefits paid to employees whose terminations were voluntary were held to be wages subject to FICA taxation.

***BUCK COMMENT.*** *This ruling created uncertainty in the application of the FICA rules, with some employers following the court's broad interpretation, while others took the more conservative IRS position.*

On March 6, 2008, in [CSX Corporation v. United States](#), the United States Court of Appeals for the Federal Circuit reversed the lower court's ruling with respect to the benefits based on involuntary terminations that did not meet IRS standards, following instead the IRS interpretation of the law. Since CSX had not argued that its programs conformed to the IRS standards, the court held that all payments were subject to FICA withholding.

***BUCK COMMENT.*** *Although this represents a more restrictive reading of the rules, it provides welcome certainty in their application.*

## Conclusion

The IRS rulings, supported by the CSX holding, provide consistent guidance on the FICA treatment of severance payments. Employers faced with workforce reductions may want to explore the use of SUB plans where appropriate.

Buck Consultants is committed to helping employers weather the current economic environment and has considerable experience in the design, implementation and administration of severance pay plans. For employers interested in establishing a SUB plan that is exempt from FICA, Buck's Severance Solution<sup>®</sup> team would be pleased to discuss its specialized services. For more information, please contact [Robert.Gallman@buckconsultants.com](mailto:Robert.Gallman@buckconsultants.com).

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*This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.*