

Refund Claims for Severance Payments

In a significant new case, a district court has ruled that severance payments are not “wages” for employment tax purposes. This decision could create refund opportunities for employers who have previously treated severance payments as wages.

Facts of the new case: A retailer facing bankruptcy was forced to close hundreds of stores and distribution centers. It also fired thousands of employees and made severance payments to them.

The employer withheld both federal income tax and the employee’s share of employment tax from the severance payments while paying the employer’s share of employment tax.

Subsequently, the retailer filed several refund claims with the IRS. It sought to recover over \$1 million in overpaid Social Security taxes.

Result: The Michigan District Court said the severance payments were not in the nature of traditional wages. Instead, they should be treated as wage-replacement benefits used to provide support to workers who had lost the ability to earn wages. Thus, the Court ruled that the payments are not subject to employment tax.

Based on this new case, an employer may initiate a protective refund claim for open tax years if it has downsized its workforce and made severance payments during that time. Caution: The IRS is likely to appeal this pro-taxpayer decision.