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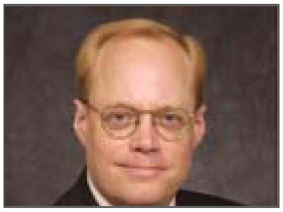

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# Cyber Monday: How Is Severance Taxed?

The answer is the same Cyber Monday as any other day. You may get severance pay when you quit your job, are laid off or fired. You also might get severance later if you sue and settle. Whether or not your pay is labeled "severance" and regardless of when paid, the IRS generally views severance like any other pay. It's taxed as wages so is subject to withholding and employment taxes.

If your employer hands you a severance check as you walk out the door you will probably expect it to have all the payroll deductions you're used to seeing. But payroll deductions may be a big surprise if you've sued and several years later are settling and expecting a big check. Many people are surprised that a *former* employer can withhold taxes when you no longer work for them. How can a payment be "wages" subject to withholding if you haven't been an employee for years?

As it turns out, timing doesn't matter. Whether you get a gross check for the full amount or one with payroll tax deductions depends on several variables. They include how careful your employer is about its tax obligations and how it agrees to resolve your case. See 10 Things To Know About Taxes On Damages. Most employment disputes are settled and it's common to split a settlement between severance (treated as wages) and non-wage income.

The employer may agree that some of the settlement is pay for discrimination, emotional distress, or other non-wage income. The severance pay is subject to withholding and employment taxes. The rest would be paid on a gross check with no withholding and reported on a Form 1099. See 10 Things You Should Know about 1099s.

**Two Components.** There are two parts to the tax puzzle, income tax withholding and employment taxes. Income tax withholding is simply the employer deducting tax money according to withholding tables and sending it to the IRS under your Social Security number. Then in January of the following year the company will issue an IRS Form W-2 showing your total income and the taxes withheld.

While you might regard the income tax withholding part of the equation as mere timing, the employment tax gets expensive. The employer and employee each pay half the employment tax. From the first $106,800 of your wages, you pay 7.65%. So does your employer. Beyond that amount, you pay 1.45%, as does your employer.

There's recently been a controversy in the courts over whether all severance pay should be subject to employment taxes. Severance pay arguably isn't for services that ***have been*** rendered, but for services that will ***never*** be rendered. The IRS position is that any severance pay is subject to employment taxes. However, a district court in Michigan recently held payments made to involuntarily terminated workers by a company going out of business were not wages for FICA purposes. See *United States v. Quality Stores, Inc.*

The Sixth Circuit Court of Appeals is due to decide the case on appeal. The American Payroll Association has filed an *amicus curiae* (friend of the court) brief supporting the view that FICA tax should not apply. In 2008, the IRS won a similar case in the Federal Circuit. See *CSX Corp. v. United States*. That case says any such payments are subject to FICA.

It's best and safest to assume that pay labled "severance" will face employment taxes. The same is true for pay constituting severance, regardless of how it is labeled.

For more, see:

Beware Personal Liability For Employee Taxes

Criminal Penalties For Misclassifying Independent Contractors?

IRS Speaks Out on Employment Lawsuit Settlements

Tax on Employment Settlements Addressed by IRS

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