

US v. Quality Stores, Inc.: Supreme Courts Finds Severance Payments Taxable Wages Under FICA - Federal Insurance Contributions Act

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In an 8-0 [decision](#)¹ issued March 25, 2014 in *United States v. Quality Stores, Inc.*, the Supreme Court held that severance payments made to employees who are involuntarily terminated are taxable wages for the purposes of withholding Federal Insurance Contributions Act (“FICA”) taxes, i.e., Social Security and Medicare. This decision resolves a circuit split created when the Sixth Circuit ruled in 2012 that these kinds of severance payments did not constitute “wages” under FICA² while the Third, Eighth and Federal Circuits had all previously held that at least some severance payments were “wages” subject to FICA taxes³.

In the wake of this decision, employers should, under most circumstances, treat severance payments made to involuntarily terminated employees as taxable wages subject to FICA taxes. There are exceptions to the general rule, however, and it is important for employers to seek competent legal counsel to assist in determining the tax status of a specific severance program.

Background

Quality Stores, Inc. filed an involuntary Chapter 11 bankruptcy petition in 2001 and, along with its affiliated companies (collectively “Quality Stores”), terminated thousands of employees in connection with the bankruptcy. The terminated employees received severance pay ranging from one-week to 18-months depending on years of service and position. The severance pay was not tied to receipt of state unemployment benefits. Quality Stores reported the payments as wages on the employees’ W-2 tax forms, paid the employer’s share of FICA taxes, and withheld the employees’ share of FICA taxes. Quality Stores subsequently filed for a refund of the FICA taxes on its own behalf and for certain employees who had authorized it to file on their behalf. When the Internal Revenue Service (“IRS”) took no action on the refund claim, Quality Stores initiated a proceeding in Bankruptcy Court. The Bankruptcy Court granted summary judgment in favor of Quality Stores and the District Court and Sixth Circuit Court of Appeals subsequently affirmed.

Quality Stores argued that severance payments did not qualify as “wages” under FICA, notwithstanding the broad definition of “wages” in the statute. The company asserted that because such payments were merely deemed to be wages for income tax withholding purposes under Section

3402(o) of the Internal Revenue Code,^[4] they did not actually qualify as “wages” as defined in the code. Accordingly, the company argued that because the definitions of “wages” for income-tax withholding under the Internal Revenue Code and under FICA are similar, severance payments should not be considered “wages” under FICA either. As explained in greater detail below, the Court found this argument unconvincing.

Analysis

The Court began its analysis by examining FICA’s definition of “wages” and concluded that the definition is broad enough to encompass severance payments. 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). Because severance is, by its very nature, only provided to employees, the Court determined that it must be considered “remuneration for employment.” This conclusion was bolstered by FICA’s extensive list of exemptions from the definition of “wages,” including a specific exemption for any severance payments made “because of ... retirement for disability.” § 3121(a)(13(A)). It was significant to the Court’s analysis that such an extensive and specific list of exemptions did not include severance payments. The decision found further support for its conclusion that the term “wages” includes severance payments in FICA’s legislative history—Congress had previously promulgated and then repealed an express exception from the definition of “wages” for dismissal payments which the employer is not legally required to make.

Next the Court examined and dismissed Quality Store’s argument that Section 3402(o) of the Internal Revenue Code supported a finding that severance payments did not constitute wages under FICA. First, the Court determined that the language indicating that supplemental unemployment compensation shall be treated “as if it were a payment of wages” did not conclusively indicate that severance payments would not otherwise qualify as wages. Second, the Court found that the legislative history of Section 3402(o) undermined Quality Store’s proffered interpretation. The Court explained that Section 3402(o) was enacted to address a very specific issue that had arisen with respect to a certain type of supplemental unemployment compensation benefits negotiated in a few unionized industries to provide a secondary measure of protection against layoffs. These benefits were negotiated as an alternative to guaranteed annual wages sought by the unions and were specially structured so that their payment was tied to the receipt of state unemployment benefits. To work in this context, the compensation could not be considered wages because many states would only provide unemployment benefits if the employee was not earning any wages. To address this specific problem, the IRS promulgated several Revenue Rulings, which took the position that these specially structured supplemental unemployment benefit payments were not “wages” under FICA or for the purposes of income-tax withholding. However, to prevent employees from facing significant tax liability at the end of the year—because the compensation was still considered taxable income—Congress enacted Section 3402(o) to allow the supplemental unemployment benefits to be treated “as if” they were wages for income tax withholding purposes. Quality Stores had in essence argued that because no similar provision was enacted under FICA, severance payments could not constitute “wages” for FICA purposes. The Court found this argument unavailing, however, because it had already concluded that severance payments generally qualify as wages and because of the very specific nature of the problem Section 3402(o) was enacted to address.

Conclusion

It is clear in the wake of this decision that severance payments are generally subject to FICA taxes, as well as income-tax withholding. The Supreme Court specifically noted, however, that the IRS

rulings exempting the specially structured arrangements for severance payments explicitly tied to the receipt of state unemployment benefits from income tax withholding and FICA taxation are still in effect as they were not at issue in the case.

[1] Justice Kagan took no part in the consideration of the case.

[2] *In re Quality Stores, Inc.*, 693 F.3d 605 (6th Cir. 2012).

[3] *CSX Corp. v. US*, 518 F.3d 1328 (Fed.Cir. 2008); *University of Pittsburgh v. US*, 507 F.3d 165 (3rd Cir. 2007); *North Dakota State Univ. v. US*, 255 F.3d 599 (8th Cir. 2001).

[4] Section 3402(o) provides that a severance payment “shall be treated **as if** it were a payment of wages by an employer to an employee for a payroll period.” (emphasis added).

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