

Do Defendant Employers Withhold Taxes On Settlements?

By Robert W. Wood

The majority of employment cases settle, and in many — in most, I hope — employer and employee actually agree on the tax treatment of the payments. Typically, a portion is wages subject to withholding, and a portion is taxable on a Form 1099. Sometimes, there is a tax-free element too, when the plaintiff claims physical injury or physical sickness.

In *Domeny*, T.C. Memo. 2010-9, a woman suing her employer claimed that stress at work exacerbated her existing multiple sclerosis. She succeeded in having a portion of her settlement be tax-free. In *Parkinson*, T.C. Memo. 2010-142, a man suing his employer claimed that workplace stress gave him a heart attack. Over Internal Revenue Service objections, the Tax Court ruled that he too was allowed to exclude his damages.

In contrast, recoveries for emotional distress are taxed. So are payments for emotional distress even if they are accompanied by physical symptoms such as headaches, stomachaches, and insomnia. Indeed, most employment cases — whether wage and hour, discrimination, wrongful termination, etc. — produce taxable damages. But are they wages subject to withholding?

Cifuentes v. Costco

A recent case suggests new reasons to settle employment cases. At least in settlements, employer and employee can hash out what is being paid and agree on whether withholding will be taken. In *Cifuentes v. Costco Wholesale Corp.*, 2015 DJDAR 7300 (Cal. App. 2d Dist., June 26, 2015), the California Court of Appeal held that lost wages are subject to withholding. Tax advisers will say that hardly sounds surprising.

Yet employment lawyers may not be so sure. The case is a victory for Costco, which had long claimed that it had fully paid Cifuentes his judgment when it sent part of the money to the IRS and California Franchise Tax Board. Going back to court multiple times to argue over tax treatment after one has already lost a case is no fun for any defendant.

Cifuentes sued Costco for wrongful termination. The jury awarded him \$28,125 in past wage loss and \$273,253 in future wage loss. With costs and interest, the judgment totaled \$325,692.07. Costco tendered Cifuentes a net check, not a gross check. That may sound pretty reasonable, since every employer *knows* that wages are subject to withholding.

Indeed, the employer has liability for the taxes if it fails to withhold. Costco withheld federal and state payroll taxes from the award. Cifuentes claimed the judgment was not satisfied, citing *Lisec v. United Airlines Inc.*, 10 Cal. App. 4th 1500 (1992). *Lisec* had held that an employer is not required to withhold payroll taxes from an award of lost wages to a former employee.

Dispute Number Two

Costco paid the judgment, but withheld \$116,150.84 in payroll taxes from the \$301,378 attributed to lost wages. Costco said that it had fully satisfied the judgment. Cifuentes said that withholding was improper, so Costco owed him more.

The dispute narrowed when Cifuentes received \$69,078 in tax refunds from the IRS and California Franchise Tax Board. Costco again demanded that he acknowledge satisfaction of the judgment. Cifuentes again refused, claiming he was still owed \$23,764.95, plus interest.

Costco asked the court for an acknowledgement of satisfaction of judgment. Costco even requested the court to order that Cifuentes pay Costco's \$20,060 in attorney fees. Costco argued that the payments to Cifuentes were wages on which it *had* to withhold. Not to withhold could mean Costco would have to pay twice, paying the taxes too.

Cifuentes responded that *Lisec* requires the judgment to be satisfied in the amount *as written*. The trial court determined it was bound by *Lisec*. The Court of Appeal reversed, noting that an employer that fails to withhold payroll taxes from an award of back or front pay to a former employee exposes itself to penalties and personal liability for those taxes.

The court declined to follow *Lisec*, and adopted instead the prevailing federal view that gives a much broader reading to the scope of "wages." In the years since *Lisec*, many employers settling employment suits have probably pushed the envelope in *not* withholding taxes on settlements. Yet most employers know that they may do so at their peril.

Numerous federal courts since *Lisec* have considered whether back or front pay to a non-reinstated employee is subject to income/FICA taxation and withholding. Most courts have said that back or front pay is still pay, and pay is subject to withholding. The IRS's view of wages is expansive, and so is the courts'.

Costco Withholding

When Costco paid the judgment to Cifuentes, the court said it had a choice. It could follow *Lisec* and risk liability to the IRS and other taxing authorities. Or it could follow the prevailing view of the federal courts that back and front pay are wages subject to withholding. The appellate court ruled that withholding was proper, and Costco had fully satisfied the judgment.

Cifuentes could fight the IRS, but he could not keep suing Costco for taxes that Costco was required to remit to the IRS. However, the court did not award attorney fees to Costco. The court reasoned that until now, *Lisec* was the sole California authority on point.

Lisec legitimized Cifuentes' position, and was binding on the trial court. As a result, the appellate court said that Cifuentes had been justified in refusing to acknowledge the full satisfaction of judgment. But in the future, employers will withhold, and that will be that.

Lessons

The vast majority of employment disputes are settled. In a case that is settling, the plaintiff and defendant are likely to consider taxes before they sign. They certainly should! The norm is *some* wage treatment, but much of the recovery being reported on a Form 1099.

It is generally possible for plaintiff and defendant to agree on an allocation and on tax reporting. With a judgment, the possibility for a misunderstanding increases exponentially. Having to go to court all over again to fight over withholding and a satisfaction of judgment? That may be one more reason to settle the case in the first place.



Robert W. Wood is a tax lawyer with a nationwide practice (www.WoodLLP.com). The author of more than 30 books including "Taxation of Damage Awards & Settlement Payments" (4th Ed. 2009 With 2012 Supplement www.taxinstitute.com), he can be reached at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.