

Termination Pay Withholding Issues

By Robert W. Wood



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Robert W. Wood practices law with Wood LLP in San Francisco (<http://www.WoodLLP.com>) and is the author of *Taxation of Damage Awards and Settlement Payments* (2009 with 2012 supplement), *Qualified Settlement Funds and Section 468B* (2009), and *Legal Guide to Independent Contractor Status* (2010), all available at <http://www.taxinstitute.com>. This discussion is not intended as legal advice and cannot be relied on for any purpose without the services of a qualified professional.

There is wide variation in how employers address termination pay. When paying terminating or terminated employees, the tax questions should be addressed before checks are prepared. This article reviews the rules and possibilities, noting that withholding for income and employment taxes should be the norm unless there are non-wage claims being released.

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Suppose you are paying off a departing employee. You might be issuing a check on the employee's last day. Alternatively, perhaps the employee previously terminated employment and you are trying to avoid a lawsuit. Maybe a claim against you is already brewing, is being drafted, or has already been filed.

Under any of those scenarios you might reach for your checkbook, hoping to make the problem go away. Apart from how much money will be enough to resolve the potential claim, one big question will be whether to withhold taxes and if so, on what amount. Even if you decide to withhold, you must consider whether the withholding should be income taxes only or should also include Social Security taxes, and what the rate of withholding should be.

Those questions are not easy to answer. Even after 30 years of advising on those matters, I am continually surprised by the wide range of client responses. Some companies withhold income and employment taxes on everything. Some withhold on nothing. Some companies pick from a wide range of midpoints and may or may not be able to justify those midpoints based on the facts. As you would expect, the facts and legal claims in contention matter in determining what is and is not wages. That means you should consider the issues carefully, and you may not want to assume that one size fits all. Although the last thing you want is for a settlement to be derailed, facing taxes and penalties for failure to withhold can be as bad or worse.

By definition, if adverse tax consequences occur, they will generally arise months or even years after the case is over. At that point, the milk cannot be put back into the bottle. Fortunately, how the company characterizes the payment and its intent in making the payment can both matter.

General Rule: Treat It as Wages

If you are the employer, your default rule should be to assume that a payment to an employee or former employee is wages and to withhold on that payment. Plainly, that means you and the ex-employee will pay higher taxes than if you simply described the payment on Form 1099-MISC as "other income." However, if the person was an employee and you are paying wages, you must withhold.¹

Some of that is self-proving. Wage terminology clearly spells out withholding, but what is wages? The term is generally defined as all remuneration for services performed by an employee for his employer.² It even includes the value of remuneration paid in something *other* than cash unless it is within a limited class of exclusions from wage treatment such as particular fringe benefits.³

A similar (but not identical) set of rules applies to FICA withholding.⁴ Small fringe benefits such as coffee and some office meals are not counted as wages, but the rules are narrower than you might

¹Section 3402(a)(1).

²Section 3401(a).

³*Id.*

⁴Sections 3101 and 3121(a).

assume. Thus, unless you are confident a payment is excepted from the wages category, it pays to be conservative.

Although it is safest to adopt the conservative position that a payment to a departing employee is wages, some things go too far and should probably not be subject to withholding. Payments for emotional distress should be income, but not wages for employment tax purposes. That would mean issuing a Form 1099 (not withholding taxes) and then issuing a Form W-2.⁵

Similarly, in the context of a contested claim with an attorney representing the plaintiff, what about a payment of the attorney fees to the lawyer? In *Commissioner v. Banks*,⁶ the Supreme Court resolved a split in the circuits over the tax treatment of attorney fees. The question was whether fees a plaintiff paid to his contingent fee attorney represented income to the plaintiff even if paid directly to the attorney by the defendant. The Court enunciated a general rule that the plaintiff had income on the payment of the legal fees to the attorney.

There has been much discussion about potential exceptions to that rule. However, its general principles suggest that if a plaintiff receives solely wages from an employer and hires a contingent fee lawyer to collect them, the fees paid to the lawyer would *also* be wages deemed paid to the employee. Thus, unless the 100 percent wage claim is an exception to the general rule, the holding in *Banks* suggests that the employer should withhold, even on the lawyer's fees.

It is unlikely that withholding on the attorney fee portion of the wages occurs frequently in practice. Rev. Rul. 80-364⁷ provides guidance on this issue.⁸ Yet given the practical problems, most employers find a way to justify not withholding on the portion of the funds being paid to the lawyer.⁹ Finding a justification is easier when not all the funds the

plaintiff will receive are wages, but even when the plaintiff receives solely wages, withholding on the fees is rare.¹⁰

Severance Pay Is Wages

The most common type of payment to a terminated employee is severance pay. It is taxable compensation income and treated as wages.¹¹ In fact, if you call something "severance pay," you have effectively made your withholding decision: because severance pay is wages, you must withhold.

Severance pay may be taxable as wages even if, as part of a separation agreement, the departing employee signs waivers releasing the former employer from potential future claims, including claims of unlawful discrimination.¹² That the worker is releasing claims does not necessarily mean the payment is not wages. However, it is appropriate to allocate settlements when there are multiple reasons for a payment. Specific agreements and explicit allocation language are appropriate, perhaps even necessary.

Amounts paid to a terminated employee may be compensatory and taxable as severance pay, even when the employer had no legal obligation to make the payments.¹³ Severance or dismissal pay is generally treated as supplemental wages and fully subject to federal income tax withholding. The IRS allows two alternative withholding methods on severance pay: the flat rate method and the aggregate method.¹⁴

The flat rate withholding method allows an employer to withhold from the severance payment at a flat rate of 25 percent without regard for the employee's filing status or allowances claimed on Form W-4. An employer may only use this method if it has also withheld income tax from regular wages paid to the employee during the same calendar year as the severance payment, or if it has done so in the preceding calendar year and if the supplemental wages are separately stated on the employer's payroll records.

⁵See 2011 IRS Instructions for 1099-MISC, available at http://www.irs.gov/pub/irs-pdf/i1099misc_11.pdf; IRS Lawsuits, Awards, and Settlements Audit Techniques Guide (Rev. May 2011), available at <http://www.irs.gov/businesses/small/article/0,,id=248471,00.html>.

⁶543 U.S. 426 (2005), Doc 2005-1418, 2005 TNT 15-10.

⁷1980-2 C.B. 294.

⁸PMTA 2009-035, Doc 2009-15305, 2009 TNT 129-19. Although the program manager technical assistance was released in July 2009, it is dated October 22, 2008.

⁹For further discussion, see Robert W. Wood, "IRS Speaks Out on Employment Lawsuit Settlements," *Tax Notes*, Sept. 14, 2009, p. 1091, Doc 2009-18678, or 2009 TNT 175-4 (the IRS recites the different factual situations analyzed in Rev. Rul. 80-364).

¹⁰For further discussion, see Wood, "Should Employers Withhold on Attorney Fees?" *Tax Notes*, Nov. 7, 2011, p. 751, Doc 2011-21711, or 2011 TNT 217-14.

¹¹Section 61; *Ramella v. Commissioner*, T.C. Memo. 1979-177.

¹²*Webb v. Commissioner*, T.C. Memo. 1996-50, Doc 96-4680, 96 TNT 32-3; *Sodoma v. Commissioner*, T.C. Memo. 1996-275, Doc 96-17546, 96 TNT 117-9; *Foster v. Commissioner*, T.C. Memo. 1996-276, Doc 95-17545, 96 TNT 117-8.

¹³*Schwartz v. Commissioner*, T.C. Memo. 1989-97.

¹⁴IRS Information Letter 2010-0042, Doc 2010-8642, 2010 TNT 76-45.

The aggregate method requires the employer to add the supplemental and regular wages (if any) for the most recent payroll period in the current year. The employer then calculates the income tax withholding as if the total were a single payment. This calculation takes into consideration the employee's filing status and withholding allowances. The employer subtracts the amount withheld from regular wages (if any) and withholds the remaining amount from the supplemental wages. Employers may use this method when they are paying an employee supplemental wages that do not exceed \$1 million for the calendar year.

Withhold for FICA, Too

There are some types of pay that are wages for income tax purposes but not for employment tax purposes. However, except for a highly sophisticated employer (keenly aware of exactly what it is doing on the right facts), I would withhold for all purposes and not merely for income tax purposes. Whether severance pay is actually subject to FICA tax withholding has been debated in at least a few circumstances; the IRS generally says that it is.¹⁵ Rather than fighting City Hall, my suggestion from the company's perspective is to treat the pay as fully subject to FICA.

Some companies, however, have disagreed with the IRS and have gone to court over it. In 2002 the Court of Federal Claims held that severance pay was not subject to FICA. However, in 2008, the Federal Circuit reversed and held that severance pay paid in the taxpayer's various downsizing programs was subject to FICA.¹⁶ Most recently, a federal district court held that severance is not subject to FICA withholding.¹⁷ Thus, the severance pay area is unsettled.

Back Pay Distinguished From Severance

Back pay and severance pay are closely related but are not necessarily the same thing. Back pay is to compensate a person for pay he would have received up to the time of settlement or court award but for the employer's wrongful conduct. For example, back pay is awarded to an employee if he is illegally terminated by an employer, or to an applicant whom the employer chooses not to hire for illegal reasons.

¹⁵Reg. section 31.3401(a)-1(b)(4), 31.3402(g)-1(a); Rev. Rul. 74-252, 1974-1 C.B. 287; Rev. Rul. 71-408, 1971-2 C.B. 340.

¹⁶*CSX Corp. v. United States*, 518 F.3d 1328 (Fed. Cir. 2008), *Doc 2008-4957*, 2008 TNT 46-15, *rev'g* 52 Fed. Cl. 208 (Fed. Cl. 2002), *Doc 2002-8862*, 2002 TNT 77-5.

¹⁷*In re Quality Stores Inc.*, 424 B.R. 237 (W.D. Mich. 2010), *Doc 2010-4102*, 2010 TNT 38-14.

In most cases, back pay is taxable, subject to FICA and income tax withholding.¹⁸ The employer subtracts the amount withheld from regular wages (if any) and withholds the remaining amount from the supplemental wages. It must be reported on Form W-2 for the year the payment is actually received (rather than the year payment is earned or should have been received).¹⁹ Thus, as with severance, it is generally treated as wages.

However, the origin of the claim and the nature of the damages must be considered. Back pay for lost wages received on account of personal physical injuries or physical sickness is not subject to FICA or income tax withholding. Put differently, payments that are excluded from gross income are (obviously) not subject to withholding (income tax or FICA), either.²⁰

In the Eighth Circuit, back pay (and front pay) awarded for an illegal refusal to hire is *not* subject to FICA and income tax withholding.²¹ However, the back pay is taxable to the recipient and reportable by the payer on Form 1099-MISC, Box 3 Other Income. In other circuits, back pay *is* subject to FICA and income tax withholding and is reportable on Form W-2.²²

Front Pay Is Wages

Front pay differs from back pay. Front pay is paid to an individual to compensate him for pay he would have received after the settlement date or court award but for the employer's wrongful conduct. The assumption with front pay is that the employee will not actually be rendering services to the employer. There may be hostility between employer and employee or other circumstances that prevent it.

Unlike back pay (where services were actually rendered), with front pay no services will be performed. The assumption is that the worker cannot actually render services but is still entitled to payment from the employer. Many people have therefore argued that front pay may be subject to income tax but it should not be subject to employment taxes. They argue that if wages are paid for services *rendered*, pay for services that are *not* rendered cannot be wages.

¹⁸See generally *Rivera v. Saker West Inc.*, 430 F.3d 1253 (9th Cir. 2005).

¹⁹*Cleveland Indians Baseball Co. v. United States*, 532 U.S. 200, 220 (2001), *Doc 2001-11045*, 2001 TNT 75-7.

²⁰*Anderson v. United States*, 929 F.2d 648, 654 (Fed. Cir. 1991).

²¹*Newhouse v. McCormick & Co.*, 157 F.3d 582, 587 (8th Cir. 1998), *Doc 98-30499*, 98 TNT 197-79 (explaining that no employment relationship existed so the character of the payment could not be wages).

²²Rev. Rul. 78-176; 1978-1 C.B. 303; see also IRS Publication 957.

Nevertheless, except in the Fifth Circuit, front pay is generally considered wages subject to FICA and income tax withholding and must be reported on Form W-2.²³ Thus, the Fifth Circuit has held that only back pay is subject to FICA and income tax withholding (wages is compensation for services already performed, not for services that will not be performed).²⁴ Moreover, in the Eighth Circuit, front pay and back pay are exempt from FICA and income tax withholding when no employment relationship existed.²⁵

As with back pay, however, front pay can sometimes be awarded in circumstances that render it nontaxable. In a suit by a person injured in an auto accident, the plaintiff might be awarded damages for personal physical injuries, back pay for being laid up and having to miss work, and front pay for the additional time he expects to be out of work. Given the genesis of the lawsuit and the physical nature of the injuries, the entire recovery (including both front and back pay elements) should be tax free under section 104.

Canceled Employment Contracts Payment

According to Rev. Rul. 2004-110,²⁶ an amount paid to an employee as consideration for cancellation of an employment contract and the relinquishment of contract rights is ordinary income and wages for purposes of FICA, FUTA, and federal income tax withholding. Before the issuance of Rev. Rul. 2004-110, severance payments made to an employee in consideration for early termination of an employment contract were not considered wages or compensation. They were considered ordinary income but not subject to FICA, FUTA, or income tax withholding.²⁷

In *Newhouse v. McCormick & Co.*,²⁸ the Eighth Circuit overturned a long-standing IRS rule that an employer has an obligation to withhold income and FICA taxes for employment discrimination even if an employer-employee relationship never existed. Newhouse worked for McCormick for 23 years before being terminated because of outsourcing. Newhouse worked for an unrelated employer for

five years before applying for a new position at McCormick but was denied employment by McCormick because of age discrimination.

After a jury trial, Newhouse obtained a large judgment for lost back pay and front pay against McCormick. McCormick withheld income tax and FICA on the judgment payments to Newhouse, but Newhouse filed suit demanding that McCormick pay the entire amount. The Eighth Circuit agreed with Newhouse, reasoning that if no employment relationship ever existed, then the judgment payments could not be subject to employment taxes or income tax withholding. However, the Eighth Circuit's position is contrary to the IRS's position and certain decisions in other circuits. Of course, even though the Eighth Circuit held that no wage withholding or FICA tax was applicable to Newhouse, his payments were still subject to income tax.

Conclusion

Paying severance pay or any amount in settlement of potential employment claims can be tricky. In most cases, whether or not the employer or former employer thinks there are valid legal claims, it will want to secure a signed release. Yet it also wants things to go smoothly and to proceed in a businesslike manner.

Although employers want to resolve potential claims, they also want to ensure that they do not face scrutiny (or worse) from the IRS and state tax authorities. From a tax perspective, the safest thing to do usually is to withhold taxes (both income and employment) on the full amount. That is so whether the employer denominates the payment as severance, front pay, back pay, or any combination of those.

At the same time, if the payment is in the nature of a litigation settlement, treating the entire payment as wages can be too narrow. For example, suppose a settlement is meant to be one-half severance and back pay and one-half payment for emotional distress on account of race discrimination. Plainly, one should withhold on the severance and back pay but not on the emotional distress portion.²⁹

Whatever you do, consider these issues in advance and clearly communicate your plans to the ex-employee or his counsel. No one wants to be surprised.

²⁹2011 IRS Instructions for 1099-MISC, available at http://www.irs.gov/pub/irs-pdf/i1099misc_11.pdf; IRS Lawsuits, Awards, and Settlements Audit Techniques Guide (Rev. May 2011), available at <http://www.irs.gov/businesses/small/article/0,,id=248471,00.html>.

²³*Gerbec v. United States*, 164 F.3d 1015, 1026 (6th Cir. 1999), Doc 1999-2311, 1999 TNT 11-26; *Mayberry v. United States*, 151 F.3d 855, 860 (8th Cir. 1998), Doc 98-25388, 98 TNT 155-5; and *Hemelt v. United States*, 122 F.3d 204, 209 (4th Cir. 1997), Doc 97-23218, 97 TNT 154-44.

²⁴*Dotson v. United States*, 87 F.3d 682, 690 (5th Cir. 1996), Doc 96-20362, 96 TNT 140-8.

²⁵*Newhouse v. McCormick & Co.*, 157 F.3d 582 (8th Cir. 1998).

²⁶2004-2 C.B. 960, Doc 2004-22454, 2004 TNT 227-5.

²⁷Rev. Rul. 74-252, 1974-1 C.B. 287; Rev. Rul. 58-301, 1958-1 C.B. 23; Rev. Rul. 55-520, 1955-2 C.B. 393.

²⁸157 F.3d 582.