SETTLING EMPLOYERS: DO YOU WITHHOLD OR NOT?[1]

By Robert W. Wood

One of the painful issues confronting both plaintiffs and defendants in settling employment actions is whether the agreed upon sum is subject to withholding. Federal income tax and federal employment tax, as well as state employment tax, obligations can be serious for both the defendant and the plaintiff. Whether in a settlement or judgment context, disputes often arise about whether withholding on an amount was proper. Sometimes the Internal Revenue Service is a party to these actions, and sometimes the dispute is solely between private parties.

Employer Quandary

On the settlement of an employment-related claim (or a payment pursuant to a judgment), the defendant can be in a doubly difficult situation. Quite apart from the financial and publicity concerns. Unfortunately, the IRS takes the position that payroll taxes and withholding are required if any payment is taxable and arises out of the employment relationship. Even though it may seem ridiculous, even if a former worker was terminated or quit five years before the action is settled, if an amount is characterized as front pay or back pay, then the IRS takes the position withholding is required.

As a practical matter, many defendants argue that there should be no withholding in cases where the employment relationship was terminated long before the settlemental judgment. Unfortunately, these disputes are not easy to resolve, and the former employer and former employee often have disagreements over these issues.

One of the famous examples of such a dispute involved an age discrimination and wrongful termination action brought by Mr. Redfield against the Insurance Company of North America. His case proceeded to trial and he obtained a judgment. The company appealed, but Redfield prevailed on appeal. When he refused to sign satisfaction of judgment forms because the insurance company kept trying to tender him net checks (withholding having been taken out of them), Redfield sued for declaratory judgment arguing that withholding was improper.

The IRS refused to join into this action to help bail the employer out. So, the employer fought this matter in district court and eventually won (withholding was considered proper). Undaunted, Mr. Redfield went to the Ninth Circuit Court of Appeals. Lo and behold, the court reversed, not expressing any opinion about whether the recovery was taxable income to Mr. Redfield. The Ninth Circuit confined itself solely to the question whether withholding on that amount was proper. It was not, said the Ninth Circuit. So after several years of litigation, and countless dollars of expense, Insurance Company of North America had to pay out the full amount of the judgment. For further details, see Redfield v. Insurance Company of North America, 940 F.2d 542 (9th Cir. 1991).

Agreement Makes Sense

Ideally, plaintiff's counsel and defense counsel will agree up-front on what is appropriate in a case arising out of wage-based claims. But the answer is not always simple. A famous California case,

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Lisec v. United Airlines, 10 Cal.App. 4th 1500 (1992) reached a determination that was similar to the court's conclusion in Redfield. Again, there was much needless litigation and expense.

Recent Discussion

The most recent authority on this question is Richard Newhouse v. McCormick & Co., Inc., Dkt. Nos. 97-3233 and 97-3667 (8th Cir., Oct. 2, 1998). In Newhouse, there were backpay and frontpay awards made to an individual who was no longer an employee. After all, in most employment litigation, the plaintiff litigant is no longer an employee. The court considered whether withholding on the award was proper. The worker had a checkered history, having worked at one time for McCormick as a spice sales representative for 23 years until he was terminated in 1987. Then, for the following five years, Mr. Newhouse worked for a food broker.

In 1992, he applied for a new position with McCormick and, it ultimately developed, was allegedly not hired because of his age. An age discrimination action then ensued. When this matter finally came to judgment, Newhouse was awarded damages, and the court based these damages on backpay and frontpay. The question, though, was whether this prospective applicant for employment (notwithstanding his at one time 23-year tenure with McCormick) was sufficient to make him qualify for "employee" status notwithstanding the hiatus of years.

The Eighth Circuit Court of Appeals, went laboriously through the tax regulations dealing with the definition of wages. Most management employment lawyers (or conservative tax lawyers, for that matter), would probably have said that wages are defined in the tax law sufficiently broadly enough that they probably could have scooped up these payments. They were, after all, made to a former employee (he was an employee for 23 years!). They were also made explicitly with respect to frontpay and backpay (thus calculated by wages). See I.R.C. §3402(a)(1). See also Treas. Reg. §31.3121(a)-1. Indeed, the court cited with favor a provision in the employment regulations that remuneration for employment does constitute wages (and thus is subject to withholding), even though the employment relationship no longer exists at the time the remuneration is paid. Treas. Reg. §3121(a)-1(c).

No Go

Notwithstanding all of this, the court concluded that there was simply no basis for finding a current or previous employer/employee relationship between Newhouse and the Company that would justify withholding on payroll taxes. Indeed, the court seemed to separate Newhouse's prior career of 23 years with McCormick with the substantial lapse of years after which he merely became a job applicant. A job applicant, said the court, simply does not have the status of an employee under the common law rules. Furthermore, the court found that Mr. Newhouse did not gain the status of an employee through his lawsuit.

Referring to the company's recitation of cases dealing with withholding, the court found that most of these cases (that admittedly supported withholding) did so only where there was an employee relationship that was improperly severed. There was no improper severance in this case. Mr. Newhouse simply was not hired, even though he allegedly should have been. Again, his prior status as a 23-year veteran of McCormick seems to go unnoticed (or at the very least, is considered unimportant).

It is difficult to summarize the rambling and lengthy Eighth Circuit opinion in Newhouse. Interestingly, in a rare appearance, the United States government appears in the Eighth Circuit case as an amicus curiae, filing a brief—needless to say—supporting withholding.

What to Do?

Employers and plaintiff's counsel alike are frequently concerned about withholding obligations. The employer is concerned about them because the employer might ultimately have to pay them, including penalties and interest. The plaintiff's lawyer may be concerned about them primarily because he or she is trying to convince the employer (or former employer) not to withhold. The plaintiff's lawyer may also be concerned about withholding liabilities because there may be an indemnity obligation requiring the plaintiff (or sometimes even the plaintiff's lawyer) to indemnify the company for any failure to withhold liabilities.

Unfortunately, cases such as Newhouse v. McCormick do nothing to assuage the concerns that are now pent-up in many law offices, boardrooms and HR departments around the country. The tension is rising, and there is no wholly satisfactory answer.

The conventional wisdom in situations of this type is troubling, simply because what advice one gives depends very much on who one represents. In the settlement of wage-based claims, most attorneys representing defendants will advise that the safest thing to do is withhold. In situations where this politically is unattractive (in other words, if the plaintiff says flatly that the case will not settle if withholding is taken), then the defendant may well not heed this traditionally conservative advice. Conversely, plaintiff's lawyers routinely request that no withholding be taken on amounts, even if something is admittedly taxable. Unless tax advice has been obtained, this position can be quite dangerous. Ultimately, what is perhaps most appropriate is for the settling plaintiff and settling defendant to agree what portion of a settlement amount represents lost wages, and to have withholding taken on this amount. Not only will this save the plaintiff's portion of social security tax (social security tax is split between the employer) but it will help the plaintiff plan for tax obligations as well. After all, if no withholding is taken on an award or settlement, and the plaintiff only wakes up to the tax obligation at tax return filing time (potentially a year later), the liability can be crushing. Withholding serves a useful function in this regard.

As to the portion of the settlement or judgment amount that does not represent wages (for example, an amount that plaintiff and defendant agree is properly allocable to emotional distress damages) then withholding should clearly not be taken. On this amount, both the settling company and the plaintiff should be comfortable that employment taxes are simply inapplicable. Punitive damages, although taxable to a plaintiff (and under President Clinton's proposal, nondeductible to the defendant!) would also fall into the category of a payment that should not give rise to withholding obligations.

Ultimately, perhaps the best advice about the "to withhold or not to withhold" question is to consider each case on its facts. There is no substitute for tax advice prior to the settlement, even if the tax advice is obtained literally on the cusp of the payment. At the very least, with a little planning cases such as Redfield and the expensive and time- consuming litigation over withholding can be avoided.