

## When Defendant Employers Are Sued (Again) for Withholding Taxes

By Robert W. Wood



Robert W. Wood

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*, *Qualified Settlement Funds and Section 468B*, and *Legal Guide to Independent Contractor Status*, 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.

Wood discusses how the recent *Cifuentes* decision in California state court reverses long-standing law and allows employers to withhold taxes on settlements in employment suits and thereby protect themselves from potential tax liability.

Copyright 2015 Robert W. Wood.  
All rights reserved.

Employers do not want to be sued. If they are sued, however, they generally hope to settle. Fortunately, most cases are resolved this way. Settlements are usually split between wages (taxable and subject to withholding) and non-wage income (taxable but with no withholding, reported on a Form 1099).

Sometimes, there is a tax-free element too, when the plaintiffs claim physical injury or physical sickness.<sup>1</sup> Cases such as *Domeny v. Commissioner*<sup>2</sup> and *Parkinson v. Commissioner*<sup>3</sup> have made it more likely for plaintiffs in employment cases to be able to exclude some portion on account of physical injuries or physical sickness. In *Domeny*, 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.

<sup>1</sup>See Robert W. Wood, "Taxing Physical Sickness, Workers' Compensation, and PTSD," *Tax Notes*, Feb. 24, 2014, p. 857.

<sup>2</sup>T.C. Memo. 2010-9.

<sup>3</sup>T.C. Memo. 2010-142.

In *Parkinson*, a man suing his employer claimed that workplace stress gave him a heart attack. Over IRS objections, the Tax Court held that he was allowed to exclude his damages. On the other hand, the law is clear that mere recoveries for emotional distress are taxed.

Payments for emotional distress are also taxed, even if they are accompanied by physical symptoms. Common examples include headaches, stomachaches, and insomnia. Indeed, most employment cases — whether wage and hour, discrimination, wrongful termination, etc. — produce taxable damages.

Of course, a portion of the recovery in most employment cases is wages subject to withholding. Many plaintiffs are disappointed at the tax treatment of their settlements. Many employers likewise find negotiations over the tax issues to be difficult.

The tax issues raised by attorney fees add to the stress. An employer's payment to a plaintiff's attorney usually requires the defendant to issue a Form 1099 to the lawyer, with a duplicate Form 1099 to the client. Even with an above-the-line deduction for attorney fees, plaintiffs and their lawyers often do not like the result.

A recent case suggests that some plaintiffs may now face even greater tax angst. If employment plaintiffs become unhappier with the tax issues at settlement, some defendants could feel the pinch too. The tax issues are symbiotic.

### *Cifuentes v. Costco*

In *Cifuentes v. Costco Wholesale Corp.*,<sup>4</sup> the California Court of Appeals 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.

In short, Costco tendered Cifuentes a net check, not a gross check. That may sound pretty reasonable. After all, every employer *knows* that wages are subject to withholding. Indeed, the employer is liable for the taxes if it fails to withhold. With that

<sup>4</sup>2015 Cal. App. LEXIS 559 (June 26, 2015).

liability (and even personal liability for the company's responsible persons), employers take withholding seriously.

But employment litigation can be messy. Resolving claims can be messy too, and tax advisers usually aren't in control of how the cases get resolved. That is part of the explanation for *Cifuentes v. Costco*.

Cifuentes won a judgment for lost wages against his former employer, Costco. Costco withheld federal and state payroll taxes from the award. Cifuentes claimed the judgment was not satisfied, citing *Lisec v. United Airlines Inc.*<sup>5</sup> *Lisec* had held that an employer is not required to withhold payroll taxes from an award of lost wages to a former employee.

*Lisec* — like *Cifuentes* — involved a plaintiff and defendant arguing about taxes outside the presence of the IRS. In that sense, the party most able to resolve the issue was simply not in the room. Litigators sometimes try to compel the IRS to join or at least cajole the IRS to comment or lend a hand. But those efforts often fail, and the parties — and the judges — have to sort out the tax issues as best they can.

Believing it was bound by *Lisec*, the trial court in *Cifuentes* held that the withholding was improper and denied Costco's motion for acknowledgment of satisfaction of the judgment. Costco eventually prevailed, but not until it spent significant time and money litigating the point. The dispute started when Cifuentes reported to his supervisor that he had observed a manager hugging a female employee outside the Costco store.

Six months later, the manager reported seeing Cifuentes consuming food in the store without paying for it, and Cifuentes was fired. Cifuentes sued for wrongful termination and achieved mixed results. He lost his tort claims but prevailed on his breach of contract claim. 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.

### Dispute Number 2

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

The parties disagreed, but the dispute narrowed when Cifuentes received \$69,078 in tax refunds from the IRS and FTB. Costco again demanded that

he acknowledge satisfaction of the judgment. Cifuentes refused, claiming that he was still owed \$23,764.95, plus interest.

Costco asked the court for an acknowledgment of satisfaction of judgment. Costco even requested the court to order that Cifuentes pay Costco's \$20,060 in attorney fees. Citing cases and IRS materials, Costco argued that *Lisec* was wrongly decided and that withholding was required.

### Withholding and *Lisec*

Is an employer required to withhold payroll taxes when paying a judgment to a former employee for lost past wages (back pay) and lost future wages (front pay)? If you ask the IRS, the answer is yes. But the IRS was not involved in this case. So when Costco appealed, state court judges had to decide.

Costco argued that the payments to Cifuentes were wages on which it had to withhold. Not withholding could mean Costco would have to pay twice — paying the judgment and 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*.

However, the court of appeals said 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. Back and front pay are wages, period.

When *Lisec* came before the court in 1992, there was little guidance on the scope of "wages" as defined in the tax statutes. The plaintiffs in *Lisec* had prevailed on a wrongful termination claim, winning back and front pay.<sup>6</sup> Their former employer withheld payroll taxes, claiming that the award constituted wages.<sup>7</sup>

When the plaintiffs complained that the judgment was not satisfied, the employer moved for an acknowledgment of satisfaction of judgment. The trial court in *Lisec* denied the motion, finding that the employer could not unilaterally reduce the judgment by withholding taxes.<sup>8</sup> In affirming the decision, the court of appeals noted that the employees were not reinstated.

Without reinstatement, the court held that the award did *not* constitute remuneration for services performed. As a result, the payment did not constitute wages for purposes of withholding.

<sup>6</sup>*Id.* at 1501-1502, 1504.

<sup>7</sup>*Id.* at 1501-1502.

<sup>8</sup>*Id.* at 1503, 1507-1508.

<sup>5</sup>10 Cal. App. 4th 1500 (1992).

### Post-*Lisec* Tax Laws

In the years since *Lisec*, many employers settling employment suits have probably pushed the envelope in not withholding taxes on settlements. But most employers know they do so at their peril. The IRS is not bound by *Lisec* and often sees wages differently than do plaintiffs.

In any event, numerous federal courts since *Lisec* have considered whether back or front pay to a non-reinstated employee is subject to income and FICA taxation and withholding. The IRS view of wages is expansive, and so are the views expressed by the courts. With the exception of the Fifth Circuit,<sup>9</sup> federal appellate courts have adopted *Nierotko*'s broad interpretation of "wages" for taxation and withholding purposes.<sup>10</sup>

For example, in *Rivera v. Baker West Inc.*,<sup>11</sup> the Ninth Circuit concluded that payroll taxes had to be withheld from lost wages in a wrongful termination claim. Even though the plaintiff was no longer employed, his claim arose from the employer-employee relationship. The court said it could not exempt him from tax withholding merely because the payment was not in return for actual services performed.<sup>12</sup>

Cifuentes argued that these cases were distinguishable from his case. For one thing, they involved settlements, not judgments, he argued. However, Cifuentes could cite no case law suggesting that back or front pay should be treated differently for tax purposes because it arose from a judgment rather than a settlement. Back or front pay is still pay, and pay is subject to withholding.

### Costco's Withholding

When Costco paid the judgment, 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. If Costco did that, of course, it would risk a judicial declaration that the judgment was not satisfied.

Costco chose the latter approach, and the dispute followed a predictable path. Yet in the appellate court, it was determined that Costco had chosen

correctly. Withholding was proper, and Costco therefore had actually paid Cifuentes the full amount of his judgment.

The court even referred to comparative economics. Costco's potential exposure for failing to withhold the payroll taxes outweighed the inconvenience to Cifuentes of seeking a refund for any excess withholding.

### Wages

Beginning with *Nierotko*, federal courts have taken a consistently broad view of wages and employment for FICA taxation purposes.<sup>13</sup> By enacting FICA, Congress "intended to impose FICA taxes on a broad range of employer-furnished remuneration in order to accomplish the remedial purpose of the Social Security Act."<sup>14</sup>

Cifuentes did not demonstrate that his award of lost wages was exempt from FICA taxes or that he was entitled to reimbursement of those taxes. Indeed, the court noted that Cifuentes's own financial expert testified that his award would be subject to FICA and state disability insurance withholding. Even the trial court had found Costco's position to be compelling, despite its holding for Cifuentes. The court implied that but for *Lisec*, it would have held for Costco.

The appeals court said the law was clear, especially post-*Lisec*, that Costco was required to withhold payroll taxes from the award of lost wages. Costco complied with federal tax law and satisfied the judgment by paying Cifuentes the remaining balance. Cifuentes could fight the IRS, but he could not keep suing Costco for tax money Costco was required to remit to the IRS.

### Attorney Fees

Costco had moved for an order that it had satisfied the judgment. Costco had also requested attorney fees. But on this issue, the court of appeals held for Cifuentes.

Costco had prevailed, of course. But the appellate court thought that it could not award fees when they would have to be determined at the trial court level. Awarding fees to Costco on appeal would be giving retroactive effect to a decision, which the court declined to do.

In fact, the court noted that it was changing the law. Until now, the court found that *Lisec* was the sole California authority on point. *Lisec* legitimized Cifuentes's position in the case. *Lisec* was even binding on the trial court.

<sup>9</sup>See *Dotson v. United States*, 87 F.3d 682, 690 (5th Cir. 1996).

<sup>10</sup>*Social Security Board v. Nierotko*, 327 U.S. 358 (1946). See *Gerbec v. United States*, 164 F.3d 1015, 1026 (6th Cir. 1999). The Fourth and Eighth circuits reached the same conclusion in two other Continental settlement cases. *Hemelt v. United States*, 122 F.3d 204, 209 (4th Cir. 1997); *Mayberry v. United States* 151 F.3d 855, 860 (8th Cir. 1998).

<sup>11</sup>430 F.3d 1253, 1259 (9th Cir. 2005).

<sup>12</sup>*Id.* at 1259-1260; see *Gerbec*, 164 F.3d at 1026; reg. section 31.3121(a)-1(i).

<sup>13</sup>*Nierotko*, 327 U.S. at 365-366.

<sup>14</sup>*Associated Electric Cooperative Inc. v. United States*, 226 F.3d 1322, 1326 (Fed. Cir. 2000); *Nierotko*, 327 U.S. at 364.

Cifuentes was entitled to rely on *Lisec*. Therefore, he properly refused to acknowledge the full satisfaction of the judgment. As such, the court said this was an appropriate case to exercise discretion to give its decision limited retroactive effect.

Costco properly withheld payroll taxes when it paid Cifuentes the lost wages he was owed under the judgment. Nonetheless, the court would not award Costco with attorney fees.

### Lessons?

The vast majority of employment disputes are resolved by settlement. In some of those settlements, defendants may know they should withhold taxes. They may agree not to withhold them. Getting the case resolved may be worth the tax risk. Tax advisers rarely control those negotiations.

In some cases, the defendant does not even think about the wage issue. Putting the entire settlement amount on a Form 1099 may be a knee-jerk reaction. Some defendants will think about the tax exposure but may assume that the actual wages being paid are small.

In any event, in a case that is settling, the plaintiff and defendant are likely to consider taxes (at least fleetingly) before they sign a settlement agreement. The settlement agreement will usually say whether there are taxes being withheld. The norm in many cases will be *some* wage treatment, but much of the recovery will be reported on a Form 1099.

The settlement process may not be pretty, but it is generally possible for plaintiff and defendant to agree on an allocation and on tax reporting. This makes it all the more striking that with a judgment, all bets are off. Many a judgment is effectively compromised and “settled” even though its procedural posture makes the pending appeal more one of form than of substance.

Still, at least quasi-settlements like these are generally documented with a settlement agreement. Hopefully there is even some reference to taxes. But with a true and unadulterated judgment, the parties do not “settle.”

They are also unlikely to work out tax and withholding expectations. The possibility of misunderstanding can be palpable. When there is a conflict, having to go to court all over again to fight over withholding and a satisfaction of judgment can be doubly irksome. And that may just be one more reason to settle the case in the first place.