Insight

IN-DEPTH DISCUSSION

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California Appellate Court Holds Employer Must Withhold Taxes on Back Pay

BY WILLIAM HAYS WEISSMAN

On June 26, 2015, a California appellate court rendered a precedential opinion[1] that should hopefully put to rest the issue of whether an employer must withhold taxes on settlements or judgments made to former employees in employment-related litigation. The case, *Cifuentes v. Costco Wholesale Corporation*, is typical of many of these kinds of employment-related disputes. The plaintiff won a judgment for lost wages against his former employer, which then withheld federal and state payroll taxes from the award. The former employee claimed the judgment was not satisfied, citing to *Lisec v. United Airlines*.[2]

In *Lisec*, the court held that an employer could not unilaterally withhold taxes from a judgment because at the time of the payment, the worker was not performing any service for the employer, and thus was not seeking or receiving "wages." The court explained, "In the context of the narrow issue of withholdability, only, we determine that the economic damages award won . . . does not constitute 'wages' for 'services performed,' and therefore is not subject to withholding of state and federal income or Social Security taxes."[3]

In the more recent case at issue, the employer moved for satisfaction of the judgment. The trial court, believing itself bound by *Lisec* as authority of a higher court, denied the motion, and the employer appealed.

The appellate court began by setting forth its holding:

> In the 23 years since *Lisec*, the Internal Revenue Service (IRS) and the vast majority of federal appellate courts have broadly interpreted the applicable Internal Revenue Code (IRC) provisions as requiring an employer to withhold payroll taxes for all "wages" arising from the employer-employee relationship, even after that relationship has terminated. Persuaded by these authorities, we adopt this prevailing view and conclude [the employer] properly withheld the payroll taxes.[4]

1 *Cifuentes v. Costco Wholesale Corp.*, 2015 Cal. App. LEXIS 559 (June 26, 2015).

2 *Lisec v. United Airlines*, 10 Cal.App.4th 1500 (1992).

3 *Id.* at 1507.

4 *Cifuentes*, Slip Op. at 1-2.

The court ran through the statutory provisions of the IRC and California law requiring withholding of taxes on wages.[5] followed by a discussion of *Social Security Bd. v. Nierotko*.[6] In *Nierotko*, the U.S. Supreme Court held that back pay awarded under the National Labor Relations Act to an employee who had been wrongfully discharged was "wages" under the Social Security Act. The Court noted that the back pay constituted remuneration and also held that the remuneration was for "employment" even though the back pay related to a period during which the petitioner did not perform any service. After next discussing a 1972 Revenue Ruling that held that three weeks' pay to a discharged employee in settlement of a discrimination claim constituted wages, the California appellate court noted "[w]hen *Lisec* came before the court in 1992, there was little additional decisional guidance on the scope of "wages" as defined in the tax statutes."[7] However, "[i]n the years since *Lisec*, numerous federal courts have considered whether an award of back or front pay to a non-reinstated employee is subject to income/FICA taxation and withholding" and proceeded to discuss such case law in detail.

The plaintiff sought to frame the discussion of those authorities as involving settlements rather than judgments. The court rejected that contention, finding that the plaintiff cited no case law to support that contention, and irrespective "[i]t is well established . . . that 'whether a claim is resolved through litigation or settlement, the nature of the underlying action determines the tax consequences of the resolution of the claim.'"[8] Practical concerns that have always plagued *Lisec* as valid authority played a further role in the court's decision. One such concern is the possibility of an employer being liable for the taxes even after paying the plaintiff. Another is the lack of consistency in the application of tax law:

> [The employer] contends that if the courts do not consistently apply the definition of wages for taxation and withholding purposes, employers and employees will have a difficult time understanding when payroll taxes must be withheld from judgments and settlements. We agree. The IRS does not base its enforcement scheme on state court decisions. Consistent rulings among the state and federal courts will allow the parties in employment litigation to accurately discern whether a payment, in the form of either a settlement or judgment, constitutes wages from which withholdings must be taken or income from which withholdings are not necessary. Employers who face penalties for making the wrong decision should not have to guess as to whether withholding is required.[9]

The court's opinion in *Cifuentes* is a rare, but very welcome, state tax decision addressing employers' obligations to withhold taxes on settlements and judgments for back and front pay damages. While it will not end the disputes between plaintiffs and defendants about the amount to allocate to wages and non-wages, it will hopefully end debate about the need to withhold taxes on wages paid to former employees. And while *Cifuentes* was addressing California state taxes, its reasoning should apply to every state when addressing the obligations to withhold, report and remit taxes on wages paid in settlement of employment disputes.

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5 *Id.*, at 5-7 ["The IRC requires employers to collect income and FICA taxes by withholding them from wages paid to employees. (26 U.S.C. §§ 3102(a), 3402(a)(1); *Maxfield v. United States Postal Service* (9th Cir. 1984) 752 F.2d 433, 434). California law similarly requires employers to withhold state income and disability insurance taxes. (Unemp. Ins. Code (UIC), §§ 13020, subd. (a)(1), 986.)"]).

6 *Social Security Bd. v. Nierotko*, 327 U.S. 348 (1946).

7 *Cifuentes*, at 7.

8 *Id.* at 9 (quoting (*Tribune Pub. Co. v. United States* (9th Cir. 1988) 836 F.2d 1176, 1177; *Sager Glove Corp. v. C.I.R* (1961) 36 T.C. 1173, 1180 ["The taxability of the proceeds of a lawsuit, or of a sum received in settlement thereof, depends upon the nature of the claim and the actual basis of recovery"], *aff'd* (7th Cir. 1962) 311 F.2d 210).

9 *Id.* at 13.