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Best in Law: Tax Ruling Confirms Protocol on Job-Related Judgments

BB&K Attorney Katrina Veldkamp Writes on Newly Decided Case That Gives California Employers Clear Guidance on Taxation of Employment-Related Settlements and Judgments

By **Katrina Veldkamp**

The California Court of Appeal recently confirmed that employment-related settlements or judgments are wages from which employers must withhold payroll taxes.

In *Cifuentes v. Costco Wholesale Corp.*, Cifuentes challenged former employer Costco's withholding of payroll taxes from a wrongful termination judgment.

The court ruled in favor of Costco, holding that tax law requires employers to withhold payroll taxes or face liability to the IRS and other tax authorities.

Cifuentes was awarded more than \$300,000 in both back pay and front pay for wrongful termination. Costco withheld approximately \$116,000 in payroll taxes from the judgment, including Federal Income Contribution Act (FICA) contributions, federal and state income taxes, and state disability insurance.

Cifuentes claimed that, due to the tax withholding, Costco had failed to satisfy the judgment in full. The appellate court disagreed.

Whether or not to withhold payroll taxes from back pay and similar settlements has been a pressing issue for employers, especially in California. Until now, the only California appellate decision regarding taxation of employment settlements held that an employer is not required to withhold payroll taxes from an award of lost wages to a former employee. However, since that decision, *Lisec v. United Airlines, Inc.*, the majority of state and federal courts, including the U.S. 9th Circuit Court of Appeals, have agreed that employers should withhold taxes from such settlements.

Furthermore, the IRS has consistently affirmed its position that employment-related judgments and settlements are wages subject to payroll tax withholding. Because of the conflicting state and federal guidance, California employers

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were faced with a choice between not satisfying a judgment or potentially being liable for the taxes not withheld. The court in Cifuentes resolved this conflict by repudiating Lisec and following the majority view.

The Internal Revenue Code generally defines wages that are subject to income and FICA tax withholding as any payment for services performed by an employee for his or her employer. The Supreme Court has clarified that this definition encompasses the entire employer-employee relationship, not just the work actually done. California tax law is identical to federal law with respect to withholding from wages. As a result, back pay, front pay, and any other payment associated with the employer-employee relationship are considered wages for federal tax purposes, even if the award is not linked to actual service. Whether any such award is granted as part of a judgment, as opposed to a settlement, does not affect its tax treatment (except in the case of back pay for lost wages on account of personal physical injury or physical sickness, which is not considered wages subject to taxation).

On the other hand, damages in hiring discrimination suits that are granted to individuals who were never actually hired are not considered wages because no employment relationship ever existed.

If an employer does not withhold payroll taxes as required by law, it becomes liable for the taxes, including the employee's far greater share. In addition, an employer that does not properly withhold payroll taxes may be subject to penalties and interest for underreporting and failing to pay taxes.

Even if an employer is able to prove that an employee paid the income and/or FICA taxes, it may still be liable for applicable penalties and interest. Because of this risk of liability for improperly withheld taxes, the court in Cifuentes concluded that "Costco chose correctly" in withholding from the judgment. Costco's potential exposure for failing to withhold taxes outweighed the slight inconvenience to Cifuentes of seeking a refund for any overpaid tax.

California employers now have clear guidance regarding the taxation of employment-related settlements and judgments. To avoid the risk of potential tax exposure, employers should withhold appropriate payroll taxes on awards for lost wages. Such withholding will not prevent an employer from fully satisfying a judgment.

** This article first appeared in [The Press-Enterprise](#) on Oct. 4, 2015.
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