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## EMPLOYMENT LAW

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### Some Taxing Questions For Employment Lawyers

**T**axing questions confront lawyers for both plaintiffs and defendants at the conclusion of employment cases. Whether a case ends by settlement or verdict, tax issues can significantly lessen the amount of recovery, which makes reaching a settlement more difficult or makes a plaintiff less satisfied with a judgment.

Practitioners should ask two pertinent questions when considering the tax implications of employment cases:

1. Is the award gross income that must be included in tax liability? and

2. If it is gross income, is it also wages, which are the base for measuring Social Security, Medicare, unemployment and income-tax withholding.

This article addresses the second issue, because most practitioners know the answer to the first question: under current law the majority of awards are deemed income due to the Tax Code's broad definition of income and narrow definition of exclusions. See 26 U.S.C. Sec. 61(a)(gross income is "all income

from whatever source derived" not expressly excluded by the code); *United States v. Burke*, 504 U.S. 229, 233 (1992); but see *Abrams v. Lightolier Inc.*, 50 F.3d 1204, 1220 (3d Cir. 1995)(citing *Burke* for guidance in determining that a back pay award under New Jersey's Law Against Discrimination (LAD) represented nontaxable income).

Although the answer to the second question is less well known, provisions in both the Internal Revenue Code and the Social Security Act distinguish between income and wages. Awards in employment cases that are income may not be wages. The U.S. Supreme Court has recognized that "wages" is a narrower concept than "income." *Rowan Companies Inc. v. United States*, 452 U.S. 247, 253 (1981). For example, most practitioners treat awards for emotional harm damages as income, but not wages.

#### *Kim v. Monmouth College*

A more complicated issue is presented by back pay awards or economic damages. Should such recoveries automatically be treated as "wages" — and thus subject to withholding and payroll taxes? A recent case, *Kim v. Monmouth College*, 320 N.J. Super. 157 (Law Div. 1998), is the first decision in New Jersey to address

the wage question. In *Kim*, the court held that back pay awards, while includable in gross income, should not be characterized as "wages" that are subject to withholding.

This ruling has several implications. First, while the recovery is still gross income, if it is not wages subject to withholding, the plaintiff, rather than the employer, can calculate what taxes are owed. The plaintiff can then make appropriate deductions, such as attorneys' fees, to offset the taxes owed.

Second, and perhaps even more importantly, income that is not wages is not subject to Federal Insurance Contributions Act (FICA), Medicare and Federal Unemployment Tax Act (FUTA) taxes. FICA and Medicare taxes together are withheld at a rate of 15.3 percent.

To answer whether back pay awards are "wages," the court in *Kim* began by examining the statutory definition of "wages." It noted that the Internal Revenue Code provides that withholdings only apply to "wages," 26 U.S.C. Sec. 3402(a)(1), which are defined as "all remuneration ... for services performed by an employee for his employer." 26 U.S.C. Sec. 3401(a)(emphasis added). The code, in turn, defines "employment" as "any service, of whatever nature, performed ... by an employee for the person employing him." 26 U.S.C. Sec. 3121(b).

Definitions substantially similar to these are used in FICA, which requires that withholding be made from "wages." See 26 U.S.C. Secs. 3101, 3102, 3121(a), 3121(b). Thus, both the code and Social Security Act define wages to be for "ser-

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