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IN PRACTICE

EMPLOYMENT LAW

By DEBORAH ELLIS AND ANDREW DWYER

Some Taxing Questions For Employment Lawyers

Taxing 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-

Ellis is a partner at Newark's Dwyer & Ellis and an adjunct Professor of Law at New York University School of Law. Dwyer is a partner at firm and represented plaintiff Sang-Hoon Kim in Kim v. Monmouth College, which is discussed in this article.

vices performed." The Internal Revenue Service's own regulations make the same distinction. For example, 29 C.F.R. Sec. 31.312(a)(1)(i) specifically requires the performance of services in order for the payment to constitute wages for withholding purposes.

The *Kim* court applied the statutory definition to the facts before it. Emphasizing that Kim's award was for "the period following his termination until the time of his trial," and thus was not for "services performed," the *Kim* court concluded that the award was not wages and held that defendant Monmouth College improperly withheld income, FICA and Medicare taxes. 320 N.J. Super. at 163.

The court was correct to focus on the plain meaning of the statute. The key language under both the Internal Revenue Code and FICA is that a payment constitutes "wages" only if it is made as remuneration "for services performed."

As noted in *Kim*, the unequivocal statutory language is supported by the weight of case law. The *Kim* court distinguished the primary case relied upon by the defendant, *United States v. Burke*, for two reasons. First, *Burke* held only that a back pay award under the pre-1991 version of Title VII is not excludable from gross income. It did not even address the wage or withholding question.

Second, *Burke* was an unusual employment case, in that the female plaintiffs were awarded back pay for being paid lower salaries than male employees. Thus, the award was for services already performed for the employer, and therefore clearly under the code's definition of wages.

Other Authority

Other courts to examine the issue have also found the statutory language requiring "services performed" to be controlling. See, e.g., *Lisec v. United Airlines*, 10 Cal. App. 4th 1500 (1992). For example, in *Churchill v. Star Enterprises*, 3 F. Supp. 2d 622 (E.D.Pa. 1998), the court held that a back pay verdict under the Family Medical Leave Act was not "wages." It too found the statutory language compelling, concluding that the award was not wages because the plaintiff was not employed by the defendant for the period covered by the judgment, even though she was later reinstated.

The *Churchill* court rejected two Internal Revenue Service rulings that suggest an opposite result. The rulings held that back pay payments to former employees because of illegal discrimination constitute "wages" for withholding purposes. Rev. Rul. 72-341, 1972-2 C.B. 32, obsoleted by, Rev. Rul. 96-65, 1999-2 C.B. 6; Rev. Rul. 78-176, 1978-1 C.B. 303.

However, the court found that these rulings "expressly contradict the language of the statute" that wages are for services performed, 3 F. Supp. 2d at 624, and held that under principles of statutory interpretation revenue rulings are given less weight than the statute itself. Therefore, the court concluded that it was "bound to follow the plain language of the statute." 3 F. Supp. 2d at 624 (citing *Commissioner of Internal Revenue v. Schleier*, 515 U.S. 323, 336 n.8 (1995)).

In conjunction with reliance on the statutory definition of wages for "services performed," courts addressing the wage issue have focused on the nature of the employment relationship between plaintiff and defendant. For example, in *Newhouse v. McCormick & Co.*, 157 F.3d 582 (8th Cir. 1998), no employment relationship ever existed because plaintiff was only an applicant and never an employee.

In *Newhouse*, the plaintiff won a final judgment of front and back pay because his application was denied on the basis of age. Focusing on the definition of "wages" and "employment," the Eighth U.S. Circuit Court of Appeals held that because Newhouse had never worked for the defendant, an "employer-employee relationship" had never existed and therefore the award could not be wages.

Although the weight of authority supports the view that back pay awards are not wages, some cases reach the opposite result. For example, in *Gerbec v. United States*, 164 F.3d 1015 (6th Cir. 1999), the court analyzed whether settlement proceeds for violations of the Employment Retirement Income Security Act were subject to FICA withholding.

Reversing the district court, the Sixth Circuit held in *Gerbec* "that the phrase 'remuneration for employment' includes certain compensation in the employer-employee relationship for which no actual services were performed." 164 F.3d at 1025. In so holding, the court disregarded the statutory definition that "employment" is for "services performed." The appeals court justified its disregard by opining that the phrase "services performed" should be interpreted broadly, relying on a 1946 case, *Social Security Board v. Nierotko*, 327 U.S. 358 (1946) which made a similarly broad interpretation.

However, the *Gerbec* court's reliance on *Nierotko* was misplaced. *Nierotko* held that back pay under the National Labor Relations Act (NLRA) constituted wages for the purposes of receiving credit to the worker's Social Security account. Under the NLRA an employee is defined as "any individual whose work has ceased ... because of any unfair labor practice." *Nierotko*, 327 U.S. at 363.

Thus, although his employer attempted to terminate the relationship, Nierotko remained an "employee" under the NLRA. That fact was crucial to the analysis of "service" and the court's conclusion that "service ... performed" should encompass "the entire employer- employ-

Back pay awards and economic damages in employment cases present complicated tax issues. For instance, should these recoveries automatically be treated as 'wages' and be subject to withholding and payroll taxes?

ee relationship." 327 U.S. at 363. In contrast, under most employment laws such as Title VII or the New Jersey LAD, a terminated employee is no longer an "employee." Moreover, in *Nierotko* the employees were reinstated, so an employer-employer relationship existed when back pay was awarded.

Applying the Case Law

In applying these cases to future settlements and verdicts, certain principles emerge. First, it is important to consider whether an award is for back pay or some other type of damage, such as compensatory damages for pain and suffering or punitive damages.

For example, an award for emotional harm damages to a sexual harassment plaintiff who continued working for her employer and suffered no lost income is not "wages," even though it may be "income." When drafting settlements, it is important to specify what amounts are for what purpose to clarify what portion is for "wages."

With particular regard to economic damages, cases can be distinguished by different types of employment relationships. The easiest case is the applicant case. In those cases, where no employment relationship ever existed, it would stretch credulity to treat an award as "wages." At the other end of the spectrum is the employee who sues over a pay disparity but continues working — in other words, performing services — for the employer, such as the plaintiffs in *Burke*.

Near that end of the spectrum is the reinstated employee, as in *Nierotko*. In reinstatement cases, the award still is not for services performed, but there is at least an existing employer-employee relationship, arguably making a stronger case for treating the payments as wages.

But the most common scenario in employment litigation involves the discharged employee. For these cases, the weight of authority dictates that back pay awards are not "wages" because they are not for services performed. *Kim*, the only authority in our jurisdiction, follows this "plain language" approach to withholding. Meanwhile, *Churchill* — the Pennsylvania case — held that even payments to a reinstated employee do not constitute "wages."

If other courts likewise follow the statutory language and weight of authority, they will also conclude that back pay awards or settlements for terminated employees are not "wages." ■