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A federal district court in New Jersey has held that both back pay and front pay paid as part of a settlement award to a former employee were wages, and, thus, subject to federal employment tax withholding. The court also rejected the former employee's argument that the employer must pay the taxes by "grossing up" the settlement, because she had entered into the settlement voluntarily and was stuck with its tax consequences.

Federal District Court Rules that Back Pay and Front Pay Are Wages Subject to Employment Taxes

By William Hays Weissman

In *Josifovich v. Secure Computing Corp.*[1] a federal district court in New Jersey held that both back pay and front pay paid as part of a settlement award to a former employee were wages and thus subject to federal employment taxes. The court also rejected the former employee's argument that the employer must pay the taxes by "grossing up" the settlement, finding that because the plaintiff had entered into the settlement voluntarily, she must accept its tax consequences.

Background

Diane Josifovich filed suit against her former employer, Secure Computing Corporation, in 2007, New Jersey state court. The employer removed the case to federal court, and in 2008, Ms. Josifovich filed an amended complaint alleging, among other things, that the defendant failed to pay her earned commissions, and violated the New Jersey Conscientious Employee Protection Act (CEPA) and the New Jersey Law Against Discrimination (NJLAD). She sought various forms of relief, including: (1) back pay, (2) front pay, (3) emotional distress damages, and (4) attorneys' fees and costs.[2]

On May 29, 2009, the district court conducted a seven-hour settlement conference where the parties agreed to a settlement, which they put orally on the record with the expectation that it would be reduced to writing. No mention of withholding or taxes was made during the settlement conference. However, while attempting to put the agreement in writing, the parties could not agree on the tax consequences resulting from the settlement. Therefore, both parties asked the court to determine what portion, if any, of the settlement was subject to employment taxes.[3]

The Court's Decision

The employer argued that it was required to withhold employment taxes on any portion treated as wages, while the employee argued that she was entitled to the entire settlement on a gross basis, that any taxes were the company's obligation to pay, and if taxes were to be withheld, she should be grossed up to ensure she received the entire settlement.

The only issue facing the district court was whether any portion of the settlement proceeds were wages subject to employment taxes. The court began its analysis by explaining that "an employer has a legal duty to deduct and withhold taxes when 'making [the] payment of wages,' and the failure to do so may subject the employer to liability."[4] The court then looked at the Internal Revenue Code, which defines the term "wages" as "all remuneration ... for services performed by an employee for his [or her] employer."[5]

The court then relied on the U.S. Supreme Court's decision in *Social Security Board v. Nierotko*,[6] which held that a back pay award should be treated as wages. Citing numerous other cases, the court found that "[o]ther courts have applied *Nierotko* where an employer seeks to withhold taxes from settlement proceeds allocated to back and front pay."[7] Thus, it had no problem concluding "that back pay, paid as compensation for a period in which the former employee actually rendered services, must be the subject of withholding. Accordingly, this Court finds that Defendant must withhold taxes from any amount of the settlement proceeds allocated to Plaintiff's back pay claims."[8]

With respect to front pay, however, the district court found that the issue was less clear. Ms. Josifovich argued that she did not perform services during the front pay time period, and thus no deduction could be made for taxes, citing to *Carr v. Fresenius Med. Care*,[9] *Churchill v. Star Enterprises*,[10] *Kelly v. Hunton & Williams*,[11] *Kim v. Monmouth College*,[12] and *Lisec v. United Airlines*.[13] However, the court found all of those cases distinguishable.

For example, the court found that *Carr and Churchill* were distinguishable because those cases arose under the Family Medical Leave Act (FMLA), which contains "unique language creating a remedy of 'damages ... *equal to the amount of wages*,' [that] played a significant role in the outcome."[14] Because neither the CEPA nor NJLAD contained similar unique language to the FMLA, *Carr and Churchill* were inapposite. Further, the court found that "neither *Kim* nor *Kelly* even cites to *Nierotko*. [Citation omitted.] To the extent that Kim and Kelly are inconsistent with Nierotko, this Court declines to follow them."[15] While acknowledging that *Lisec* cites to *Nierotko*, the court similarly found that its analysis conflicted with the Supreme Court's decision, and thus declined to follow it.

Therefore, the court stated that "because the Supreme Court in *Niertotko* held that services performed -- a component of the definition of wages, which are subject to withholding -- encompasses the entire employee-employer relationship and not merely the work actually performed, this Court concludes that front pay, like back pay, is subject to withholding taxes."[16]

The court also addressed Ms. Josifovich's assertion that, to the extent that any portion of her settlement proceeds is subject to withholding, she is entitled to have that amount grossed up. She cited to *Eshelman v. Agere System Inc.*,[17] which held that courts had equitable power under the state laws at issue to increase a jury award to make a prevailing employee whole for the tax withheld on the back pay awarded to her.

The court rejected this argument, noting that Ms. Josifovich entered into a settlement agreement voluntarily, and thus, "as opposed to the recipient of a jury award, possessed control in arriving at the terms of the settlement and the amount of the payment."[18] The court added that it would:

> not alter the terms of that voluntary settlement agreement and require Defendant to pay more simply because Plaintiff now, after the close of negotiations, is dissatisfied with the anticipated tax consequences of her agreement. A settlement agreement is a contract and, consequently, a court will not rewrite that contract simply to provide one party with a better bargain than the one she negotiated.[19]

What Employers Need to Know

Many employers engaged in settlement discussions with former employees routinely hear the same argument that Ms. Josifovich advanced, such as claims that neither back pay nor front pay are subject to employment taxes or withholding of any kind, or that any settlement reached must be for the gross amount rather than net of taxes. The opinion fails to point out that taxes that are withheld by an employer from the employee's wages are deemed to have been paid to the employee and are thus part of the employee's income

for tax purposes.[20] Put differently, if the employer pays an employee $1,000 and withholds $326.50 for FICA and federal income taxes, so that the employee's check is only $673.50, the employee is still treated as if he received $1,000.

Nonetheless, this decision is an excellent one for employers involved in settlement negotiations with former employees. It reminds employers of the importance of addressing tax issues during settlement, not merely afterwards, and also provides good legal analysis for plaintiffs and their counsel who balk at suggestions that taxes must be paid for any amounts allocated to either back pay or front pay.

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[1] *Josifovich v. Secure Computing Corp*., 2009 U.S. Dist. LEXIS 67092 (D.N.J. July 31, 2009).

[2] Slip Op., at 3-4.

[3] *Id*., at 4-5.

[4] *Id*., at 6 (citing IRC §§ 3402(a)(1); 3403; 3509).

[5] *Id*. (quoting IRC §§ 3401(a)).

[6] 327 U.S. 358, 365-66 (1946).

[7] Slip Op., at 7.

[8] *Id*., at 9.

[9] *Carr v. Fresenius Med. Care*, 2006 U.S. Dist. LEXIS 29627 (E.D. Pa. 2006).

[10] *Churchill v. Star Enters*., 3 F. Supp. 2d 622 (E.D. Pa. 1998).

[11] *Hunton & Williams*, 1999 U.S. Dist. LEXIS 14605 (E.D.N.Y. 1999).

[12] *Kim v. Monmouth College*, 320 N.J. Super. 157 (1998).

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

[14] *Josifovich*, 2009 U.S. Dist. LEXIS 67092 , slip Op., at 10.

[15] *Id*., at 11.

[16] *Id*., at 12-13.

[17] *Eshelman v. Agere Sys. Inc*., 554 F.3d 426 (3d Cir. 2009).

[18] *Josifovich*, 2009 U.S. Dist. LEXIS 67092 at 18.

[19] *Id*., at 17-18.

[20] IRC § 3123.