The IRS Concludes that a "Penalty" is a "Penalty" (Except When it Isn't)

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If you have ever paid a current or ex-employee in a settlement or after a trial or arbitration (and what employer has not?), then you know the importance of properly characterizing the payment for tax purposes. For example, if the amounts are wages, then the employer must issue a Form W-2; pay the employer's one-half share of Social Security and Medicare taxes; and withhold income taxes and the employee's one-half share of Social Security and Medicare. If the amounts are for emotional distress, then the employer must issue a Form 1099-MISC but need not withhold or pay any tax; instead, the employee is responsible for properly reporting the payment and paying any income tax and self-employment tax (the equivalent of Social Security and Medicare). Amounts may also be attributable to pre- or post-judgment interest, or penalties under federal or state law, in which case different rules apply.

One such penalty (**waiting time penalties** or **WTPs**) applies under California Labor Code section 203 to an employer that willfully fails to timely pay final earned wages to a terminated employee. The employer will owe an amount (expressly designated by section 203 as a penalty) equal to the employee's daily wages from the due date until the date of payment, up to a maximum of 30 days. The IRS recently released an internal memorandum from its in-house legal department, Chief Counsel Advice 201522004 (**CCA 201522004**) concluding that WTPs are *not* wages for federal tax purposes (and, therefore, there is no payroll tax payments or withholding on WTPs). CCA 201522004 analyzes 70 years' worth of court precedent and IRS guidance as to what constitutes wages and concludes that WTPs are not so described because the employer's obligation to pay them does not arise from the employee's performance of his or her services; rather, they arise from the employer's failure to pay wages on time. Though internal memoranda like CCA 201522004 are not binding precedent, they are useful for gauging the IRS's position on similar facts and in any case the conclusion in CCA 201522004 is sound; reflects the California Department of Industrial Relations' view that WTPs are not wages; and corresponds to the 2010 decision by the California Supreme Court in *Pineda v. Bank of America, N.A.* (in a different context) that WTPs are not wages.

Although CCA 201522004 addressed WTPs, the IRS legal office went on to address meal and rest payments under California Labor Code section 226.7. Section 226.7 – unlike section 203 – does not refer to those payments as penalties and California law sometimes refers to these payments as penalties and sometimes as wages. CCA 201522004 suggests that these payments are 'wages because the meal and rest period payments are essentially additional compensation for the employee performing additional service during the period when the meal and rest periods should have been provided.

So what are the take-aways from all this?

- ***Labels don't mean much***. The IRS will not be bound by labels (for example, penalties versus wages versus something else) in determining the correct tax treatment. Instead, the IRS applies what tax advisors call the origin of the claim test – that is, what are the underlying events and conduct under the facts and circumstances that give rise to the payment? If the conduct is the employee's performance of services, then the payment is likely wages even if a state statute uses a different term. If the conduct is the employer's failure to follow the law, then the payment more likely constitutes a penalty.
- ***Penalties can be bad***. If a payment is a penalty, that characterization can be disadvantageous for the employer. The reason is that, whereas an employer generally can deduct back wages or other damages as an ordinary and necessary business expense under Internal Revenue Code section 162 (even if the employer was in the wrong), a taxpayer generally *cannot* deduct fines or penalties paid to the government. Though WTPs are paid to the terminated employee, other penalties under the Labor Code are paid to the government (and in any event there is precedent to the effect that restitution or similar payments to a private party under government compulsion may constitute a non-deductible fine or penalty). CCA 201522004 addressed only whether WTPs are wages for payroll tax and withholding purposes, and not whether the employer could deduct them. The employer's best course of action is to avoid the question by paying final wages on time.
- ***Get it in writing and don't bend over backward***. CCA 201522004 is another example of how both sides in employment litigation need to agree on a consistent tax treatment of the payments so that each side understands its payment, reporting and withholding obligations. The IRS generally (but not always) will follow the treatment agreed to by the two sides considering that the two sides have competing economic, tax and other interests, so long as the agreed treatment is consistent with the underlying facts (remember the origin of the claim test). For example, whereas the employee may want to have the payments treated as tax-free damages for personal injury, that treatment is rarely justified by the facts of a typical employment dispute outside of a workplace accident. As another example, it is usually not advisable to accommodate an employee's request to treat meal and rest payments (wages as suggested by CCA 201522004 and therefore reported on Form W-2 subject to payroll taxes and withholding) as emotional distress damages (not wages and reported on Form 1099) because, really, how many employees suffer emotional distress upon learning that they were not paid for meal and rest periods?