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Dear _____ :

This is in response to your letter of October 31, 2005 concerning the employment tax treatment of court-awarded back pay. Although we cannot answer your specific questions, we can provide a general discussion of the employment tax obligations the Internal Revenue Code imposes on an employer that makes a payment of back pay. As discussed below, back pay is generally treated as wages subject to the withholding and payment of income tax, Federal Insurance Contributions Act (FICA), and Federal Unemployment Tax Act (FUTA) taxes when paid. We have assumed for purposes of this response that there is no dispute as to whether the payment is back pay.

Income Tax Withholding

Income tax withholding is imposed under § 3402(a), which requires every employer making payment of wages to deduct and withhold income tax on those wages. The amount deducted and withheld is determined in accordance with tables or computational procedures prescribed by the Secretary of the Treasury.

Section 31.3401(a)-1(a)(5) of the Employment Tax Regulations provides that remuneration for services, unless such remuneration is specifically excepted, constitutes wages even though at the time paid the relationship of employer and employee no longer exists between the person in whose employ the services were performed and the individual who performed them.

FICA and FUTA

FICA tax generally is imposed on each employer and employee. Under I.R.C. § 3111, FICA tax is imposed on the employer in an amount equal to a percentage of the wages that the employer paid with respect to employment. Under I.R.C. § 3101, FICA tax is also imposed on the employee in an amount equal to a percentage of the wages received by the employee with respect to employment.

FICA tax is composed of a tax for Old Age, Survivors, and Disability Insurance (OASDI) and a tax for hospital Insurance (HI). The OASDI portion of the FICA tax is imposed separately on the employer and the employee in an amount equal to 6.2 percent of wages. Under section 3121(a) the wages subject to the OASDI portion of the FICA tax are limited to the applicable wages base for OASDI for that year (\$90,000 for the calendar year 2005). The HI portion of the FICA tax is imposed separately on the employer and the employee in an amount equal to 1.45 percent of wages. There is no dollar limit on the amount of wages subject to the HI portion of the FICA tax.

Under section 3102 the employer is required to collect the employee portion of the FICA by deducting the amount of the tax from the wages, as and when paid, and is liable for payment of the tax required to be collected. Sections 3101(a) and (b) provide that the rate of tax depends on the calendar year in which the wages are received by the employee. Treas. Reg. § 31.3101-2(c) provides that the employee tax is computed by applying to the wages received by the employee the rate in effect at the time such wages are received. See the example set forth therein. Treas. Reg. § 31.3101-3 provides that "The employee tax attaches at the time that the wages are received by the employee." The regulations further state that "In general, wages are received by an employee at the time that they are paid by the employer to the employee." Treas. Reg. § 31.3121(a)-2.

I.R.C. § 3301, relating to the FUTA, imposes on every employer a tax equal to 6.2 percent of the total wages (as defined in § 3306(b)) paid by the employer during the calendar year with respect to employment (as defined in § 3306(c)). Under § 3306(b), wages of an employee subject to the FUTA tax are limited to wages of \$7,000 per year. Under § 31.3301-4 of the regulations, wages are considered paid when actually or constructively paid.

For purposes of FICA, FUTA and income tax withholding wages are defined similarly as all remuneration for employment, unless specifically excluded. I.R.C. §§ 3121(a), 3306(b) and 3401(a). "Employment" as used in this definition means "any service of whatever nature performed by an employee for the person employing him." I.R.C. § 3121(b). Section 31.3121(a)-1(i) of the regulations, pertaining to FICA, provides that remuneration for employment, unless specifically excepted, constitutes "wages" even though at the time paid the relationship of employer and employee no longer exists between the person in whose employ the services were performed and the individual who performed them. See also § 31.3306(b)-1(i) relating to the FUTA.

Neither the statute nor the regulations except back pay from the definition of wages. In United States v. Cleveland Indians Baseball Company, 532 U.S. 200 (2001), the Supreme Court held that back wages are subject to taxes under FICA and FUTA according to the year in which the wages are in fact paid, rather than in the year or years in which they should have been paid.

Back Pay

In determining the tax treatment of damages received from a lawsuit or in settlement of a lawsuit, one looks to the nature of the item for which the damages are a substitute. Hort v. Commissioner, 313 U.S. 28 (1941). In Social Security Board v. Nierotko, 327 U.S. 358, 365-66 (1946), the Supreme Court held that back pay awarded under the National Labor Relations Act to an employee who had been wrongfully discharged constituted "wages" under the Social Security Act. The Court noted that the back pay constituted remuneration and also held that the remuneration was for "employment" even though the back pay related to a period during which the petitioner did not perform any service. The Court emphasized the breadth of the definition of "employment":

The very words "any service ... performed ... for his employer," with the purpose of the Social Security Act in mind, import breadth of coverage. They admonish us against holding that "service" can be only productive activity. We think "service" as used by Congress in this definitive phrase means not only work actually done but the entire employer-employee relationship for which compensation is paid to the employee by the employer.

Nierotko has been cited in several recent cases dealing with the question of whether payments upon termination of employment or upon settlement of lawsuits for various employee rights are wages for federal employment tax purposes. Courts of Appeals have held that the definition of wages should be construed very broadly, and that back and front pay awards come within the broad definition of wages for federal employment tax purposes. Mayberry v. United States, 151 F.3d 855 (8th Cir. 1998); Hemelt v. United States, 122 F.3d 204 (4th Cir. 1997).

We hope you find the forgoing discussion helpful. This letter has called your attention to certain general principles of the law. It is intended for informational purposes only and does not constitute a ruling. See Rev. Proc. 2005-1, §2.04, 2005-1 IRB 7 (Jan. 3, 2005). If you have any additional questions, please contact _____ of our office at _____.

Sincerely,

Marie Cashman
Special Counsel, (Exempt
Organizations/Employment Tax/Government
Entities)
(Tax Exempt & Government Entities)