Employment Law

Court Says No To Withholding Taxes on FMLA Settlement

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Congratulations! You have somehow managed to convince a very reticent employer and their all-powerful counsel to finally settle that difficult Family and Medical Leave Act (FMLA) case with you. The only thing left to do is to get paid, right? Guess again. Until the parties can agree on how the settlement payment should be reported to the IRS, the settlement will remain in payment purgatory. There can be a "sticking point" in these situations if a plaintiff is paid by W-2, because the defendant is obligated to deduct applicable taxes, withholdings for Social Security and Medicare and its employer tax, whereas a plaintiff paid by Form 1099-MISC is responsible for all of these taxes.

A recent case from the U.S. District Court for the Eastern District of Pennsylvania tackled this very issue. In *Gunter v. Cambridge-Lee Industries*, No. 14-2925 (E.D. Pa. July 14, 2016), Vincent Gunter filed an action alleging a violation under the FMLA. The parties reached terms of settlement as to a monetary amount but could not agree on how the proceeds should be reported to the IRS. The plaintiff argued the settlement proceeds were not wages and therefore not subject to withholding or reporting to the IRS with a Form W-2, but should be reported to the IRS on Form 1099 without withholding. The employer asserted that the settlement proceeds constituted wages to the plaintiff that must be reported to the IRS on Form W-2 subject to withholding of taxes and other payroll charges.

For almost two decades, the prevailing case in the Eastern District relating to tax treatment of FMLA awards was the case of *Churchill v. Star Enterprises*, 3 F. Supp.2d 622 (E.D. Pa. 1998), decided by District Judge Harvey Bartle III. The *Churchill* decision, while not without its detractors, seemed to be the foremost authority on the issue. In fact, *Churchill* also spawned progeny such as *Carr v. Fresenius Medical Care*, No. 05-2228, 2006 U.S. Dist LEXIS 29627, (E.D. Pa. 2006), which similarly concluded that no portion of the settlement proceeds in an FMLA case was subject to withholding and that the withholding provisions of both federal and state statutes applied only to wages or remuneration for services actually performed.

The *Churchill* and *Carr* decisions were premised on the specific statutory language of the FMLA

which provides that employers who violate the FMLA are not, in fact, liable for lost wages or "back pay" but are liable for damages "equal to the amount of ... any wages, salary, employment benefits, or other compensation denied or lost to such employee by reason of the violation." This distinction is what makes the FMLA different from other employment statutes wherein the remedy is specifically couched in terms of "back pay."

As mentioned, the *Churchill* decision is not without its fair share of criticism. The criticism stems from the IRS's interpretation, through ruling and regulations, that awards for employment discrimination claims shall be considered 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." As noted in the *Gunter* case, the *Churchill* decision has become the minority view as there is no uniform consensus on the proper payment of such settlement funds in courts throughout the country. Moreover, the IRS continues to view such settlement payments as wages paid by an employer to an employee that must be paid in the form of a W-2, as in *Natale v. East Coast Salon Services, Inc.,* No. 13-1254, (D.N.J. Feb. 18, 2016).

Even with *Churchill* as the prevailing authority in the Eastern District since 1998, many employers simply would not risk being at odds with the IRS. Thus, employers have expressed strong resistance to paying an FMLA settlement with a Form 1099-MISC for fear they could be civilly and criminally liable for failing to withhold the applicable taxes. In situations where employers begrudgingly agree to utilize a Form 1099, they will typically insist on indemnification language which holds the employer harmless from all tax payments, liabilities, penalties or interest in connection with the settlement payment.

Turning back to *Gunter* for the moment, the court compared and contrasted all of the relevant holdings relating to the tax ramifications of discrimination settlements. The court took specific note of the *Churchill* and *Carr* decisions because of the way those decisions analyzed the IRS revenue rulings. Due to the fact that the IRS rulings were contrary to the plain language of the FMLA statute, the court found the *Churchill* line of cases to be more persuasive. Consequently, the court held that no withholding was required for the proceeds of the settlement in the case payable to the plaintiff.

It is reasonable to now suggest, in light of the *Gunter* decision and its reliance on the *Churchill* rationale, that future FMLA settlements in this jurisdiction should be handled in a manner where no withholding occurs, even if the settlement or award was premised on some quantification of lost wages or back pay. The rationale being that an FMLA award, unlike other discrimination statutes, provides for damages "equal to the amount of ... any wages, salary, employment benefits, or other compensation denied or lost to such employee by reason of the violation."

Taking this one step further, employee rights attorneys may also point to the *Gunter* decision as highly persuasive authority (though, not precedential) to resist indemnification language in settlement agreements. Naturally, employers will continue to insist that the *Churchill/Carr/Gunter* cases are not binding and constitute merely one interpretation of IRS rules and regulations. However, until there is some contrary authority within the U.S. Court of Appeals for the Third Circuit, which there currently is not, withholding taxes from an FMLA settlement runs counter to the opinion of at least three judges in the Eastern District of Pennsylvania. •

Jeffrey Campolongo is the founder of the Law Office of Jeffrey Campolongo, which, for over a decade, has been devoted to counseling employees, working professionals and small businesses in employment discrimination and human resource matters. The law office also counsels aspiring and established artists and entertainers regarding various legal issues arising in the entertainment and media industries.