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subject:

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LEGEND

Corporation X

ISSUES

Whether payments ("late payment penalties") that an employer (Corporation X) is required to make under California (State) law to a terminated or quitting employee if the employer fails to pay the employee's final wages within the required time period provided by State law, are wages for purposes of the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and federal income tax withholding.

CONCLUSIONS

The payment of the late payment penalties is not wages for FICA, FUTA, and federal income tax withholding purposes.

FACTS

Corporation X was required to pay the late payment penalties when it failed to pay final paychecks by the due date provided under State law.

Section 203 of the California State Labor Code provides for the late payment penalty (also referred to as the waiting time penalty) if an employer willfully fails to pay, without abatement or reduction, in accordance with the due dates imposed by the State Labor Code governing the payment of wages, any wages of an employee who is discharged or who quits. Under section 203, if the late payment penalty applies, "the wages of the employee shall continue as a penalty from the due date … [of the final paycheck] at the same rate until paid or until an action therefor is commenced; but the wages shall not continue for more than 30 days." An employee who secretes or absents himself or herself to avoid payment to him or her, or who refuses to receive the payment when fully tendered to him or her, including any penalty then accrued under this section, is not entitled to any late payment penalty for the time during which he or she so avoids payment.

The State Labor Office (California Department of Industrial Relations) website provides that the late payment penalty under section 203 of the State Labor Code "does not require that the employer intended the action or anything blameworthy, but rather that the employer knows what he is doing, that the action occurred and is within the employer's control, and that the employer fails to perform a required act." The website also provides that the penalty does not apply if there is a "good faith dispute" whether the wages are due. The website provides that in order for the penalty to apply, there must be a true employer-employee relationship and a quit or a discharge, which includes a layoff. The penalty applies to the willful failure to pay "any wages," which references the definition of "wages" in the State Labor Code. The website provides that "all compensation must be considered in determining if all wages due were paid as prescribed by law."

The penalty under section 203 of the State Labor Code is based on the employee's daily rate of pay and is calculated by multiplying the daily wage (average wage on working days) by the number of days that the employee was not paid, up to a maximum of 30 days. Overtime wages are included in calculating the penalty only if overtime is regularly scheduled each week. Thus, occasional or infrequent overtime is not included in the calculation of the daily rate of pay for purposes of computing the penalty. The 30-day period is calendar days, and includes weekends and holidays and any other days that the employee would not normally work. Payment of the wages or the commencement of an "action" stops the penalty from accruing. Filing a complaint in court commences an action. An employee's filing a claim with the State Labor Office is not considered the commencement of an action, and does not stop the penalty from accruing. The State Labor Office website states that payment of the late payment penalty is not wages and that no deductions are taken from the penalty payment.

The Supreme Court of California has held that the late payment penalty under section 203 of the State Labor Code may not be recovered as restitution under the State Unfair Competition Law (UCL), in contrast to unpaid wages that give rise to the penalty. Pineda v. Bank of America, 241 P.3d 870 (2010). The court noted that once earned, unpaid wages become property to which the employee is entitled and thus can recover as restitution. The court stated that "by contrast, permitting recovery of section 203 penalties would not restore the status quo by returning to the plaintiff funds in which he or she has an ownership interest." The court further stated, at 241 P.3d 878-879, as follows with respect to the late payment penalty:

> Section 203 is not designed to compensate employees for work performed. Instead, it is intended to encourage employers to pay final wages on time, and to punish employers who fail to do so. In other words, it is the employers' action (or inaction) that gives rise to section 203 penalties. The vested interest in unpaid wages, on the other hand, arises out of the employees' action, i.e., their labor. Until awarded by a relevant body, employees have no comparable vested interest in section 203 penalties. We thus hold section 203 penalties cannot be recovered as restitution under the UCL.

LAW AND ANALYSIS

Section 3101 and 3111 of the Internal Revenue Code (Code) impose FICA taxes on "wages." The term "wages" is defined in section 3121(a) for FICA purposes as all remuneration for employment, with certain specific exceptions. Section 3121(b) defines "employment" as any service, of whatever nature, performed by an employee for the person employing him, with certain specific exceptions.

FUTA tax is imposed on employers by section 3301. Although there are differences in the statutory exceptions concerning what constitutes wages and employment, the general definitions of the terms "wages" and "employment" for FUTA purposes are similar to the definitions for FICA purposes.

Section 3402(a), relating to income tax withholding, generally requires every employer making a payment of wages to deduct and withhold upon those wages a tax determined in accordance with prescribed tables or computational procedures. The term "wages" is defined in section 3401(a) for Federal income tax withholding purposes as all remuneration for services performed by an employee for his employer, with certain specific exceptions.

Sections 31.3121(a)-1(c), 31.3306(b)-1(c), and 31.3401(a)-1(a)(2) of the Employment Tax Regulations provide that the name by which remuneration for employment is designated is immaterial. Thus, salaries, fees, bonuses, and commissions on sales or on insurance premiums, are wages if paid as compensation for employment.

Sections 31.3121(a)-1(d), 31.3306(b)-1(d), and 31.3401(a)-1(a)(3) of the regulations provide that generally the basis upon which the remuneration is paid is immaterial in

determining whether the remuneration is wages. Thus, it may be paid on the basis of piecework, or a percentage of profits; and it may be paid hourly, daily, weekly, monthly, or annually.

Section 31.3121(b)-3(b) defines employment for FICA purposes as including services performed by an employee for an employer, unless specifically excepted under section 3121(b). With respect to the FUTA, section 31.3306(c)-2(b) provides that services performed within the United States by an employee for the person employing him, unless specifically excepted under section 3306(c), constitute employment for FUTA purposes.

Sections 31.3121(a)-1(i), 31.3306(b)-1(i), and 31.3401(a)-1(a)(5) of the regulations provide that remuneration for services, unless such remuneration is specifically excepted by the statute, 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.

Section 31.3401(a)-1(a)(4) provides that any payments made by an employer to an employee on account of dismissal, that is, involuntary separation from the service of the employer, constitute wages regardless of whether the employer is legally bound by contract, statute, or otherwise to make such payments.

In United States v. Quality Stores, Inc., 572 U.S. ___(2014), the United States Supreme Court held that severance payments made to employees who were involuntarily terminated are wages for purposes of the FICA. The Court noted the broad definition of wages in the FICA in section 3121(a) as "all remuneration for employment," and the broad interpretation that the Supreme Court has given "wages" in Social Security Bd. v. Nierotko, 327 U.S. 358 (1946), and Mayo Foundation for Medical Ed. and Research v. United States, 562 U.S. ___ (2011). The Court also noted that "employment is defined in section 3121(b) as 'any service, of whatever nature, performed … by an employee for the person employing him.'" The Court cited Nierotko to the effect that the term "service" in the definition of "employment" means "not only work actually done but the entire employer-employee relationship for which compensation is paid to the employee by the employer."

Rev. Rul. 2004-110, 2004-50 I.R.B. 960, holds that an amount paid to an employee as consideration for cancellation of an employment contract and relinquishment of contract rights is ordinary income and wages for purposes of the FICA, the FUTA, and federal income tax withholding. Rev. Rul. 2004-110 holds that employment for purposes of FICA, FUTA, and federal income tax withholding encompasses the establishment, maintenance, furtherance, alteration, or cancellation of the employer-employee relationship or any of the terms and conditions thereof.

Rev. Rul. 72-268, 1972-1 C.B. 313, concerns the employment tax status of payments for previously unpaid minimum wages, unpaid overtime compensation, and liquidated

damages under the Fair Labor Standards Act of 1938 (FLSA) and the Walsh-Healy Government Contracts Act. Liquidated damages equal to the amount of the unpaid minimum wages or unpaid overtime compensation recovered are payable under the FLSA unless the employer shows to the satisfaction of the court that the act or omission giving rise to the unpaid minimum wages or unpaid overtime compensation was in good faith and that the employer had reasonable grounds for believing that its act or omission was not a violation of the FLSA. 29 U.S.C. 260. Generally, the liquidated damages are paid directly to the affected employees pursuant to the order of the Secretary of Labor. Rev. Rul. 72-268 holds that since the payments of unpaid minimum wages and unpaid overtime compensation are remuneration for employment, the payments are wages for federal employment tax purposes (FICA, FUTA and federal income tax withholding), whether the amounts are paid as a result of a judgment of a court or in accordance with a stipulation or settlement reached by the parties involved. The ruling further holds that since payments representing liquidated damages made by an employer to its employees pursuant to 29 U.S.C. 216(b) of the FLSA are not remuneration for employment, they are not wages for federal employment tax purposes. The ruling notes that such liquidated damages payments are includible in the gross income of the employee.

The late payment penalty in this case is different from severance pay because it is based on the employer's failure to pay final wages on a timely basis. It is imposed by state law because of the employer's action or inaction with respect to the final paycheck. The employee has no right to payment of the late payment penalty based on the service of the employee; it only applies if the employer fails to pay wages on a timely basis. The payment of the late payment penalty also does not satisfy the definition of wages in Rev. Rul. 2004-110 because the penalty is not part of the terms and conditions of employment, but a separate statutorily imposed penalty.[1]

The late payment penalty is similar to the liquidated damages in Rev. Rul. 72-268 that were held not to be wages for employment tax purposes. The late payment penalty is a statutorily-imposed penalty for employer misconduct that is additional to the employee's wages. The penalty varies in amount based on the extent of the employer's misconduct (i.e., the number of days that the employer fails to pay the wages after the due date) rather than the level of services performed by the employee, and is not a substitute for the employer's liability for the payment of wages.[2] Based on Rev. Rul. 72-268, we conclude that the payment of the late payment penalty is not wages for federal employment tax purposes.

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[1] The state law requirement for the payment, by itself, does not take the payment out of the definition of wages. Many legally mandated benefits are wages for employment tax purposes. The distinguishing factor here is that the late payment penalty is a state-imposed penalty on the employer for its action.

[2] In fact, because the penalty is based on calendar days rather than work days, the penalty amount is not the same as the amount of wages the employee would have received if still working during the period the penalty is imposed.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Our conclusion about the California late payment penalty under section 203 of the California Labor Code only applies to that penalty. Specifically, it does not apply to the meal and rest period payments made under California Labor Code Section 226.7. Under that provision, if an employer fails to provide an employee a meal period or rest period in accordance with State requirements, the employer must pay the employee one additional hour of pay at the employee's regular rate of compensation for each day that the meal or rest period is not provided. Because the meal and rest period payments are essentially additional compensation for the employee performing additional services during the period when the meal and rest periods should have been provided, it appears those payments would be wages for federal employment tax purposes.

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Please call (202) 317-4774 if you have any further questions.