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IRS Chief Counsel: CA Waiting Time Penalties Are Not Wages

For years now, Section 203 of the California Labor Code has required employers to pay a penalty for willful failure to provide a departing employee with their final wages on their last day of employment (or within 72 hours for employee who suddenly quit). The amount of this penalty, often referred to as “waiting time penalty,” equals one day of pay for each day the employee is made to wait for the final paycheck, up to a limit of 30 days.

There was some ambiguity and disagreement over the years regarding whether these waiting time penalties should be considered wages and subject to applicable tax withholdings. However, on May 29, 2015, the IRS Chief Counsel’s Office issued interpretative guidance (CCA 201522004) to clarify the tax treatment of such late payment penalties, concluding that they are not wages for the purposes of FICA, FUTA, or federal income tax withholding.

The IRS guidance compares the late payment penalties under Section 203 to liquidated damage payments, which are awarded when an employer fails to pay its employees minimum wage or overtime compensation. These two payments are similar on two significant grounds: (1) both serve to punish the employer and (2) both are imposed by statute, instead of by the terms and conditions of the employment relationship.

Unlike wages, which are awarded for the past or present services of the employee, late penalty and liquidated damage payments are not dependent on any action by the employee. Even though the late payment penalty amount is calculated based on the employee’s average daily wages, whether the penalty is owed is entirely dependent on the employer’s failure to pay the employee’s final wages.

Because the late payment penalties under Section 203 have this unique purpose and are not related to the employee’s services, they do not fit within the broad definition of wages under FICA, FUTA, or the Treasury Regulations relating to federal income tax withholding. Hence, the IRS Chief Counsel concludes that employers

are not required to pay federal payroll taxes for such penalties. However, employers are still required to issue 1099 forms to reflect these penalty amounts, and employees must report the amount of these penalties on their federal income tax returns.

Given the IRS Chief Counsel's ruling on this issue, it is likely that the California taxing authorities will follow suit. Indeed, the California Department of Industrial Relations has long adopted the same view as the IRS on this issue [https://www.dir.ca.gov/dlse/FAQ_WaitingTimePenalty.html].

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