The Taxation of Back Wages According to the Year the Wages Are Actually Paid

The U.S. Supreme Court has ruled that awards of back wages to employees are subject to federal taxation according to the year in which the wages are actually paid, not the year in which the wages should have been paid or were actually earned. This holding appears to reconcile what had previously been an area of unsettled controversy between taxpayers and the Internal Revenue Service (IRS); i.e., the issue of when and how to tax back wages.

The Exclusion of Personal Injury Awards From Federal Taxation
The amount of gross income earned by an individual in the tax year is subject to federal taxation. However, Internal Revenue Code Section 104(a)(2) excludes from gross income amounts received from personal injury awards. Specifically, the provision provides that "gross income does not include...the amount of damages received on account of personal physical injuries or sickness." This means that the government may not require the recipients of personal injury awards to pay taxes on their awards. The policy rationale behind not taxing personal injury awards is basically humanitarian – we do not want to add insult to injury by forcing injured individuals to pay taxes on the compensation they have received for their injuries.

As awards for back wages are often connected with a personal injury that interfered with the employee taxpayer's earning capacity, understanding the distinction between awards for back wages and their personal injury award counterparts is crucial. The key difference between awards for back wages and personal injury awards is that awards for back wages are subject to federal taxation, while personal injury awards are excluded from federal taxation.

The Rationale Behind the Taxation of Back Wages
Unlike a personal injury award, an award for back wages is subject to federal taxation. In other words, an employee who sues and is successful on a claim against his employer for back wages will ultimately face tax liability for the award of back wages. This is true regardless of whether or not the loss of earning capacity is directly related to a personal injury suffered by the employee. Allowing for the taxation of the back wages element of personal injury awards is consistent with the general practice of taxing gross income: people who earn a profit and have an income are subject to taxes.

Abandoning the "Relation-Back" Rule
Although the taxation of back wages is well-settled law as a matter of principle, the issue of how to tax back wages has stirred more controversy. The U.S. Supreme Court recently considered the question of whether back wages should be taxed in the year of the award or in the year when the regular wages were not paid.

The aforementioned case concerned federal employment taxes owed on back wages paid under the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA). In that case, several baseball players received back pay awards in 1994 for 1986 and 1987 salary damages, and the IRS taxed the awards according to 1994 tax rates. On the issue of whether to apply 1986/1987 tax rates or 1994 tax rates to the award for back wages, the U.S. Court of Appeals applied the "relation-back" rule, holding that back pay wages are deemed paid in the periods when regular wages were not paid for purposes of federal taxation. This meant that the baseball players' back pay awards should have been taxed according to the 1986 and 1987 tax rates, the years for which the players did not receive the additional salary to which they were entitled. However, the U.S. Supreme Court reversed, and effectively abandoned the relation-back rule. Instead, the Court held that the back wages paid by league owners to the baseball players were subject to federal taxation according to the year in which the wages were actually paid (1994 tax rates).

Ultimately, the Court's holding may have a significant impact on the taxation of lump-sum awards for back wages in labor cases. Specifically, taxing back wages in the year of the award could either unfairly increase the amount of taxes owed, or altogether relieve the recipient of the tax obligation if the wage award is no longer taxable.