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Employment Taxes

Court Reminds Employers to Follow "Lock In" Letters for Employees' Income Tax Withholdings

March 2008

By:
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A United States district court in Pennsylvania recently held that employers are obligated to follow an IRS "lock in" letter, and, as a result, cannot be held responsible by the employee for following the IRS's instructions.[1] This case serves as a reminder that employers should follow employees' instructions on withholding, but they should immediately implement any "lock in" letters they receive.

The facts of the case are straightforward. Charles Giles worked for Volvo Trucks North America (VTNA). In April 2004, Mr. Giles submitted an IRS Form W-4 claiming he was exempt from federal tax withholding, as allowed under Internal Revenue Code (IRC) section 3402(n). He also sent VTNA a demand to stop withholding Social Security taxes and the legal support for his demand. VTNA attempted to comply with Giles' request by entering 99 allowances into its payroll system, effectively eliminating any withholding from Giles' pay. VTNA then sent the IRS Giles' IRS Form W-4.

For the remainder of 2004 until May 2006, the IRS accepted Giles' claim that he was exempt from all federal income tax withholding. On May 25, 2006, Giles received a letter from IRS agent Maureen Judge that questioned his exemption claim and gave him a limited amount of time to establish that he was exempt from federal income tax withholding before his tax status would be changed to that of a single person with no allowances. A copy of this "lock in" letter was also sent to VTNA. Upon receipt of this letter, VTNA changed Mr. Giles' withholding status to single with zero allowances and refused to accept further tax documentation from him.[2]

On February 2, 2007, Mr. Giles sued. He asserted that he provided VTNA with everything it needed to establish his exempt status and that his attempts to discuss the matter with Agent Judge failed. He accused them of "running a racket by taking money from Charles D. Giles, Agent to satisfy a nonexistent 'debt.'"

The court noted that while "Plaintiff's claims suffer a lack of clarity, it appears that Plaintiff alleges Defendants unlawfully adjusted his federal tax withholding status and deprived him of property without due process of law, in violation of the Fifth Amendment, when they failed to provide him adequate notice and a hearing prior to the tax status change." Plaintiff also accused IRS Agent Judge and VTNA of acting in violation of the Racketeer Influenced and Corrupt Organizations Act (RICO).

The defendants filed a motion to dismiss. VTNA contended that Mr. Giles could not maintain a suit against it for withholding federal taxes from his wages pursuant to an IRS "lock in" letter or for forwarding his IRS Form W-4 to the IRS as required by law. Additionally, VTNA contended that Plaintiff's Fifth Amendment claim against it was deficient, as it was a private entity.[3]

The court granted VTNA's motion to dismiss. The court began by noting that under the IRC, an employer is shielded from liability to an employee for withholding that employee's taxes.[4] Such statutory shield from suit has been repeatedly upheld by the courts.[5] Mr. Giles argued that the amounts were not "required to be deducted and withheld" and, therefore, VTNA was prohibited from withholding any amount from his wages in light of his exemption claim, as allowed under IRC section 3402(n). He also asserted a court order was required to disregard his withholding instructions.

The court rejected these arguments. It found that while IRC section 3402(n) allows for an exemption from income tax withholding, it also specifically authorizes the development of regulations coordinating certain subsections of IRC section 3402. Plaintiff's tax status was adjusted pursuant to these regulations. The court explained that applicable Treasury Regulations in effect at the time (1) authorized the IRS to "notify the employer in writing that the employee is not entitled to claim a complete exemption from withholding" and (2) obligated the employer to "withhold tax on the basis of the maximum number of withholding exemptions specified in the written notice received from the IRS."[6]

The court found that VTNA had received a letter from the IRS in May 2006 questioning Plaintiff's claim that he was exempt from taxes and readjusting his withholding status "to that of a single person with 0 allowances," and, in compliance with the letter, VTNA began to withhold federal taxes from Plaintiff's wages. The court also found that Mr. Giles' continued dispute regarding his obligation to pay taxes did not change the fact that VTNA was withholding amounts from his pay at the direction of the IRS, as required by law. Therefore, the court found that Giles' claims against VTNA failed as a matter of law.

This case serves as an important reminder that employers should follow their employees' withholding instructions except where there is a "lock in" letter from the IRS. In addition, when an employee claims to be exempt from all income tax withholding, employers must nevertheless comply with such request unless the employee affirmatively tells the employer that the W-4 is false or until a "lock in" letter is received.[7]

Employers should remember that there is no express requirement to confirm that the information on a W-4 that appears valid on its face is in fact accurate. IRS guidance on the issue is somewhat contradictory, because the IRS has stated that employers need not verify W-4s, but at the same time expressed the opinion that an employer should know that a W-4 is invalid on its face when it represents a sudden dramatic departure from the employee's prior withholding. This puts employers in the somewhat awkward position of having to make judgment calls about the validity of W-4s.

Nonetheless, in cases where employees claim to be exempt when it would otherwise appear unlikely, employers should confirm with the employee that the W-4 properly reflects his or her intent with respect to withholding (that is, that the employee did not simply make an error in filling out the W-4), and also advise the employee of the penalties for filing a false W-4, including civil penalties, fines and possible imprisonment. So long as an employer has taken these steps and follows the employee's instructions, or the directives of a "lock in" letter if received, the employer cannot be liable for any damages claimed by employees relating to such withholding.

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[1] *Giles v. Volvo Trucks of North Am.*, 2008 U.S. Dist. LEXIS 12991 (M.D. Pa., Feb. 20, 2008).

[2] Slip Op., at 2-4. An identical "lock in" letter was sent again in April 2007.

[3] *Id.*, at 4-6.

[4] See 26 U.S.C. section 3403, which states: "The employer shall be liable for the payment of the tax required to be deducted and withheld under this chapter, *and shall not be liable to any person for the amount of such payment.*" (Emphasis added.)

[5] Slip Op., at 8-9 (citing *Shiaffino v. Genuardi's Family Markets*, No. 00-1892, 2000 U.S. Dist. LEXIS 10742, 2000 WL 1141857, at *1 (E.D. Pa. June 30, 2000) (finding the language of 26 U.S.C. section 3403 to be "clear and unambiguous," holding that a "plaintiff has no cause of action against its employer ... for withholding taxes from his wages and paying them to the IRS," and remarking that "it would be against public policy and senseless to penalize [an employer] for simply obeying the law"); *Wise v. Comm'r of the I.R.S.*, 624 F. Supp. 1124, 1128 (D. Mont. 1986) ("[A]n employee has no cause of action against his employer to recover wages withheld and paid to the government in satisfaction of federal income tax liability."); *see also Benz v. United Parcel Serv.*, 815 F.2d 75, (6th Cir. 1987) published in full-text format at 1987 U.S. App. LEXIS 1629, [WL] at *1 ("[A]n employer cannot be made liable for failing to honor an employee's W-4 form when it has been directed to do so by the Internal Revenue Service.") (citing cases).

[6] Treas. Reg. § 31.3402(f)(2)-1T(g)(ii)(2), and (g)(iv) (eff. Apr. 14, 2005, to July 12, 2007).

[7] However, employers should remember that a claim of exempt from income tax withholding expires on February 15 of the following year, so an employee must execute a new one each year.

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