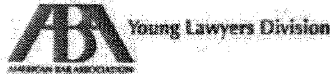
THE TAX CONSEQUENCES OF SETTLING AN EMPLOYMENT CLAIM



The Tax Consequences of Settling an Employment Claim

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Settling an employment lawsuit involves the complicated process of finding that magic number. How much will the plaintiff take, and the defendant pay, to forgo the cost, effort, and risk of taking the case to trial? Of course, in some cases, no amount of money—however high or low—will keep the plaintiff from having her day in court, or keep the defendant from exposing the frivolity of the plaintiff's claims. But when an acceptable number does exist, counsel must understand the tax consequences of settling an employment dispute, and must adequately address those consequences in the settlement agreement. Otherwise, the fight between the parties will continue when the IRS comes looking for the government's portion of that "magic number." This article provides four guidelines for understanding and addressing the tax consequences of settling an employment claim.

Guideline #1: Almost *All* Settlement Proceeds Are Included in Plaintiff's Taxable Income.

As a general rule, nearly all settlement payments in an employment lawsuit are included in the plaintiff's taxable income. This includes payments for back wages, front pay, emotional distress damages, interest awards, and punitive/liquidated

damages. The only exceptions to this general rule are: (1) certain

payments for attorneys' fees (which are discussed below in Guideline #2); and (2) payments intended to compensate the plaintiff for damages "on account of personal *physical* injuries or *physical* sickness." I.R.C. § 104(a)(2) (emphasis added). In addition, payments for mental anguish are not taxable if they do not exceed the actual medical expenses attributable to the emotional distress. I.R.C. §§ 61, 104(a)(2).

To exclude a settlement recovery (or any portion thereof) from taxation under section 104(a)(2)'s "physical injury/sickness" exception, the taxpayer must show that the settlement payment was received "on account of personal *physical* injuries or *physical* sickness." *Id.* (emphasis added). The key to excluding settlement proceeds from gross income under section 104(a)(2) is establishing that the taxpayer suffered observable or documented bodily harm, such as bruising, cuts, swelling or bleeding. *See IRS Counsel Memorandum*, Income and Employment Tax Consequences and Proper Reporting of Employment-Related Judgments and Settlements (Oct. 22, 2008). If the plaintiff did not suffer these types of observable physical injuries as a result of the conduct in question, she is not eligible to exclude any portion of the settlement proceeds under section 104(a)(2). However, if the plaintiff did suffer these types of observable physical injuries, the plaintiff may exclude any settlement proceeds intended to compensate her for these injuries, and for other damages caused by these injuries. For example, if the plaintiff was sexually assaulted by a supervisor and asserts a hostile work environment claim, the plaintiff may exclude any settlement amounts paid as compensation for: (1) the physical injuries suffered in the assault, (2) emotional distress arising out of the plaintiff's physical injuries, and (3) wages lost because of the plaintiff's physical injuries. However, settlement payments for physical symptoms that result solely from emotional distress unrelated to any observable physical injuries are not excludable under section 104(a)(2). *See* I.R.C. § 104(a)(2); H.R. Rep. No. 104-737, at 301 n. 56 (1996) (Conf. Rep.)., 1996-3 C.B. 741, 1041.

Most employment-related disputes do not involve physical injuries, such as bruising, cuts, swelling, or bleeding. Instead, the injuries typical in employment cases (such as insomnia, headaches, weight loss, stomach disorders, etc.) are related to the emotional distress allegedly caused by being discriminated against, or by being subjected to a hostile work environment. Settlement payments to compensate for these types of "soft" injuries are not "on account of a" physical injury or physical sickness, and are, therefore, not excludable from the plaintiff's gross income under section 104(a)(2). *Id.* Thus, absent a claim involving a battery, settlements for

injuries in an employment case will generally be included in the plaintiff's gross income.

Guideline #2: Settlement Payments for Attorneys' Fees Are Generally Included in Plaintiff's Taxable Income.

As another general rule, attorneys' fees received in settlement of an employment dispute are taxable to the plaintiff, even if the fees are owed or paid directly to the plaintiff's attorneys. However, this rule is also not without exception. The first exception where settlement payments for the plaintiff's attorneys' fees are not included in the plaintiff's gross income is when the attorneys' fees and costs are associated with the recovery of nontaxable physical injury/sickness payments (*see* Guideline #1). Because physical injuries/sicknesses are relatively uncommon in employment disputes, this exception has limited use in the employment context.

Second, attorneys' fees paid directly to class counsel out of a settlement fund are not included in a class member's gross income if: (1) the class member did not have a separate contingency fee arrangement or retainer agreement with class counsel; and (2) the class action was an opt-out class action. *See* PLR 200625031; PLR 200610003; PLR 200609014; PLR 200551008; *Sinyard v. Commissioner*, T.C. Memo. 1998-364, *aff'd*, 268 F.3d 756 (9th Cir. 2001).

Third, attorneys' fees that are expenses of another person or entity are not taxable income to the plaintiff. For example, when a union files claims against a company on behalf of its members and subsequently obtains a settlement that includes the payment of attorneys' fees, the union members do not need to report the payment for attorneys' fees in their taxable income. *See Erickson & Mirsky*, Tax Consequences of Employment Cases, Journal of Compensation and Benefits, November/December 2009.

And the final twist concerning the taxability of attorneys' fee payments in employment settlements is that, while payments for attorneys' fees must be included in plaintiff's gross income, they can often times be deducted above the line when calculating the plaintiff's adjusted gross income. *See* I.R.C. §§ 62(a)(20); 62(e). Specifically, above-the-line deductions for attorneys' fees are permitted when the plaintiff receives fees in settlement of claims under the following employment statutes: the Civil Rights Act of 1991, the National Labor Relations Act, the Fair Labor Standards Act, the Age Discrimination in Employment Act, the Rehabilitation Act of 1973, the Employee Retirement Income Security Act, the Employee Polygraph Protection Act of 1988, the Worker Adjustment and Retraining Notification Act, the Family and Medical Leave Act, Title VII, the Uniformed Services Employment and Reemployment Rights Act, the Americans With Disabilities Act,

federal whistleblower statutes, and any state or local equivalents of the aforementioned laws. *See* I.R.C. §62(e). Plaintiffs who receive attorneys' fees in settlement of claims brought under employment

statutes not listed above may deduct the fees on Schedule A as miscellaneous itemized deductions, which are subject to the 2% floor of I.R.C. § 67. Any above-the-line deduction under section 62(a)(20) is limited to the amount of the award includable in the plaintiff's income for the year in which the deduction is taken. *See IRS Counsel Memorandum*, Income and Employment Tax Consequences and Proper Reporting of Employment-Related Judgments and Settlements (Oct. 22, 2008).

Other attorneys' fee issues that frequently arise in employment settlements include "how many checks should the employer issue?" and "to whom should they be made payable?" The bottom line here is that neither the number of checks, nor the payee(s) affect the general rule that settlement payments for attorneys' fees are included in the plaintiff's gross income. However, the number of checks and the payees will affect how the parties must report the settlement payments.

If the employer only issues one check for the entire settlement payment (including attorneys' fees) made payable jointly to plaintiff and her attorneys, the employer will need to issue a Form-1099 MISC to the attorneys and the plaintiff for the entire amount of the settlement payment, even though the attorneys disbursed most of the settlement to the plaintiff. To avoid this issue, the attorneys may insist on two checks: one to the attorneys for their fees, and one to the plaintiff for the remaining balance. In this instance, the attorneys will only receive a 1099-MISC for the amount of the attorneys' fee payment, which will simplify matters when the attorneys are reporting their taxes.

Guideline #3: Settlement Agreement Generally Controls Tax Treatment of Payments.

The plaintiff/taxpayer has the burden of demonstrating that settlement proceeds (or any portion thereof) are excludable from her taxable income. *See e.g., Getty v. Commissioner*, 913 F.2d 1486 (9th Cir. 1990). Specifically, the plaintiff must show the portions of the settlement proceeds that were intended to compensate the plaintiff for excludable items, such as attorneys' fees and damages "on account of personal *physical* injuries or *physical* sickness." I.R.C. § 104(a)(2) (emphasis added).

To help meet the burden of proving that the settlement proceeds are excludable, counsel should include an express allocation of the proceeds in the settlement agreement. When a settlement agreement expressly allocates the settlement proceeds among various types of damages, the allocation is generally binding for tax purposes, as long as the agreement is entered into by the parties in an adversarial context, at arm's length, and in good faith. *See e.g., Bagley v. Commissioner*, 105 T.C. 396, 406 (1995), *aff'd* 121 F.3d 393 (8th Cir. 1997). An express allocation will only be disregarded where the facts and circumstances

surrounding the underlying case indicate that the payment was intended to be for a different purpose.

The key inquiry in evaluating the authenticity of a settlement allocation is the employer's intent when it paid the settlement. *See Knuckles v. Commissioner*, 349 F.2d 610, 613 (10th Cir. 1965); *Agar v. Commissioner*, 290 F.2d 283, 284 (2d Cir. 1961). In other words, in lieu of what was the settlement paid? *See Robinson v. Commission*, 102 T.C. 116, 126 (1994) (emphasis in original). Although the employee's belief is relevant to the inquiry, the character of the settlement payment hinges ultimately on the employer's dominant reason for making the payment. *See Agar*, 290 F.2d at 284.

Importantly, employers should take precautions to protect themselves from unanticipated tax burdens in the event the settlement allocation is ever challenged. For example, employers could insist on the inclusion of an indemnification provision in the settlement agreement, such as the following:

> *"[Plaintiff] agrees that, should any taxing authority assess any taxes, penalties or interest against either [Plaintiff] or [Employer] as a result of the settlement payments, [Plaintiff] will be solely responsible for the taxes, penalties, or interest, if any, which may be owed to any governmental agency as a result of the settlement payments, and [Plaintiff] agrees that he will indemnify, defend, and hold harmless [Employer] for any such taxes, penalties, or interest."*

An indemnity provision such as the preceding one should obligate the plaintiff to indemnify and defend the employer if the IRS ever challenges the settlement allocation. However, because individual plaintiffs ordinarily do not have the resources to engage in protracted litigation with the IRS, indemnification provisions may be of little practical value. Therefore, in addition to the indemnification provision, employers should always insist on a settlement allocation that accurately reflects the circumstances and substance of the settled claims.

Guideline #4: Settlement Payments Create Reporting and Withholding Obligations.

The payment of a settlement imposes reporting obligations on the parties, which depend on the nature of the settlement proceeds. There are two primary methods in which a settlement (or a portion of a settlement) may be reported to the I.R.S.: (1) Treasury Form W-2; and (2) Treasury Form 1099-MISC as "other income."

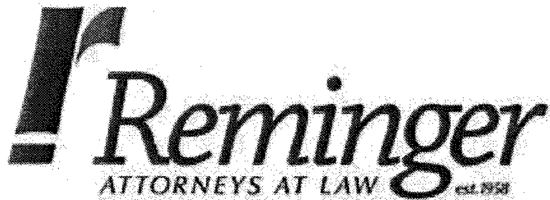
Any portion of the settlement proceeds paid to compensate for wages must be reported through Form W-2, and will essentially be

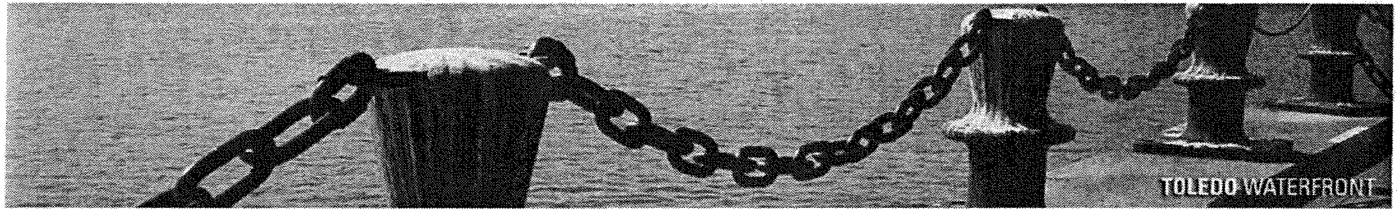
treated by the employer as a payroll check. *See* I.R.C. § 6051. The employer will deduct applicable taxes and withholdings for Social Security and Medicare, and will remit the matching taxes to the IRS. *See* I.R.C. § 3402(a). Any portion of the settlement proceeds paid for non-wages are typically reported through Form 1099-MISC as "other income." *See* I.R.C. § 6041. The employer will not deduct any taxes or withholding and will not remit any matching taxes on these non-wage payments.

Plaintiffs often request that employers treat the entire settlement payment as "other income" under Form 1099-MISC, to avoid the deduction of taxes and withholdings. While this practice may temporarily result in a larger settlement check for the plaintiff, it subjects both the employer and the employee to substantial potential tax liability. If portions of the settlement proceeds are misclassified as "other income" when, in fact, they are wages, the plaintiff will be responsible for all taxes, including the employer's portion. If the employee is unable to satisfy the tax burden of settlement proceeds, the IRS will likely turn to the employer for payment. In addition, if an employer fails to deduct and withhold income tax amounts by treating the employee or former employee as a nonemployee, the employer may be subject to additional liability, penalties, and interest. *See* I.R.C. § 3509. Thus, employers should again insist on a settlement allocation that accurately reflects the circumstances and substance of the employment claims settled, and specifically should generally not agree to treat the entire settlement as "other income" under Form 1099-MISC.

Conclusion

The tax consequences of settling an employment claim can be significant, and depend on the specific facts of each case. Therefore, employers, employees, and their attorneys should carefully consider these consequences before reaching a settlement, and should strongly consider consulting with tax practitioners concerning this complex and ever-changing area of the law.





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Employment Practices Defense

BY JONATHAN H. KROL

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The tax implications of settlement payments are usually an afterthought when negotiating the resolution of a lawsuit. Yet, tax liabilities are an important consideration, especially in the context of employment cases. Most employment claims are governed by statutory causes of action, which can allow for a host damages: compensatory, back/front pay, punitive, and/or attorneys' fees. When resolving an employment lawsuit, it is important to understand tax implications of these different damage categories, and how each is treated for purposes of settlement.

In employment cases, plaintiffs often request defendant employers to designate settlement payments in such a way to avoid income tax withholdings. While this may result in a larger settlement check for the plaintiff—and perhaps an easier settlement negotiation for the employer—doing so could subject both parties to substantial tax liability down the road. If settlement proceeds are misclassified to avoid income taxes, the plaintiff-employee might be held responsible for *all* taxes, including the employer's unpaid portion. And if the employee is unable to satisfy the tax burden, the IRS can look to the employer to foot the bill.

Moreover, where an employer fails to deduct and withhold taxes for wage payments made to an employee, the employer may be subject to additional liability, penalties, and interest. *See* 26 U.S.C. § 3509. Because of the potential exposure to employees and employers for inaccurate tax reporting, all parties should make it a priority to allocate settlement payments accurately based on the facts and circumstances of the settled claims.

Allocating Settlement Proceeds

Settlements are taxed according to the potential damages available to the employee. It is wise to designate the settlement proceeds ***during negotiations***, instead of leaving that determination to post-settlement discussion. Soon after the determination is made, it should be memorialized in a signed settlement agreement, which is generally given deference by the IRS, as long as the agreement was negotiated at arms' length and in good faith. *See, e.g., Bagley v. Comm'r*, 105 T.C. 396, 406 (1995), *aff'd* 121 F.3d 393 (8th Cir. 1997).

Still, a settlement allocation is not binding on the IRS, and the IRS may disregard an agreement if the facts and circumstances indicate that the parties actually intended the payments to be made in compensation for different damages. *Robinson v. Comm'r*, 102 T.C. 116 (1994). An inquiry into the tax treatment of settlement funds generally hinges on the employer's primary reason for making the settlement payment. Thus, the settlement agreement should set forth the rationale for any allocation of damages.

Tax Implications

As a general rule, almost all settlement payments in an employment lawsuit are includable in the plaintiff's taxable income (subject to limited exceptions for physical injuries and medical expenses)—but this does not mean that the settlement funds are subject to income tax withholdings. The settlement agreement should specify which payments are made for lost wages (both back and front pay), which are subject to income tax withholdings and reported via a Form W-2, and which payments are made for non-wage recoveries (*e.g.*, payments for emotional distress or attorneys' fees) that are not subject to income tax or withholding.

Monies received for physical injuries (*i.e.*, observable or documented bruises, cuts, swelling or fractures) are excluded from the plaintiff's income. All damages that flow from a physical injury or physical sickness are also excludable, even if the recipient of the damages is not the injured party (*e.g.*, damages received by an individual on account of a claim for loss of consortium due to the physical injury of that individual's spouse). Payments for medical expenses, whether incurred to treat physical or non-physical injuries, are also not considered income. Note, however, that unlike other tort actions, physical injuries are generally not present in employment cases, except perhaps where there is a claim for unwanted physical contact resulting in physical injury (*i.e.*, a battery-like offense).

Emotional distress and other nonphysical injuries are deemed income to a plaintiff but are not subject to payroll taxes. These awards should be reported as "other income" (box 3) on Form 1099-MISC. This is true even if the emotional distress produces physical symptoms. (However, emotional distress damages attributable to personal physical injuries are excludable from income.)

Like emotional distress, punitive damages are taxable income to the plaintiff but are not subject to payroll taxes. Punitive damages, including punitive damages received on account of physical injuries or physical sickness, are reported on Form 1099-MISC.

Whether attorneys' fee awards are considered income or not for the plaintiff depends upon the nature of the underlying claims. Generally, attorneys' fees are considered income of the plaintiff if they relate to a payment/award that is deemed income, and vice versa. In other words, if the payments made to the employee are includable as income, the related attorneys' fees will be considered income to the employee. This is true whether the attorney was paid via a contingency arrangement or pursuant to a fee-shifting statute. See *Comm'r v. Banks*, 543 U.S. 426 (2005). As mentioned above, because most employment claims do not relate to physical injuries/sickness, most attorneys' fee awards are includable as income of the plaintiff. Attorneys' fee payments are reported on Form 1099 with respect to the attorney and Form 1099-MISC with respect to the employee. If the entire settlement amount is made payable in one check to the plaintiff and his/her attorneys jointly, then the employer will need to issue a Form 1099-MISC to the attorneys and to the plaintiff for the entire amount.

Lastly, prejudgment interest is considered income to a plaintiff, but it is not subject to payroll taxes. *Greer v. Comm'r*, TC Memo 2000-25 (Jan. 19, 2000). Prejudgment interest is reported on Form 1099-MISC.

Because it is important that all parties report the payments consistently on their tax returns, the settlement agreement should specify whether a Form W-2 or Form 1099 will be issued to the recipient. It is important to consult with a tax professional to ensure proper tax reporting.

Penalties for Failure to Withhold

If an employer fails to withhold proper payroll taxes from its payments to an employee (or former employee), the employer is liable for the amount that should have been withheld. 26 U.S.C. § 3403; Treas. Reg. § 31.3102-1(d); Treas. Reg. § 31.3403-1. An employer who fails to withhold payroll taxes may be served a notice and demand for payment by the IRS; failure to pay within ten days of notice can result in an additional assessment equal to 0.5% of the amount of the tax for each month the tax remains unpaid, up to 25% of the amount due. 26 U.S.C. § 6651(a)(2) and (3). An additional penalty can be imposed for failure to deposit employment taxes, unless such failure is due to reasonable cause and not due to willful neglect. 26 U.S.C. § 6656(a). Interest on unpaid taxes or penalties continues to accrue if any amount is not paid when due.

It is wise for an employer to include indemnification language in the settlement agreement in the event that the IRS challenges the settlement allocation. But because such a clause will not prevent the IRS from seeking to recoup unpaid taxes from the employer, the employer should insist that the settlement allocation accurately reflect the realities of the settled claims and the plaintiff's actual damages.

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A Timely Analysis of Legal Developments

ASAP®

September 13, 2013

IRS Reaffirms Advice on the Proper Employment Tax Treatment of Settlements

By GJ Stillson MacDonnell and William Hays Weissman

On August 30, 2013, the IRS reiterated its longstanding positions on the proper tax treatment of litigation settlements with current or former employees. In its Chief Counsel Advice (CCA) Memorandum 20133501F, the IRS presented and answered three questions:

1. When are attorney's fees paid by an employer as part of a settlement agreement with a former employee subject to employment taxes?
2. What are the information reporting requirements for attorney's fees paid by an employer pursuant to a settlement agreement with a former employee?
3. What penalties can be asserted if an employer fails to comply with reporting requirements for attorney's fees paid as part of a settlement agreement with a former employee?

Background Facts

An employer enters into several typical settlement agreements with former employees wherein the employees waive rights to bring further claims under various statutes such as the Age Discrimination in Employment Act (ADEA), the Americans with Disabilities Act (ADA), and Title VII of the Civil Rights Act (Title VII) in exchange for lump sum payments. The lump sum payments are characterized as including wages, tort damages, reimbursements of medical costs, and attorney's fees. The attorney's fees are, variously, paid directly to the employee, only to the employee's attorney, or jointly to the attorney and the employee.

The Memorandum addresses three examples of settlement payments that include attorney's fees. In the first example, all sums but attorney's fees are reported on a 1099 issued to both the employee and counsel. In the second example, the employer reports the lump sum payment as wages on a W-2 to the employee and attorney's fees on a 1099 to counsel, but does not report any portion of the attorney's fees on a 1099 to the employee. The third example includes a lump sum to settle all claims paid to the employee's attorney without any allocation between types of claims or claims and attorney's fees.

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Analysis

The IRS began its analysis by laying out a four-step process:

- First, determine the character of the payment and the nature of the claim that gave rise to the payment.
- Second, determine whether the payment constitutes an item of gross income.
- Third, determine whether the payment is wages for employment tax purposes.
- Fourth, determine the appropriate information reporting for the payment, including payments of attorney's fees.

The CCA does not analyze the first step in the process, explaining that this determination simply requires (1) an examination of the claims made and (2) the intent of the parties in making the payment.

With respect to the second step, inclusion in income, the IRS explained that generally gross income includes income from settlements, including amounts paid directly to attorneys, relying upon the Supreme Court's opinion in *Commissioner v Banks*.[1] Attorney's fees are income even when the fees are paid under fee shifting statutes.[2] The CCA does note the potential "above-the-line" deduction for attorney's fees paid in employment related litigation under Internal Revenue Code (Code) section 62(a)(20).

Turning to the third step, whether the payment constitutes wages for employment tax purposes, the CCA explains that whether an amount received in settlement of a dispute is remuneration for employment subject to employment tax depends on the nature of the item for which the settlement amount is a substitute.[3] It does not matter whether an employment relationship exists at the time of payment.[4]

Relying heavily upon Revenue Ruling 80-364, the CCA concludes that when an employment-related claim brought under a fee-shifting statute is settled outside of court and the settlement agreement clearly allocates a reasonable amount of the settlement proceeds as attorney's fees, the amount allocated to attorney's fees, while includable in income, is not wages for employment tax purposes. On the other hand, if the settlement agreement does not clearly allocate an amount for attorney's fees, and/or the claim is brought under a statute that does not provide for fee-shifting, the entire amount paid to the claimant-employee is wages for employment tax purposes.

Addressing the fourth step, the proper reporting requirements, the CCA cites to both the general reporting requirements under Code section 6041 and its regulations to conclude that when the entire amount of the settlement is includable in income and includes attorney's fees, such fees must be reported as income to the plaintiff. With respect to the reporting of the attorney's fees to counsel, the CCA cites to Code section 6045 and its regulations, concluding that Code and regulations make clear that separate reporting of such fees to both the plaintiff and plaintiff's counsel is required. This is commonly referred to as "dual reporting." The CCA also notes that failure to perform proper tax reporting can result in penalties of between $100 and $250 per failure.[5]

CCA's Conclusions

The CCA reached three summary conclusions:

1. In the absence of a specific allocation for attorney's fees in these settlement agreements, attorney's fees paid by an employer as part of a settlement agreement with a former employee, which are includable in income, are subject to employment taxes to the extent they are wages attributable to an employment-related claim. The Service's position is that payments constituting severance pay, back pay, and front pay are wages for employment tax purposes.[6]

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1 *Commissioner v Banks* 543 U.S. 426 (2005).

2 *Citing Sinyard v. Commissioner* (9th Cir. 2001) 268 F.3d 756 and *Vincent v. Commissioner*, T.C. Memo 2005-95.

3 Citing *Alexander v. Internal Revenue Service* (1st Cir. 1995) 72 F.3d 938, 942 (the test for purposes of determining the character of a settlement payment for tax purposes "is not whether the action was one in tort or contract but rather the question to be asked is 'in lieu of what were the damages awarded?'"); *Hort v. Commissioner* (1941) 313 U.S. 28 (holding that an amount received upon cancellation of a lease was a substitute for the rent that would have been paid under the lease and, thus, was taxable as ordinary income); Rev. Rul. 96-65, 1996-2 C.B. 6, (holding that payments received by an individual in satisfaction of a discrimination claim under Title VII are both income and wages).

4 Treas. Reg. §§ 31.3121(a)-1(h)(i), 31.3306(b)-1(i), 31.3401(a)-1(a)(5); *Social Security Board v. Nierotko* (1946) 327 U.S. 358, 365-66.

5 IRC §§ 6721, 6722; Treas. Reg. § 301.6721-1(f)(3), 301.6722-1(c)(1).

6 In footnotes, the IRS notes that there are some splits among the courts regarding the character of severance pay, back pay in illegal refusal to hire cases, and front pay cases.

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2. The appropriate information reporting requirements depend on the facts and circumstances of each case. Unless the attorney's fees are specifically allocated in a settlement agreement, the payments made in settlement of wage-based claims are generally considered wages that are required to be filed and furnished to the employee on Form W-2, Wage and Tax Statement. If the attorney's fees are specifically allocated, they are generally required to be filed and furnished to the employee on Form 1099-MISC, Miscellaneous Income. The reportable amounts are always filed and furnished to the attorney on Form 1099-MISC.
3. An employer that fails to file and furnish correct information returns that report attorney's fees paid as part of a settlement agreement may be subject to penalties under §§ 6721(a) and 6722(a) of the Internal Revenue Code. If the employer intentionally disregarded the reporting requirements, the penalties increase under §§ 6721(e) and 6722(e).

Takeaways

The CCA does not provide any new analysis or law, nor does it signal any change in the IRS' longstanding positions. However, it is helpful in that it explains the dual reporting obligation which is often resisted by all parties. Notably, the recent Memorandum does not address the related question of when a payment need not be included in gross income, as, for example, a payment issued to compensate for a personal physical injury.

The IRS has been aggressively auditing settlement agreements between employers and current or former employees and forcing employers to defend any non-wage treatment of payments. Employers should recognize that it is not acceptable to "agree" with an employee that the entire amount of a settlement is not wages, pay the lump sum amount to to counsel's trust account, and defer responsibility (and/or liability) for an IRS challenge to the employee. Rather, employers should:

- Understand the nature of the claims being asserted, their character and the basis for settlement;
- Carefully craft settlement agreements that specify the nature of each amount being paid in the agreement with clear allocations between the kinds of payments (wages, attorney's fees, etc.);
- Ensure that amounts are properly reported on IRS forms W-2 and 1099 as required, with separate forms to plaintiff's counsel as well as plaintiff.

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TAX TREATMENT OF RECOVERIES IN EMPLOYMENT DISPUTES

Committee on Labor & Employment Law

AUGUST 2009

THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK
42 WEST 44TH STREET, NEW YORK, NY 10036

TAX TREATMENT OF RECOVERIES IN EMPLOYMENT DISPUTES

The tax treatment of settlement payments and trial/arbitration awards in employment related disputes is a complex area with many uncertainties. This pamphlet is a brief overview of some of the general principles involved.[1] The pamphlet focuses on: (i) which payments are considered income to an employee and (ii) which payments constitute "wages" for payroll tax and withholding purposes.[2]

A. Recoveries in Employment Law Cases

Employees may receive settlement payments and/or an award of damages for a variety of causes of action including: breach of contract, violation of whistleblower statutes, violation of wage and hour laws, and violation of anti-discrimination/retaliation statutes.

If an employee is successful at trial or arbitration, he or she is entitled to different categories of damages depending on the claim he or she has won. Each type of damage is taxed differently.

Settlements can be characterized as compensation for a portion of the potential damages that an employee could have received if the case had gone forward. Settlements are therefore taxed according to the type of potential damages for which the employee is being compensated. A settlement agreement should allocate payment to taxable wages, subject to withholding and reported on Form W-2, and taxable, non-wage recoveries (e.g., amounts received on account of emotional distress or attorneys' fees), which are includable in income but not subject to employment tax or withholding. Allocations in a settlement agreement will generally be given deference provided the agreement was entered into by the parties in an adversarial context and negotiated at arms' length. However, an allocation in a settlement agreement is not binding on the IRS if other facts and circumstances indicate that the parties actually intended the payment to be made for a purpose other than its stated purpose.[3] The settlement agreement should be explicit as to the reason for the characterization of a particular portion of the allocated settlement amount and whether a Form W-2 or Form 1099 will be issued. Finally, consistency in tax reporting among the parties is critical.

There are seven basic types of damages in employment law cases: 1) lost compensation, 2) emotional distress, 3) physical injuries, 4) compensation for medical expenses, 5) punitive damages, 6) interest on awards, and 7) attorneys' fees. Each of these types of damages is taxed differently. The manner in which each category of damages is taxed is discussed below.

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[1] See Robert W. Wood, Taxation of Damage Awards and Settlement Payments (3d ed. 2005) for a more in-depth treatment of this subject matter.

[2] This pamphlet does not deal with deferred compensation payments that may require special treatment. Such payments are addressed in 26 U.S.C. § 409A (2008).

[3] Robinson v. Comm'r, 102 T.C. 116 (1994).

1. Lost Compensation

Typically, the largest component of a settlement or award is payment for lost compensation. Lost compensation includes both payment for wages that have already been lost, i.e. back pay, and compensation for wages that may be lost in the future, i.e. front pay.

Both back and front pay are taxable as income unless they are received on account of personal physical injuries or physical sickness. Back and front pay constitute wages and are subject to payroll taxes such as FICA and FUTA, as well as income tax withholding.[4] Back and front pay are generally subject to FICA and FUTA taxes in the year they are actually or constructively received by a plaintiff. Thus, for example, in United States v. Cleveland Indians Baseball Co., the United States Supreme Court held that a back pay award to baseball players in a settlement was subject to FICA and FUTA taxes in the year the settlement was paid and not the year that the wages should have been paid.[5]

When determining withholdings, the parties should be aware of the Internal Revenue Service ("IRS") regulation on "Supplemental Wage Payments," 26 C.F.R. § 31.3402(g)(2009), which states that wages are either "regular" or "supplemental." Severance, back, and front pay are all different forms of supplemental wages. An employer is permitted to make income tax withholdings at different percent rates for supplemental wages. Supplemental wages may also be "subject to specific withholding amounts set forth in the regulation."[6] Similarly, there are specific New York State withholding rates applicable to supplemental wages.[7]

The Third Circuit's recent decision, Eschelman v. Agere Sys., Inc., 554 F.3d 426, 441-42 (3rd Cir. 2009), may have an impact on the structure of awards and settlements in the future. In that decision, the Third Circuit held that a district court may, pursuant to broad equitable powers granted by the ADA, award a prevailing employee an additional sum of money to compensate him or her for the increased tax burden of a back pay award. It has yet to be seen whether this approach will be adopted by other circuits.

2. Emotional Distress

Damages for nonphysical injuries (e.g. emotional distress) are considered income to a plaintiff. Emotional distress damages are not, however, subject to payroll taxes. Emotional distress awards should be reported as "other income" (box 3) on Form 1099-MISC.[8]

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[4] Rev. Rul. 78-336, 1978-2 CB 255; Rev. Rul. 78-176, 1978-1 CB 303; Soc. Sec. Bd. v. Nierotko, 327 U.S. 358 (1946).

[5] 532 U.S. 200, 219 (2001).

[6] See Circular E, Employer's Tax Guide, I.R.S. Publication 15, at 14 (2009) accessed at http://www.irs.gov/pub/irs-pdf/p15.pdf (April 27, 2009).

[7] See Withholding Tax Rate Changes for Supplemental Wages, TSD-M-88(8)I, N.Y. State Dep't of Taxation and Finance, Taxpayer Services Division, Technical Services Bureau, (Feb. 14, 1988) accessed at http://www.tax.state.ny.us/pdf/memos/income/m88_8i.pdf (April 27, 2009).

[8] See Specific Instructions for Form 1099-MISC. There is a detailed analysis of IRS information returns and 1099 Forms in Johnson v. LPL Fin. Servs., 517 F. Supp. 2d 1231 (S.D. Cal. 2007).

3. Physical Injury

Section 104(a)(2) of the Internal Revenue Code of 1986, as amended (the "Code") provides that the amount of any damages (other than punitive damages) received on account of personal physical injuries or physical sickness is excludable from income. For a recovery to be excludable under Section 104(a)(2), the underlying cause of action must be based upon tort or tort type rights and the resulting damages must be recovered on account of personal physical injuries or physical sickness.[9] All damages that flow from a physical injury or physical sickness are excludable, even if the recipient of the damages is not the injured party (e.g. damages received by an individual on account of a claim for loss of consortium due to the physical injury of that individual's spouse). Section 104 does not apply to nonphysical injuries such as loss of reputation or slander.

Emotional distress is not considered a physical sickness or physical injury even if physical symptoms such as insomnia, headaches, and stomach disorders, result from such emotional distress. Only emotional distress damages attributable to personal physical injury or physical sickness are excludable from income. Thus, for example, settlement payments for sexual harassment claims that are accompanied by a tort-like battery may be excludable under Section 104.

The term "physical" is not defined in the Code or Treasury Regulations. The IRS has stated that "direct unwanted or uninvited physical contacts resulting in observable bodily harms such as bruises, cuts, swelling and bleeding are personal physical injuries under Section 104(a) (2)."[10] In Private Letter Ruling 200041022, the IRS ruled that damages attributable to physical contact that did not cause pain or result in any observable bodily harm were not personal physical damages and thus were not excludable under Section 104(a) (2).

4. Medical Expenses

Settlement payments or awards for medical expenses incurred to treat emotional distress are not considered income. This is true whether or not the expenses were incurred because of a physical injury.[11]

5. Punitive Damages

Punitive damages are taxable income to the recipient but are not subject to payroll taxes. Punitive damages, including punitive damages received on account of physical injuries or physical sickness, are reported on Form 1099-MISC.

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9 Comm'r v. Schleier, 515 U.S. 323, 337 (1995).

10 I.R.S. Priv. Ltr. Rul. 200041022 (Oct. 13, 2000).

11 See 26 U.S.C. 104(a): "... For purposes of paragraph (2), emotional distress shall not be treated as a physical injury or physical sickness. The preceding sentence shall not apply to an amount of damages not in excess of the amount paid for medical care (described in subparagraph (A) or (B) of section 213(d)(1)) attributable to emotional distress."

6. Interest on Award

Prejudgment interest is considered income to a plaintiff, but is not subject to payroll taxes.[12] Prejudgment interest is reported on Form 1099-MISC.

7. Attorneys' Fees

In the employment context, whether payments for attorneys' fees are includable in income depends on the nature of the related claim. If an award is not considered income, the related attorneys' fees and other legal costs will not be considered income to the employee. If the payments made to the employee are considered income, the related attorneys' fees will be considered income to the employee. These rules apply whether the attorneys are paid via a contingency arrangement[13] or pursuant to a fee-shifting statute.

An employee is, however, allowed an above-the-line deduction for amounts attributable to attorneys' fees and costs received on account of certain discrimination/retaliation claims, whistleblower claims, civil rights claims, and claims against the United States. In those circumstances, an employee may be able to deduct legal expenses incurred in his or her suit as a business expense under Section 162 of the Code.

In other circumstances, legal expenses may also be deductible under Section 212 of the Code as expenses incurred for the production of income. Expenses paid or incurred for the production or collection of income are subject to a 2% floor, i.e., the employee may only deduct that amount which exceeds 2% of his adjusted gross income. In addition, deductions under Section 212 are disallowed for purposes of calculating the alternative minimum tax.

Attorneys' fees payments are reported on Form 1099 with respect to the attorney and Form 1099-MISC with respect to the employee.

B. Penalties for Failure to Withhold

If an employer fails to deduct and withhold appropriate payroll taxes from its payments to an employee, the employer is liable for the amount of the tax that should have been deducted and withheld until the tax is paid.[14] If an employer fails to withhold and/or pay FICA or FUTA and does not pay such tax within ten days after the IRS serves a notice and demand for payment, an addition to the tax equal to 0.5% of the amount of the tax for each month the tax remains unpaid, up to 25% will be assessed.[15] An additional penalty of up to 10% may be imposed under Section 6656(a) for failure to deposit employment taxes, unless such failure is due to reasonable cause and not due to willful neglect. Interest will accrue on the amount owing and any penalties or additions to the tax assessed if any amount of tax is not paid when due.

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12 Greer v. Comm'r, TC Memo 2000-25 (Jan. 19, 2000).

13 Comm'r v. Banks, 543 U.S. 426 (2005).

14 6 U.S.C. § 3403; Treas. Reg. § 31.3102-1(d); Treas. Reg. § 31.3403-1.

15 26 U.S.C. § 6651(a)(2) and (3).