

Lexis Practice Advisor[®] offers beginning-to-end practical guidance to support attorneys' work in specific legal practice areas. Grounded in the real-world experience of expert practitioner-authors, our guidance ranges from practice notes and legal analysis to checklists and annotated forms. In addition, Lexis Practice Advisor provides everything you need to advise clients and draft your work product in 14 different practice areas.

Taxation and Reporting of Settlement Payments for Employment-Related Lawsuits

by William Hays Weissman, Littler Mendelson, P.C.

This practice note outlines the most common tax and reporting issues associated with the settlement of employment-related litigation. The proliferation of employment-related litigation over the last decade has led to a significant numbers of settlements. Attorneys often overlook or fail to address the tax consequences of such litigation until after the parties reach a settlement, leading to potential issues for both the employer and employee.

We address the following issues to help you properly handle tax and reporting issues related to settlements of employment-related claims:

- Key steps for determining taxation and reporting of settlement payments
- Taxation and reporting of wages
- Taxation and reporting of non-wage payments
- IRS chart showing taxation and reporting requirements for various types of payments
- Unique issues concerning taxation and reporting of attorney's fees
- IRS charts showing taxation and reporting requirements for attorney's fees
- Tax consequences of settlement allocations
- Guidance for pushing back on opposing counsel who request and/or demand improper settlement allocations

Key Steps for Determining Taxation and Reporting of Settlement Payments

The IRS has laid out four key steps for determining taxation and reporting requirements for settlements. See [PMTA 2009-035 \(Oct. 22, 2008\)](#). We address each of these steps in turn.

Step 1: Identify the Character of the Payment and Nature of the Claim

The character of the payment is the type of payment being made to address the particular claims at issue. A payment may be characterized as severance pay, front pay, back pay, compensatory damages, liquidated damages, consequential damages, or restoration of benefits. Note that for tax purposes the labels that the parties place on payments do not determine the character of the payment. Treas. Reg. §§ 31.3121(a)1(c); 31.3306(b)(1)(c); 3401(a)1(a)(2). Thus, just calling something "compensatory" or "non-wages" damages in a settlement agreement will not be determinative of the payment's character for tax purposes.

Step 2: Determine Whether the Payment Is Taxable

Whether a payment is taxable depends both on its character and the nature of the claim. For example, payments made on account of a personal physical injury do not constitute "income" and thus are not taxable. I.R.C. § 104(a)(2). Also, certain causes of action limit the types of damages plaintiffs may receive. For instance, the Age Discrimination in Employment Act (ADEA) does not permit tort type damages; thus, the parties should not allocate any amounts of a settlement of an ADEA claim for personal physical injury. *Comm'r v. Schleier*, 515 U.S. 323 (1995).

Step 3: Determine Whether the Payment Constitutes Wages

Assuming the payment is income, the next question is what kind of income it is: wages or non-wages. From the perspective of the payor of a settlement that includes wages, such payments are subject to more requirements than non-wages.

We provide more detail on tax and reporting requirements for both wage and non-wage payments in the sections below entitled Taxation and Reporting of Wages and Taxation and Reporting of Non-wage Payments.

Step 4: Determine the Proper Reporting for Attorney's Fees

In general, attorney's fees are income to both the party receiving payment and the attorney receiving payment. Further, there are issues relating to whether the recipients of such income are entitled to deductions for paying attorney's fees, and the proper reporting of such fees. We provide more detail on tax and reporting requirements for attorney's fees payments in the section below entitled Unique Issues Concerning Taxation and Reporting of Attorney's Fees.

Taxation and Reporting of Wages

When a payment is treated as wages, it is generally subject to federal and state income tax withholding (if the applicable state has an income tax), Social Security taxes, Medicare taxes, federal and state unemployment taxes, and any other state employment taxes, such as disability insurance taxes. The wages and withholdings are reported on IRS Form W-2.

All payments of wages are treated as wages subject to employment taxes unless specifically exempted. Courts and taxing agencies classify severance pay as wages. As explained in more detail below, with limited exceptions, courts and taxing agencies also classify back pay and front pay damages as wages. Below we also discuss the inconsistent classification of amounts paid under the Family and Medical Leave Act (FMLA) and payments pursuant to claims based on failure or refusal to hire.

Back Pay

Back pay is compensation that constitutes the difference between the pay the employee received and the pay to which the employee was legally entitled to receive up to the time of the settlement date. No statute or regulation exempts back pay from the definition of wages for tax purposes. I.R.C. § 3401; *United States v. Cleveland Indians Baseball Co.*, 532 U.S. 200 (2001). This is true even if the workers receiving the payments are no longer employed by the payor for other purposes at the time the payment is made. Treas. Reg. § 31.3401(a)-1(a)(5).

The U.S. Supreme Court has held that back pay awarded under the National Labor Relations Act to an employee whose employer had wrongfully discharged him was "wages" under the Social Security Act. *Social Security Bd. v. Nierotko*, 327 U.S. 348 (1946). The Court stated that the back pay constituted remuneration and also held that the remuneration was for "employment" even though the back pay related to a period during which the petitioner did not perform any service. *Nierotko*, 327 U.S. at 365–66. Several courts dealing with whether payments upon settlement of claims constituted wages for employment tax purposes have cited *Nierotko*. See, e.g., *Mayberry v. United States*, 151 F.3d 855 (8th Cir. 1998); *Hemelt v. United States*, 122 F.3d 204 (4th Cir. 1997).

The exception to the general rule that back pay constitutes wages is when the employee receives back pay on account of a personal physical injury or illness. See, e.g., *Johnson v. United States*, 76 Fed. Appx. 873 (10th Cir. 2003).

Front Pay

Front pay is compensation for an employee that he or she would have received after the settlement date had the employer not allegedly engaged in prohibited conduct (i.e., future lost earnings). Front pay has been subject to less litigation than back pay. Nonetheless, the limited authority appears to support treating front pay as wages. For example, a federal district court in New Jersey held that both back pay and front pay paid as part of a settlement award to a former employee were wages and thus subject to federal employment taxes. *Josifovich v. Secure Computing Corp.*, 2009 U.S. Dist. LEXIS 67092 (D.N.J. July 31, 2009). The court found that "because the Supreme Court in *Nierotko* held that services performed—a component of the definition of wages, which are subject to withholding—encompasses the entire employee-employer relationship and not merely the work actually performed, this Court concludes that front pay, like back pay, is subject to withholding taxes." *Josifovich*, 2009 U.S. Dist. LEXIS 67092, at *12–13.

However, the Fifth Circuit ruled that front pay is not wages because it represents a "loss in earning capacity," not for services already performed." *Dotson v. United States*, 87 F.3d 682, 690 (5th Cir. 1996). Thus, courts are not entirely consistent in their treatment of front pay. However, outside the Fifth Circuit, it would not be advisable to treat front pay as other than wages for tax purposes.

Amounts Paid under the Family and Medical Leave Act (FMLA)

Courts and taxing agencies generally treat amounts paid under the Family and Medical Leave Act (FMLA) as wages. However, courts in the Eastern District of Pennsylvania have held that based on the peculiar language of the FMLA—which creates a remedy of damages equal to the amount of denied or lost wages (see 29 U.S.C. § 2617(a))—amounts paid under the FMLA are not for services

in employment but rather for damages that are simply equivalent to the amount of denied or lost wages, and as such are not themselves wages for tax purposes. *Carr v. Fresenius Med. Care*, 2006 U.S. Dist. LEXIS 29627, at *8 (E.D. Pa. 2006); *Churchill v. Star Enterprises*, 3 F. Supp. 2d 622 (E.D. Pa. 1998). The IRS, however, does not appear to subscribe to this view. Thus, the IRS generally will consider amounts paid under the FMLA as wages for tax purposes.

Refusal to Hire Cases

The IRS has stated that claims based on failure or refusal to hire are back pay and thus wages. Rev. Rul. 78-176. A federal district court in the Southern District of New York cited Rev. Rul. 78-176 with approval in *Melani v. Board of Higher Ed.*, 652 F. Supp. 43 (S.D.N.Y. 1986), *aff'd*, 814 F.2d 653 (2d Cir. 1987).

However, the Eighth Circuit has held differently, finding that Federal Insurance Contributions Act (FICA) tax (i.e., federal payroll tax) and income tax withholding do not apply unless an actual employer-employee relationship existed, and no such relationship existed when an employer failed to hire an individual. *Newhouse v. McCormack*, 157 F.3d 582 (8th Cir. 1998). Parties that settle failure to hire claims in the Eighth Circuit may treat the settlement as other than wages; otherwise, the IRS would likely take the position that the parties should allocate the settlement to wages.

Taxation and Reporting of Non-wage Payments

Unlike wages, non-wage payments are not subject to tax withholding by an employer, although they are usually income to the recipient, and thus taxable for income tax purposes. If the amount paid is \$600 or more, the employer must report the amount on IRS Form 1099-MISC, in box 3. The exception is for interest paid by an employer, which if \$600 or more, gets reported on IRS Form 1099-INT.

Below we provide more detail on the following types of non-wage payments:

- Personal physical injuries or illness
- Emotional distress
- Tax treatment of liquidated damages and interest
- Incentive payments to named class representatives
- Interest
- Liquidated damages
- Employment law penalties claimed by employees in litigation

Personal Physical Injuries or Illness

Under I.R.C. § 104(a)(2), amounts received from personal physical injury or illness are not income subject to tax. The IRS has defined personal physical injury or sickness as requiring an “observable bodily harm” such as bruising, cuts, swelling, and bleeding. See I.R.S. Priv. Ltr. Rul. 200041022 (July 17, 2000). Payments on account of personal physical injuries are not reported.

Amounts Received Due to Emotional Distress

Before 1996, the IRS and courts generally treated emotional distress as falling within the exemption under I.R.C. § 104(a)(2). However, for payments made after August 21, 1996, emotional distress was expressly carved out of I.R.C. § 104(a)(2). Emotional distress includes psychological distress and the physical symptoms of the emotional distress, such as stomachaches, ulcers, and headaches triggered by emotional distress. Conference Committee Report to the 1996 Act (August 1, 1996)—104 H. Rpt. 737. When considering settlements of claims, you must understand that emotional distress is taxable income. Emotional distress damages are reported on IRS Form 1099-MISC, box 3 (other income) if over \$600. But emotional distress is not taxable up to the amount of any unreimbursed medical expenses that the plaintiff paid. Therefore, it is helpful to know if any such offsets exist when negotiating a settlement agreement.

Emotional distress damages, while taxable income, are not wages, as they are not intended to take the place of wages employers pay to employees. We are not aware of any cases, revenue rulings, or other guidance that has treated emotional distress as wages subject to employment taxes.

Rather, the IRS's instructions to the Form 1099-MISC expressly state:

Other items required to be reported in box 3 [of IRS Form 1099-MISC, for other income] include the following.

1. Generally, all punitive damages, any damages for nonphysical injuries or sickness, and any other taxable damages. Report punitive damages even if they relate to physical injury or physical sickness. **Generally, report all compensatory damages for nonphysical injuries or sickness such as employment discrimination or defamation.** However, do not report damages (other than punitive damages):
 - a. Received on account of personal physical injuries or physical sickness;
 - b. That do not exceed the amount paid for medical care for emotional distress;
 - c. Received on account of nonphysical injuries (for example, emotional distress) under a written binding agreement, court decree or mediation award in effect on or issued by September 13, 1995. . . .

Damages received on account of emotional distress, including the physical symptoms such as insomnia, headaches, and stomach disorders, are not considered received for a physical injury or physical sickness and are reportable unless described in b or c above. However, damages received on account of emotional distress due to physical injuries or physical sickness are not reportable.

Also, report liquidated damages received under the Age Discrimination in Employment Act of 1967.

2017 Form 1099-MISC Instructions, p. 5 (emphasis added). In sum, treat payments for emotional distress as taxable income but not wages.

Incentive Payments to Named Class Representatives

Named plaintiffs in a class or collective action (class representative) sometimes receive an additional incentive payment to compensate them for the risk of being the class representative and participating in the litigation. There is very little authority concerning the tax treatment of such incentive payments. We address this limited authority below.

Trotter v. Rankin: Payments to Class Representatives Constitute Taxable Wages

A Delaware federal district court held that incentive payments made to eight class representatives were wages subject to employment taxes. *Trotter v. Rankin*, 253 F. Supp. 2d 812 (D. Del. 2003). *Trotter* involved a typical employment-related class action, in which the plaintiffs sought back pay and certain benefits. The parties entered into a settlement agreement that allocated the settlement based on hours worked and years of service. In addition, each of the eight named plaintiffs received a \$5,000 incentive payment for the risk of being class representatives.

The parties sought an order from the court regarding the proper tax treatment of the incentive payments. Plaintiffs asserted that the class representatives did not render services to the employer but to the class, which would usually be adverse to the employer. Plaintiffs contended that the payments would thus not be "remuneration for employment" within the meaning of the Internal Revenue Code (Code). The defendants argued that the underlying claims in this case were for back wages, that there was no claim by the named plaintiffs for services provided to the class members, and that the court should therefore consider the \$5,000 payments as wages.

The court began its analysis by noting that the definition of wages and employment are both very broad, citing to well-established precedents and the Code. It noted that the parties conceded that there were no cases, rulings, or other IRS guidance on the issue. (This appears to remain true today, as, other than *Trotter*, we have not found such guidance, rulings, or cases.) The court focused primarily upon a private letter ruling, stating:

In Priv. Ltr. Rul. 2003-03-003 (Jan. 17, 2003), a settlement agreement was reached following a class action suit based on employment discrimination for back pay, other lost compensation, and various other damages. The allocation of damages stipulated in the settlement agreement was based on various economic considerations, including work performed on the class action lawsuit. Although the settlement agreement stated that all payments made represented compensatory damages and not wages, the IRS concluded that this statement was inconsistent with the economic substance of the settlement. The ruling determined that the underlying cause of action and the calculation of damages in the settlement agreement were based solely on economic considerations and that the underlying claim was a "wage-based claim." Furthermore, the ruling concluded that the settlement agreement specifically allocated payments based on economic factors, such as, lack of promotions, lack of wage increases, undeserved discipline and *work on the class*

action lawsuit, inter alia. Additionally, the number of years of service [was] a factor in determining the amount of the payment to each member of the class. (emphasis added).

The ruling held that the entire payment was remuneration for services and constituted wages subject to withholding taxes. *Id.*

Trotter, 253 F. Supp. 2d at 817.

The court stated that “the \$5,000 incentive payment to the Class Representatives was not specifically characterized in the Plan of Allocation.” *Trotter*, 253 F. Supp. 2d at 818. It went on to explain:

As outlined above, various courts and the IRS have looked to the nature of the underlying claim to determine whether payments in a settlement are to be considered “wages.” Plaintiffs, themselves, have stated that this is a “wage case in which Class Members will receive payments characterized as back-wages.” Analogous to Priv. Ltr. Rul. 2003-03-003 discussed previously herein, the settlement agreement in the instant case specifically allocated payments based on economic factors. Included in the economic factors described in Priv. Ltr. Rul. 2003-03-003 were payments to Class Members based on hours worked, years of service, and “work on the class action lawsuit.” The ruling determined that the entire payment was remuneration for services and constituted wages subject to withholding taxes. *Id.* Pursuant to the Plan of Allocation in this case, the amount received by each Class Member, including the Class Representatives, is based on hours worked and years of service. The Class Representatives would not have received any payments if they had not been employed and met the requirements of one of the classes outlined in the Plan of Allocation. *Id.* Their services are an integral component of the “entire employer-employee relationship.” See *Soc. Sec. Bd. v. Nierotko*, 327 U.S. at 365.

Furthermore, all parties agreed during the Final Fairness Hearing, that the settlement award was to be in the aggregate with the determination of the allocation to occur according to the Agreement. Similarly, in the examples in Rev. Rul. 80-364, the settlement had not been specifically allocated, but the underlying claims were wage-based and the award was considered income and wages.

Given that the Agreement allocated payments based on economic factors, the nature of the underlying claims is to be construed as wage-based, and the award is for remuneration for services and thus subject to withholding.

Id. (citations to the record omitted).

The court in *Trotter* based its decision in part upon the facts that:

- The only underlying claim was one for wages
- The Allocation Plan did not specifically allocate these payments separately
- Plaintiffs had not made any claim in the complaint for a separate payment –and–
- The parties based the allocation on economic factors that could have included work on the lawsuit

Whether a court would come to the same result when faced with a different fact pattern is not known.

Post-Trotter IRS Chief Counsel Advice Memorandum: Payments to Class Representatives Are Taxable Wages

In a subsequent IRS Chief Counsel Advice Memorandum, the IRS cited to *Trotter* favorably, concluding that incentive payments to class representatives “represent remuneration arising from the employment relationship and there is no exception from wages that applies to these payments.” IRS Chief Counsel Advice Memorandum 201311022 (Aug. 10, 2012)—2012 IRS CCA LEXIS 252.

Interest

The IRS does not treat interest payments as wages subject to employment taxes, but it treats interest payments as taxable income. See 2017 Form 1099-INT (interest income); Rev. Rul. 80-364 (July 1980) (interest is not wages subject to employment taxes).

Liquidated Damages

Like interest payments, the IRS and courts treat liquidated damages as taxable income but not as wages. See, e.g., 2017 Form 1099-MISC Instructions, p. 5 (liquidated damages under ADEA not wages); Rev. Rul. 72-268 (Jan. 1972) (liquidated damages are not wages subject to employment taxes); *Kern v. Mid-Continent Petroleum Corp.*, 63 F. Supp. 120 (N.D. Iowa 1945), *aff’d* 157 F.2d 310 (8th Cir.

1946) (liquidated damages under the FLSA are not wages for employment or income tax withholding purposes).

Employment Law Penalties Claimed by Employees in Litigation

There are often a variety of employment law penalties claimed by employees in litigation. For example, under California law, employees may claim violations of meal and rest period breaks, California Labor Code § 226.7 (Cal. Lab. Code), or violation of waiting time penalties, Cal. Lab. Code § 203, among others.

The use of the word “penalty” does not necessarily mean the IRS will characterize a payment as a penalty payment for tax purposes. *Smith v. Comm’r*, 34 T.C. 1100, 1104 (1960). While penalties are generally not wages, there are some limited exceptions. For example, in Office of Chief Counsel Information Release 20050094, March 17, 2005, the IRS stated that the payment Cal. Lab. Code § 226.7 requires to be made is a payment subject to the federal Unemployment Insurance Tax Act (FUTA), FICA, and income tax withholding. For more information on FUTA and FICA, see [Understanding Special Tax Issues Concerning Independent Contractor and Employee Classification](#). See also [Chart – Federal and State Practice Notes and XperthHR Content \(Unemployment Insurance Tax \(FUTA/SUTA\)\)](#).

In 2007, the California Supreme Court expressly distinguished between Cal. Lab. Code §§ 203 and 226.7. See *Murphy v. Kenneth Cole Productions, Inc.*, 40 Cal. 4th 1094 (2007). Specifically, the court held that payments made under Cal. Lab. Code § 203 are penalties, not wages. *Murphy*, 40 Cal. 4th at 1108–1109. In contrast, the court held that payments made under Cal. Lab. Code § 226.7 were wages rather than penalties. *Id.* Thus, parties to a settlement should treat penalties under Cal. Lab. Code § 226.7 as wages (for both federal and California tax purposes). But, in most other cases, when employers pay penalties directly to employees, they should treat such penalty payments as income but not wages.

IRS Chart Showing Taxation and Reporting Requirements for Various Types of Payments

In 2008, the IRS developed a chart showing taxation and reporting requirements for a wide variety of types of payments that employers make to employees. See PMTA 2009-035 (Oct. 22, 2008). The chart also states whether the parties should characterize the payment as wage or non-wage payments. We provide this chart below:

Payment Character	Income Taxable?	Wages (FICA and ITW [income tax withholding])?	Reporting Requirement
Back pay (other than lost wages received on account of personal physical injury or physical sickness)	Yes	Yes (If the case is in the 8th Circuit, and involves an illegal refusal to hire, contact CC:TEGE:EOEG:ET2 for guidance.)	W-2
Front pay	Yes (If the case is in the 5th Circuit, contact CC:TEGE:EOEG:ET2 for guidance.)	Yes	W-2
Dismissal/severance pay	Yes	Yes	W-2
Compensatory or consequential damages paid on account of personal physical injuries or physical sickness	Generally, no	No	None
Compensatory damages not paid on account of personal physical injuries or physical sickness (e.g., emotional distress)	Generally, yes	No	1099-MISC, Box 3
Consequential damages not paid on account of personal physical injuries or physical sickness	Yes	No	1099-MISC, Box 3
Punitive/Liquidated damages	Yes	No	1099-MISC, Box 3
Interest	Yes	No	1099-INT, Box 1 (if \$600 or more)
Costs	Yes	No	1099-MISC, Box 3
Medical expenses	Generally, no	No	None

Payment Character	Income Taxable?	Wages (FICA and ITW [income tax withholding])?	Reporting Requirement
Overtime	Yes	Yes	W-2
Restoration of benefits: Health Premiums, TSP employee and employer contributions, and retirement contributions	To be determined	To be determined	To be determined
Taxes—employee income tax or employee portion of FICA	Yes	Yes. See Publication 15-A	W-2
Travel—if requirements of § 62(c) (accountable plan) are met	No	No	No
Travel—if requirements of § 62(c) are not met	Yes	Yes	W-2

Unique Issues Concerning Taxation and Reporting of Attorney’s Fees

Most settlements include payments for attorney’s fees. Below we discuss key issues concerning taxation and reporting of attorney’s fees.

Are Attorney’s Fees Taxable to a Plaintiff?

In 2005, the U.S. Supreme Court held that attorney’s fees are taxable income to the plaintiffs. See *Banks v. Comm’r*, 543 U.S. 426 (2005). When read in conjunction with *Banks*, Treasury Regulation § 1.6041 provides that attorney’s fees are income to the plaintiff, and to the extent that the attorney’s fees exceed \$600, they must be reported on a Form 1099 MISC, box 3 to the plaintiff.

Fee Shifting Statutes

A fee shifting statute provides that a losing party in a litigation must pay the winning party’s legal fees and costs. The Supreme Court in *Banks* decided not to address whether attorney’s fees constitute income to a plaintiff under a fee shifting statute. This issue remains unsettled and may depend upon state law. For instance, the California Supreme Court held that if there is no contract providing for the disposition of attorney’s fees, then they belong to the attorney who earned them. See *Flannery v. Prentice*, 26 Cal. 4th 572 (2001). This holding suggests that attorney’s fees do not constitute income to the plaintiff under a fee shifting statute. However, the IRS has stated that attorney’s fees paid under a fee shifting statute constitute income to a plaintiff. PMTA 2009-035 (Oct. 22, 2008). As of February 2017, there is no definitive law on this issue from a tax reporting perspective.

How Do Attorneys Report Attorney’s Fees?

To the extent income is reported to an attorney, it is reported in accordance with I.R.C. § 6045(f) on Form 1099-MISC. See also Treas. Reg. § 1.6045-5. Further, the regulations governing reporting payments to attorneys expressly explain that Form 1099s are issued to both plaintiff’s counsel and plaintiff. Treasury Regulation § 1.6045-5(f) provides several examples, including the following two:

Example 1. One check--joint payees--taxable to claimant. Employee C, who sues employer P for back wages, is represented by attorney A. P settles the suit for \$300,000. The \$300,000 represents taxable wages to C under existing legal principles. P writes a settlement check payable jointly to C and A in the amount of \$200,000, net of income and FICA tax withholding with respect to C. P delivers the check to A. A retains \$100,000 of the payment as compensation for legal services and disburses the remaining \$100,000 to C. P must file an information return with respect to A for \$200,000 under paragraph (a)(1) of this section. P also must file an information return with respect to C under sections 6041 and 6051, in the amount of \$300,000. See Sec. 1.6041-1(f) and 1.6041-2.

....

Example 3. Separate checks--taxable to claimant. C, an individual plaintiff in a suit for lost profits against corporation P, is represented by attorney A. P settles the suit for \$300,000, all of which will be includible in C’s gross income. A requests P to write two checks, one payable to A in the amount of \$100,000 as compensation for legal services and the other payable to C in the amount of \$200,000. P writes the checks in accordance with A’s instructions and delivers both checks to A. P must file an information return with respect to A for \$100,000 under paragraph (a)(1) of this section. Pursuant to Sec. 1.6041-1(a) and (f), P must file an information return with respect to C for the \$300,000.

Treas. Reg. § 1.6045-5(f). In each of these examples the plaintiff gets an IRS Form 1099-MISC, box 3, regardless of whether there is one joint check or two separate checks, and plaintiff’s counsel gets his or her own Form 1099 for the amount of the fees on an IRS Form 1099-MISC, box 14.

Tax Deductions for Plaintiffs on Attorney’s Fees Paid in Discrimination Cases

The American Jobs Creation Act of 2004 (JOBS Act), Pub. L. No. 108-357, 118 Stat. 1418 (Oct. 22, 2004) alleviated the problem of plaintiffs being taxed on attorney’s fees in discrimination cases. Under the JOBS Act, plaintiffs may take deductions for attorney’s fee payments in discrimination cases that are above-the-line, making them potentially tax neutral, but only up to the amount of the settlement award. I.R.C. § 62(a)(20). For example, suppose the parties settle a discrimination case for \$100,000 in damages to plaintiff and \$125,000 in attorney’s fees. Plaintiff would have \$225,000 in gross income, but a \$125,000 above-the-line deduction. This deduction results in net taxable income of only \$100,000, the same amount as he or she would actually receive.

Class Action Settlements

For claims-made class action settlements—where defendants agree to pay settlement awards to qualifying class members who send in claims for payments—there is also an administrative exception to the general rule that attorney’s fees are taxable income to plaintiffs. The exception for claims-made settlements is based on an IRS memorandum. See Office of Chief Counsel Memorandum, PRENO-111606-07, May 18, 2007. The legal justification for the IRS’s position is somewhat suspect, but no one has challenged it because it benefits taxpayers. Therefore, for claims-made settlements, attorneys can exclude attorney’s fee payments from inclusion in plaintiffs’ taxable income. However, the IRS may eliminate this exception for claims-made settlements at its discretion.

Income and Employment Tax Consequences When a Plaintiff Receives Attorney’s Fees and Interest Related to Back Pay

In Revenue Ruling 80-364—1980 IRB LEXIS 243, the IRS addressed the income and employment tax consequences when a court awards attorney’s fees and interest related to back pay claims. The IRS stated that attorney’s fees and interest are generally not wages to a plaintiff unless there is no specific allocation. This revenue ruling also likely would apply to settlements.

IRS Charts Showing Taxation and Reporting Requirements for Attorney’s Fees

In 2008, the IRS developed charts showing taxation and reporting requirements for attorney’s fees. See PMTA 2009-035 (Oct. 22, 2008). We provide these charts below:

Tax and Reporting Treatment of Attorneys’ Fees

Total Employer Payment Made Jointly to Attorney and Employee:

Nature of Payment	Income Taxable to employee?	Reporting to Employee	Reporting to Attorney
Court award designating attorneys’ fees (Workers’ rights statutes, such as Title VII, generally include fee-shifting provisions.)	Yes—attorneys’ fees generally taxable to employee.	Attorneys’ fees reportable in Box 3 of 1099-MISC (not W-2). Treas. Reg. § 1.6041-1(f) (1) and (2).	Box 14 of 1099-MISC in the amount of the check payable jointly to employee and attorney. Treas. Reg. § 1.6045-5(a), and (f) Ex. 1.
Court award without designation of attorneys’ fees	Yes—attorneys’ fees generally taxable to employee.	The total award is reportable, as appropriate (on 1099-MISC or W-2).	Box 14 of 1099-MISC in the amount of the check payable jointly to employee and attorney. Treas. Reg. § 1.6045-5(a), and (f) Ex. 1.
Settlement payment	Yes—attorneys’ fees generally taxable to employee.	To be determined based on the nature of the action. If wages, reportable on W-2. If not wages, reportable in Box 3 of 1099-MISC.	Box 14 of 1099-MISC in the amount of the check payable jointly to employee and attorney. Treas. Reg. § 1.6045-5(a), and (f) Ex. 1.

Separate Employer Payments to Employee, and to Attorney for Attorneys' Fees:

Nature of Payment	Income Taxable to Employee?	Reporting to Employee	Reporting to Attorney
Court award designating attorneys' fees (Workers' rights statutes, such as Title VII, generally include fee-shifting provisions.)	Yes—attorneys' fees generally taxable to employee.	Attorneys' fees reportable in Box 3 of 1099-MISC (not W-2) even though paid separately to attorney. Treas. Reg. §1.6041-1(f)(1) and (2).	Box 14 of 1099 MISC to attorney in the amount of check payable to attorney. Treas. Reg. § 1.6045-5(a), and (f) Ex. 3.
Court award without designation of attorneys' fees	Yes—attorneys' fees generally taxable to employee.	The total award is reportable, as appropriate (on 1099-MISC or W-2) even though attorneys' fees paid separately to attorney. Treas. Reg. §1.6041-1(f)(1) and (2).	Box 14 of 1099 MISC to attorney in the amount of check payable to attorney. Treas. Reg. § 1.6045-5(a), and (f) Ex. 3.
Settlement payment	Yes—attorneys' fees generally taxable to employee.	To be determined, based on the nature of the action. If wages, reportable on W-2. If not wages, reportable in Box 3 of 1099MISC.	Box 14 of 1099MISC to attorney in the amount of check payable to attorney. Treas. Reg. § 1.6045-5(a), and (f) Ex. 3.

Total Employer Payment to Employee:

Nature of Payment	Income Taxable to Employee?	Reporting to Employee	Reporting to Attorney
Court award designating attorneys' fees (Workers' rights statutes, such as Title VII, generally include fee-shifting provisions.)	Yes—attorneys' fees generally taxable to employee.	Attorneys' fees reportable in Box 3 of 1099-MISC (not W-2). Treas. Reg. § 1.6041-1(f)(1) and (2).	None. <i>See, e.g.</i> , Treas. Reg. § 1.6045-5(a), (d)(4), and (f) Ex. 4.
Court award without designation of attorneys' fees	Yes—attorneys' fees generally taxable to employee.	The total award is reportable, as appropriate (on 1099-MISC or W-2).	None. <i>See, e.g.</i> , Treas. Reg. § 1.6045-5(a), (d)(4), and (f) Ex. 4
Settlement payment	Yes—attorneys' fees generally taxable to employee.	To be determined, based on the nature of the action. If wages, reportable on W-2. If not wages, reportable in Box 3 of 1099MISC.	None. <i>See, e.g.</i> , Treas. Reg. § 1.6045-5(a), (d)(4), and (f) Ex. 4.

Total Employer Payment to Attorney:

Nature of Payment	Income Taxable to Employee?	Reporting to Employee	Reporting to Attorney
Court award under fee-shifting statute designated as attorneys' fees (Workers' rights statutes, such as Title VII, generally include fee-shifting provisions.)	Yes—attorneys' fees generally taxable to employee.	Attorneys' fees reportable in Box 3 of 1099-MISC (not W-2). Treas. Reg. § 1.6041-1(f)(1) and (2).	Total amount of check reported on 1099 MISC, box 14. Treas. Reg. § 1.6045-5(a) and (d)(4).
Court award without designation of attorneys' fees	Yes—attorneys' fees generally taxable to employee.	The total award is reportable, as appropriate (on 1099 or W-2).	Total amount of check reported on 1099 MISC, box 14. Treas. Reg. § 1.6045-5(a) and (d)(4).

Nature of Payment	Income Taxable to Employee?	Reporting to Employee	Reporting to Attorney
Settlement payment	Yes—attorneys’ fees generally taxable to employee.	To be determined, based on the nature of the action. If wages, reportable on W-2. If not wages, reportable in Box 3 of 1099-MISC.	Total amount of check reported on 1099 MISC, box 14. Treas. Reg. § 1.6045-5(a) and (d)(4).

Tax Consequences of Settlement Allocations

The IRS and state tax agencies are not parties to settlements between employers and employees. Thus, they need not respect the tax consequences inherent in such settlements. The parties’ characterization or division of settlement amounts is therefore not binding on the government. *Hemelt v. Comm’r*, 122 F.3d 204, 208 (4th Cir. 1997); *Vincent v. Comm’r*, T.C. Memo 2005-95; see also Treas. Reg. § 31.3121(a)-1(c). Instead, the nature of the claim that was the basis for actual settlement, but not the validity of the claim, controls the characterization of the income for tax purposes. *Bagley v. Comm’r*, 105 T.C. 396, 406 (1995); *Allum v. Comm’r*, T.C. Memo 2005-177. Determination of the nature of the claim is primarily a factual question that is generally made by reference to the settlement agreement. *Robinson v. Comm’r*, 102 T.C. 116, 126 (1994). Inquiry is based on payor’s intent or dominant reason for making payment. *Knuckles v. Comm’r*, 349 F.2d 610, 613 (10th Cir. 1965); *Metzger v. Comm’r*, 88 T.C. 834, 847 (1987). However, intent of the parties is not controlling. *Dotson v. United States*, 87 F.3d 682, 687 (5th Cir. 1996). Courts will make the following inquiry:

[T]he classification of amounts received in settlement of litigation is to be determined by the nature and basis of the action settled, and amounts received in compromise of a claim must be considered as having the same nature as the right compromised. . . . These two considerations lead us to our test: it “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?’” (citations omitted).

Alexander v. IRS, 72 F.3d 938, 942 (1st Cir. 1995).

When Will Courts or Taxing Agencies Respect the Allocation of Settlement Amounts?

A court or taxing agency will respect the allocation of a settlement amount if the parties enter into it:

- In an adversarial relationship
- At arm’s length –and–
- In good faith

It is not sufficient for the parties to reach a settlement figure in an adversarial relationship; rather, the parties must base the allocation on adversarial positions. For instance, in a lawsuit against a bank for failure to release a lien on a property, the parties settled for about \$10 million after a jury verdict for about \$60 million, which included \$6 million for lost profits, \$1.5 million for mental anguish, and \$50 million for punitive damages. *Robinson v. Comm’r*, 102 T.C. 116, 121 (1994). Plaintiff tried to allocate 95% of the settlement to mental anguish, which was not taxable at the time. *Robinson*, 102 T.C. at 117. The court rejected the settlement allocation because the parties did not base it on a reasonable allocation consistent with the alleged claims in the action. *Robinson*, 102 T.C. at 133–34, *aff’d in part and rev’d in part on other grounds by Robinson v. Comm’r*, 70 F.3d 34 (5th Cir. 1995). See also *Vincent v. Comm’r*, T.C. Memo 2005-95.

In addition, there is some authority stating that a person is bound by the tax consequences of their settlements. For example, a federal district court addressed the plaintiff’s assertion that, to the extent that any portion of her settlement proceeds is subject to withholding, she is entitled to have that amount grossed up (i.e., a reimbursement for the taxes paid on that portion of the settlement). *Josifovich v. Secure Computing Corp.*, 2009 U.S. Dist. LEXIS 67092 (D.N.J. July 31, 2009). In *Josifovich*, the plaintiff cited to *Eshelman v. Agere System Inc.*, 554 F.3d 426 (3d Cir. 2009), which held that courts had equitable power under the state laws at issue to increase a jury award to make a prevailing employee whole for the tax withheld on the back pay awarded to her. The court in *Josifovich* rejected this argument, noting that the plaintiff entered into a settlement agreement voluntarily, and thus, “as opposed to the recipient of a jury award, possessed control in arriving at the terms of the settlement and the amount of the payment.” *Josifovich*, 2009 U.S. Dist. LEXIS 67092, at *18.

The court added that it would not alter the terms of that voluntary settlement agreement and require Defendant to pay more simply because Plaintiff now, after the close of negotiations, is dissatisfied with the anticipated tax consequences of her agreement. A settlement agreement is a contract and, consequently, a court will not rewrite that contract simply to provide one party with a better bargain than the one she negotiated.

Josifovich, 2009 U.S. Dist. LEXIS 67092, at *17–18.

Therefore, at least in the context of settlements, taxpayers should be stuck with the tax consequences of their agreements. It is also important to note that taxes that an employer withholds from the employee's wages are deemed to have been paid to the employee and are thus part of the employee's income for tax purposes. I.R.C. § 3123. For example, if the employer pays an employee \$1,000 and withholds \$326.50 for FICA and federal income taxes so that the employee's check is only \$673.50, the employee is still treated as if he or she received \$1,000. Thus, this undercuts any argument that an employee did not receive the full amount of the settlement.

Allocate a Reasonable Amount of the Settlement Payment to Wages

The main issue regarding an employer and a settlement agreement from a taxing agency view is whether the parties allocated a reasonable amount to wages, and thereafter whether they withheld and remitted the correct amount of taxes. If there are multiple allocations for non-wage (but taxable) payments, the taxing agency has little incentive or interest to address the matter with the employer, as long as the employer reports the payments (if more than \$600 combined) on a Form 1099-MISC.

Start with the plaintiff's complaint when determining whether a settlement allocation is appropriate.

Once you determine the potential damages, then you should review the relative strength of any claims. For example, you must consider the duration of plaintiff's employment with the employer in determining a claim for back pay. Also, former employees must mitigate their damages. Therefore, you should determine if and when a former employee obtained a new job (or jobs) after leaving the employer and at what salary or pay rate. The facts will often show that the employee lost little if any wages, either because he or she did not leave the defendant-employer or because he or she quickly found a new position for at least the same salary or pay rate. In such circumstances, the parties may reasonably allocate a relatively small portion of the settlement payment to wages.

In addition, advise the employer to document the reasons for the allocation of the payment based on whatever investigation the employer has conducted. This step will help if a taxing agency later audits the settlement agreement. For example, if an investigation shows that a plaintiff claiming harassment often visited a psychologist to discuss the harassment, it may support the employer's decision to allocate a significant portion of the settlement payment to emotional distress or other compensatory damages regarding the harassment claim.

There is no clear test for determining the reasonableness of an allocation. The settlement amount is frequently less than the potential damages that a court could award under one cause of action, let alone the whole complaint. This is particularly true when dealing with employment law class and collective action claims. It is therefore essential to carefully document the settlement negotiations and conduct the negotiations in an adversarial arm's length manner. An adversarial arm's length negotiation is crucial in establishing that the parties' settlement allocations were reasonable.

Consequences of Misallocation of Settlement Payments

As noted above, an employer is liable to withhold at the source on all wage payments. Failure to do so subjects the employer to 100% liability for such failure. Simply put, either the employer can withhold taxes owed by employees from the employee's wages, or it can pay those taxes itself. On settlements, all back wages are subject to the following taxes paid by the employee:

- Federal income tax withholding (could be 25%)
- State and/or local income tax withholding, if such taxes exist
- Social Security tax (6.2% up to the wage base limit, which is \$127,200 in 2017)
- Medicare tax (1.45%)
- Other miscellaneous state taxes (e.g., California State Disability Insurance Tax)

All back wages are also subject to the following taxes paid by the employer:

- Social Security tax (6.2% up to the wage base limit, which is \$127,200 in 2017)
- Medicare tax (1.45%)
- Federal Unemployment Insurance Tax (likely around 1% but can go up to 6% on first \$7,000 paid per year)
- State Unemployment Insurance Tax (anywhere from a few hundred to a few thousand)
- Other state level taxes (e.g., California Employment Training Tax)

When added together, an employer could be paying over 40% in taxes if it fails to withhold and remit the employees' taxes from any wages paid. Penalties for late payment or failing to withhold and remit plus interest can make the sums owed substantial. In recent years the IRS has become aggressive about auditing settlement agreements and pushing back on allocations that are less than 100% wages when payments are made to current or former employees. Thus, it is important to carefully document all settlements.

Guidance for Pushing Back on Opposing Counsel Who Request and/or Demand Improper Settlement Allocations

It is common for plaintiff's counsel to seek to limit the taxes that plaintiffs must pay on settlements. In contrast, the government is interested in maximizing the amount of taxes that are paid on settlements. Employers should have an interest in proper tax reporting and reasonable allocation based on the claims. As such, employers should not just accept any allocation that plaintiff's counsel proffers. A few tips include:

- **Don't assume there is a standard allocation, such as 1/3 wages, 1/3 non-wages, and 1/3 attorney's fees.** Allocate all settlements based on their own facts.
- **Ensure that the causes of action allow for the kinds of damages being settled.**
- **Don't rely upon indemnity provisions.** The IRS looks at indemnity provisions as evidence that the employer is seeking to aid the employee in impermissibly reducing proper taxes. It is often difficult to enforce such provisions against former employees for a variety of practical reasons (e.g., the employer cannot find the former employee, or the former employee does not have the money to indemnify).
- **Be specific about allocations in any settlement agreement.** This is because specific allocations are harder to challenge.
- **Document the reasons for the allocation.** For example, if lost wages are small because the employee obtained other employment, document that fact to support the allocation.

This excerpt from Lexis Practice Advisor[®], a comprehensive practical guidance resource providing insight from leading practitioners, is reproduced with the permission of LexisNexis. Lexis Practice Advisor includes coverage of the topics critical to attorneys who handle legal matters. For more information or to sign up for a free trial visit www.lexisnexis.com/practice-advisor. Reproduction of this material, in any form, is specifically prohibited without written consent from LexisNexis.

Learn more at: lexisnexis.com/practice-advisor



LexisNexis, Lexis Practice Advisor and the Knowledge Burst logo are registered trademarks of Reed Elsevier Properties Inc., used under license. © 2017 LexisNexis. All rights reserved.