Robert W. Wood examines the tax treatment of employment settlements.

Claims for wrongful termination, sexual harassment and various forms of discrimination (especially race, gender, age and disability), have burgeoned over the last few decades. To a lesser (but still significant) extent, litigation over the tax treatment of the resulting settlements and judgments has also been active. Several tax cases in this field have even gone to the U.S. Supreme Court.1

In 1996, Congress amended Section 104 of the Internal Revenue Code (“the Code”) to require a “physical” injury or “physical” sickness in order for its exclusion from income to be available. The legislative history to this 1996 law makes it clear that the primary target of this amendment was employment litigation.2 In the 1980s and early 1990s, it had become commonplace for most discrimination (and other types of employment) recoveries to be largely allocated not to taxable wages, but rather to nontaxable emotional distress damages.

The case law was mixed, with some taxpayers succeeding in excluding their damages from income and others not. Still, exclusions from income under the auspices of Code Sec. 104 were rampant. All that changed in 1996 with the tightening of Code Sec. 104. Or did it?

The IRS and taxpayers have struggled with the changes to Code Sec. 104 and the sometimes metaphysical qualities of just what is “physical.”3 To some extent, the IRS has been hoisted by its own petard. Indeed, although the statute itself was changed 13 years ago, the IRS has not revised its regulations under Code Sec. 104.4 Moreover, the IRS has not even issued notices or announcements.

The IRS has failed to give its views (save in private letter rulings) for how Code Sec. 104 in this context should be applied. Tax advisors and taxpayers need better and clearer guidance. All these many years later, the best evidence of the IRS’s views of Code Sec. 104 remains the “bruise” ruling, LTR 200041022.5 This guidance bifurcates a sexual harassment recovery into the pre-physical and post-physical parts, the latter being excludable.6

New Dawn

The IRS has now released a memorandum entitled Income and Employment Tax Consequences and Proper Reporting of Employment-Related Judgments and Settlements (hereinafter, “IRS Memo”). Although it was released in July of 2009,7 it bears a date of October 22, 2008. It is a memorandum addressed to various IRS employees from John Richards, Senior Technician Reviewer in Employment Tax Branch 2.

Noting that the memorandum cannot be used or cited as precedent, its stated purpose is to outline the information necessary to determine the income and employment tax consequences (and appropriate reporting) of employment-related settlements and judgments. It states that it supersedes a memorandum dated September 9, 2004.

Party Line

The memo is 20 pages long, and should be useful reading for employment lawyers (both plaintiff and defendant) as well as tax lawyers and accountants. The IRS lays out the predictable references to the origin of the claim doctrine, the nature of severance pay, back pay and front pay (all wages), the nature of punitive damages (always taxable), etc. The IRS Memo even
includes a helpful list of different causes of action, including those arising under the Back Pay Act (5 USC §5596(b)(1)), Title VII of the Civil Rights Act of 1964, the Age Discrimination in Employment Act (ADEA), the Americans with Disabilities Act (ADA), the Fair Labor Standards Act (FLSA) and many others.

Concerning our old friend Code Sec. 104, the IRS Memo predictably specifies that for an exclusion to be available, the claim must be for a tort or tort-like injury. Naturally, the IRS Memo cites E.E. Schleier. It then goes on to address what constitutes physical injury.

Here, the IRS Memo disappoints. It merely cites Rev. Rul. 85-97. That old saw involved a bus accident. The IRS Memo then states:

NOTE: Damages recovered from an employment-related dispute generally are not recoveries for a personal physical injury. Thus, employment-related judgment/settlement amounts will generally be included in the employee's gross income. Therefore, the most difficult questions usually are whether the amounts are wages for employment tax purposes, and the proper reporting of the amount (Form 1099 or Form W-2, and reporting of attorneys' fees on Form 1099).

Attorney Fees

The IRS Memo spends a brief two pages on attorney fees and J.W. Banks, II. Interestingly, the IRS Memo states that Banks resolved a conflict in the Circuits, the Supreme Court agreeing with the IRS that taxpayers must include contingent fees in income. There is no mention of the fact that the Supreme Court enunciated this as a "general rule," nor that the Supreme Court identified exceptions it was not addressing.

Nevertheless, regarding attorney fees and so-called fee-shifting statutes, the IRS Memo states:

The Service's position is that generally fees awarded to prevailing plaintiffs under federal and state fee-shifting statutes belong to the plaintiff and not to the lawyer. See, e.g., Evans v. Jeff D., 475 U.S. 717, rehearing denied 476 U.S. 1179 (1986).

Indeed, the IRS notes:

We construe Banks and the AJCA [the Jobs Act provision allowing an above-the-line deduction] as endorsing the Service's position that attorneys' fees awarded under a fee-shifting statute constitute an item of gross income to the client. Although the Court in Banks did not decide this issue, it noted that the AJCA redresses the concern for many, if not most, claims governed by fee-shifting statutes.¹³

Employment Taxes

The IRS Memo does a credible job of dealing with FICA and FUTA taxes, and with the authorities detailing back pay and front pay. There has been some litigation (which the IRS notes) concerning front pay, with the Fifth Circuit Court of Appeals holding that only the back pay portion of a settlement was wages for FICA purposes. The IRS notes (with evident glee) that most appellate courts have disagreed with the Fifth Circuit.

The employment tax discussion also notes such important decisions as Cleveland Indians Baseball Co. Here again, the IRS is able to state that the U.S. Supreme Court "agreed with the IRS's long-standing position, holding that employment taxes on back wages are calculated with respect to the period during which the wages are actually paid, rather than the period during which the wages should have been paid."¹⁶

One of the most interesting discussions in the IRS Memo concerns allocations of payments. Arguably, this is the elephant in the room. The IRS Memo notes that settlements and judgments can comprise multiple elements, each of which may or may not be wages. The IRS seems to think this allocation issue is only a wage-versus-nonwage one. The IRS does not confront the issues associated with the allocation of excludable and taxable amounts, though presumably the same principles should apply.

The IRS Memo notes that a court award may break everything down piece by piece. In the case of a settlement payment, however, the IRS notes that "the parties must determine the elements of the settlement amount."¹⁷ But how do we do this? The IRS says one should consider all the facts and circumstances.

More particularly, the IRS notes that it generally considers the following facts and circumstances in determining whether to accept an allocation of damages in a settlement agreement or in a final judgment:

- Whether there was a bona fide adversarial settlement as to the allocation of payment between types of recoveries (for this the IRS cites E.E. Robinson¹⁹)
- Whether the terms are consistent with the true substance of the underlying claims¹⁹
Attorney Fees As Wages

In what is so far a vanilla IRS Memo, I found the extent to which the IRS addresses Rev. Rul. 80-364 to be surprising.²⁰ That 1980 ruling considers whether attorney fees and interest awarded with back pay are wages for employment tax purposes. After a recitation of the different factual situations analyzed in the revenue ruling, the IRS Memo addresses settlement payments, noting (quite correctly) that most employment-related disputes are settled rather than tried. The IRS Memo then states:

Whether attorneys’ fees recovered in a settlement of an action under a fee-shifting statute are excluded from wages is an open question. For example, if a suit for back pay under Title VII is settled, and provides for back pay and attorneys’ fees in the settlement agreement, the question arises whether the portion of the settlement characterized as attorneys’ fees is wages.²¹

The IRS Memo states that if this issue arises, the IRS National Office should be contacted for guidance.

In my experience, virtually no one in practice suggests that the plaintiff attorney fees even in a strictly wage case should be treated as wages. The IRS seemingly would also want to avoid this result. In LTR 200244004,²² the IRS addressed wage treatment for attorney fees related to an employment discrimination suit brought under the ADEA. The IRS acknowledged that the ADEA contains a fee shifting component. Not only that, but pursuant to the analysis in Rev. Rul. 80-364, had the employee prevailed in litigation under the ADEA, he would have received an award of attorney fees.

That would be in addition to the back wage award. Thus, LTR 200244004 concludes that the attorney fees paid under a settlement agreement in such an employment suit are not wages for federal employment tax purposes. That result (however one reaches it) seems appropriate.

Of course, the IRS has said—in this very same memo—that the presence of a right to a statutory fee as a means of avoiding gross income to the client is not necessary. The above-the-line deduction (for employment cases) takes care of that problem, the IRS Memo says. Here, of course, the IRS is talking not of income, but of wage characterization, something the above-the-line deduction would not fix.

To state the pure analytical case, consider a lawsuit (brought by one person or many) that seeks only wages, with no other types of damages. Such suits are rare, but they do occur (some FLSA cases, for example, are of this ilk). If the plaintiff will receive 100-percent wages, and the lawyer is being paid a contingent fee of 40 percent, how is the employment and income tax withholding to be accomplished?

The choices would seem to be:

- Withhold on the client’s share only, and pay the lawyer his gross 40-percent fee with no withholding.
- Withhold on 100 percent, thus shorting the lawyer, and doubtless requiring continued relations between client and lawyer at least into the next tax year, with the lawyer having a claim on monies withheld and paid over to the IRS.
- Withhold only on the client’s 60 percent, but at a rate (for both income and employment tax purposes) that takes into account the 40 percent being paid to the lawyer with no withholding. The idea of this new math would be to attribute the income (as wages) to the client, as if the client were really receiving the full 100 percent.

If anyone were to pick Choice 2 or Choice 3 (both nonchoices as far as I’m concerned), there are interesting analytical issues. For example, how would the plaintiff deduct the legal fees? Even an above-the-line deduction would not make the plaintiff whole. Quite apart from the timing problem created by withholding, how could the plaintiff recover his share of the employment taxes on the lawyer’s 40-percent contingent fee? These are interesting questions, but they are surely academic. After all, would anyone select Choice 2 or Choice 3? In my experience, no. I can count on one hand the number of times in 30 years of tax practice I’ve heard an employer in a wage case bristle about the potential need to withhold on the lawyer’s share of the funds. In the paucity of cases where I have heard such bristling, it has uniformly (and quite easily I might add) been dispelled.
It might be dispelled by someone like me arguing that there is a right to a statutory fee, so that LTR 200244004 provides some comfort. Alternatively, it might be dispelled by plaintiff’s counsel saying unabashedly to the employer: “If you withhold on the lawyer fees too, this case will not settle.” That can be pretty convincing, even if it isn’t overly analytical.

It seems that such stonewalling by the plaintiff’s counsel (if you want to call it that) is likely to have the desired effect. Surely, most companies are not too concerned about their exposure to failure to withhold penalties (even in a 100-percent wage case) if they don’t withhold on the attorney fees. Put differently, in all likelihood, the companies are far more afraid of failing to settle the lawsuit than they are of being accused of failing to withhold on the attorney fees.

I will admit that this is a messy area. How to treat contingent legal fees in a 100-percent wage case represents an interesting analytical conundrum. But as a practical matter, I’ve found it to be a nonissue. If the IRS’s “call the National Office” admonition means that the IRS is thinking differently on this, I foresee a mess—one that probably won’t end up gaining the IRS either revenue or friends.

**Third-Party Payors**

An interesting (although brief) discussion in the IRS Memo concerns third-party payors. The IRS correctly notes that an agency other than the employing agency may, in some cases, pay an amount to an employee in satisfaction of a settlement or judgment. Where this occurs, the IRS notes, the agency having control of the payment of wages is responsible for withholding.

**Reporting**

Finally, the IRS Memo discusses reporting requirements, including wage reporting, special requirements for back pay, Form 1099 reporting, and payments to attorneys. These topics are only briefly noted, with no detail.

Helpfully, however, the IRS Memo does include a number of charts. Tax rules rarely seem to lend themselves to charts, and for that reason, these charts are worth a look. As fun as it is to have some charts, they may give the illusion of precision. In the area of the taxation of employment settlements, it is an understatement to say that the current state of the law is not precise.

**Conclusion**

There has not exactly been an outpouring of guidance from the IRS on the tax issues arising in employment litigation since 1996. We need more guidance on the Code Sec. 104 issues; and we need more guidance on fringe and pension benefit issues. It is a step in the right direction that the IRS has issued some guidance in the IRS Memo.

In some ways, it is good that the IRS may be focusing on the wage-versus-nonwage issue. Indeed, it seems to me that practice regarding wage-versus-nonwage allocations in settlements varies too wildly. Sometimes the wage-versus-nonwage issue is addressed without fair regard to the causes of action and the facts. The IRS probably should look at such issues more closely.

However, the suggestion that attorney fees may be subject to wage withholding is frightening, at least to me. I admit I may be overreacting. After all, perhaps the IRS might respond to calls to the National Office with, “Don’t worry, don’t require withholding on the attorney fees.”

In any case, if you are an employment lawyer, tax practitioner, plaintiff or defendant in an employment dispute, this IRS Memo is worth reading. Given that not too much guidance is being issued on these matters, you have to take what you can get.

**Endnotes**

1. Robert W. Wood is the author of TAXATION OF DAMAGE AWARDS AND SETTLEMENT PAYMENTS (3d Ed. 2008) and QUALIFIED SETTLEMENT FUNDS AND SECTION 468B (2009). This article is not intended as legal advice and cannot be relied upon for any purpose without the services of a qualified professional.
3. In fact, in one of the ill-fated Murphy opinions decided by the D.C. Circuit Court of Appeals, the court stopped short of castigating the IRS and the Treasury, but the court’s displeasure over the lack of regulatory attention was palpable. See M. Murphy, CA-DC, 2006-2 USTC ¶50,476, 460 F3d 79, vac’d, CA-DC, 2007-1 USTC ¶50,228.
4. LTR 200041022 (July 17, 2000).
6. Income and Employment Tax Consequences and Proper Reporting of Employment,