To Withhold or Not to Withhold on Settlements?

By Robert W. Wood

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In this article, the author focuses on settlement allocations involving wages, addressing front pay, back pay, and more. The IRS is looking more closely at the wage versus nonwage dichotomy, and the author sifts through myths and examines incentives to payer, payee, and counsel. Practices vary enormously, and, in the author's opinion, many take needless risks. He also comments on a district court decision, *Josifovich v. Secure Computing Corporation*, 2009 U.S. District Lexis 67092 (D.N.J. July 21, 2009), involving a post-settlement fight over the appropriateness of withholding.

Does a settlement payment arising out of an employment dispute constitute wages subject to withholding, or does it constitute nonwage damages? This question has no universal answer. The same can be said for judgments in employment disputes, although they occur considerably less frequently than settlements, which happen every day.

If the plaintiff is suing for lost wages, there will be multiple taxes to pay. Wages are not merely taxable as income, but are subject to withholding and employment taxes. However, if the origin of the suit is physical injuries, even the wage loss is tax free and is not subject to income or employment taxes. That can be confusing, even to those somewhat tutored in tax law.

In an employment action, when a plaintiff is claiming wrongful termination or discrimination based on age, race, gender, or disability, there can be a slippery slope. Often, a portion of the claim is for lost wages, back pay, front pay, or both. Equally as often, some amount of the damages represents a payment for emotional distress or other nonwage damages.

The IRS recognizes those scenarios. In fact, the IRS makes clear (in its instructions to Form 1099-MISC) that nonwage damages should be reported on a Form 1099, not on a Form W-2.[1] All taxpayers instinctively know the difference between wage withholding and receiving a Form W-2, versus no withholding and receiving a Form 1099. Fortunately, plaintiffs and defendants customarily work out those issues as part of the settlement process.

Plaintiff and defendant may arrive at an agreeable wage figure that is large enough to make the employer (or former employer) feel comfortable that it is complying with its withholding obligations. At the same time, the wage component should not be so large that it causes the plaintiff to refuse to settle. For example, a plaintiff and defendant might agree that, of a $1 million settlement, $300,000 represents wages subject to employment taxes, while $700,000 represents nonwage damages. The split might be 50-50, 80-20, 90-10, or any other figure. It all depends on the facts.

Because of the possibility of those critical facts, and because of different people's perceptions of risk and reward, sometimes there can be huge problems. For example, what if the cause of action brought by the plaintiff requests *only* lost wages? In that case, it seems hard to argue that the settlement should somehow be allocated between wages and something else. By the pleadings, it should all be wages.[2]

Conversely, the mere fact that the case arises out of an employment setting does not necessarily mean that any portion of the settlement represents wages. If you sue your employer for defamation and receive a settlement or judgment, the mere fact that your employer is the defendant (rather than some third party) should not make the payment wages.

Variable Risk

Risk and reward represent another huge problem. As a tax adviser to litigants over the last 30 years, I have seen my fair share of controversies. Factually, the parties often disagree over what the settlement monies represent, and over which claims are the most meritorious.

I have also seen an amazingly wide spectrum of practices on those issues. On one end of the spectrum, I have seen employers who seem entirely unconcerned about withholding, when I think their withholding obligation is clear and unambiguous. On the other, I have seen employers who insist on withholding on 100 percent of a settlement, even though it seems eminently clear (to

[1] *See* Instructions to IRS Form 1099-MISC.

[2] For an argument on this point, see Jared D. Mobley, "Attorney Comments on Employment Lawsuit Settlements Article," *Tax Notes*, Sept. 28, 2009, p. 1387, *Doc 2009-21097*, or *2009 TNT 185-19*.

me, at least) that the lion's share of the settlement should *not* be subject to withholding.

If that isn't surprising enough, I have found that I cannot predict the employer's likely reaction based on its size, reputation, counsel, or demographics. I have seen various withholding practices at all types of enterprises, ranging from mom-and-pop businesses to *Fortune* 500 companies. I have found no discernable relationship between the size and sophistication of the company (or lack thereof) and the tax position taken on this point. That is disturbing.

Equally disturbing is what I've seen from plaintiffs. Some plaintiffs will fight tooth and nail to avoid having the employer withhold on *anything*. Although it is true that employment taxes are in part borne by the employee, that extra tax is not what most of the withholding fights are primarily about.

Often, plaintiffs have the misguided sense they will be far better off from a tax perspective (because of the time value of money, or their ability to do some kind of fancy tax transactions) if they receive gross pay rather than net pay. Sometimes they even think the wage versus nonwage fight is about tax versus no tax, relying on a somehow historical (or simply unrealistic) view of section 104. Even for those plaintiffs not caught in this trap, many still think withholding is bad.

Sometimes their lawyers are the ones pushing to avoid withholding, or perhaps for an unreasonably low allocation to wages. The wage versus nonwage allocation fight may be the last grand battle of the litigation, the last element of the controversy, one last skirmish. Sometimes it can represent primarily an issue between lawyer and client.

If the plaintiff is upset that he is settling for only $400,000 when he thinks he should get more, his lawyer may push for no (or minimal) withholding as a way of making the current check larger. Yet appeasing a plaintiff in that way can end up badly when it is time to file tax returns the following year. This is especially true if the plaintiff has never made estimated tax payments and is undisciplined when it comes to financial management.

New Case

All of this was on my mind when I read the district court case of *Josifovich v. Secure Computing Corp.*[3] This is not a tax case. Neither the IRS nor another taxing agency was a party. Yet it is a case solely about withholding and the mess it can become.

Quite apart from my own interest in this case, I've had several telephone calls about it. Some lawyers in the employment field seem to consider *Josifovich* as the be-all and end-all of withholding dynamics concerning settlements. In my view it is not, but I'm getting ahead of myself.

Just the Facts

Diane Josifovich worked as an employee for Secure Computing, and after a falling out, sued her employer alleging that Secure failed to pay commissions she earned. She also claimed that Secure violated the New Jersey Conscientious Employee Protection Act and the New Jersey Law Against Discrimination. She sought various forms of relief, including back pay, front pay, emotional distress damages, attorney fees, and costs.

Eventually, there was a settlement conference. At its conclusion, counsel for the parties put the essential terms of a settlement on the record. The idea, they agreed, was for those basic terms to later be embodied in a formal settlement agreement that would be executed by Josifovich and Secure. So far, so good.

But then something went off kilter. The lawyers had to notify the court that, while reducing the settlement to writing, the parties had been unable to reach agreement on the subject of tax withholding. Both sides agreed that at least some portion of the proceeds were taxable as income to Josifovich.

Still, Secure and Josifovich disagreed whether *any* withholding was required and even if *some* withholding was required, over just how much. Surely this should have been discussed earlier. Indeed, as the court pointed out with evident frustration, neither party had raised the question of withholding during a seven-hour settlement conference!

Most tax advisers will find that fact amazing. Most litigators will not. In any event, when the essential terms of settlement were hammered out on the record, no one said anything about withholding. Zounds!

Brouhaha

How does one resolve withholding questions? Bear in mind that the U.S. magistrate judge faced with deciding Josifovich's tax dispute with Secure is not a tax judge. Ultimately, interpreting the code is the job of the IRS, and the job of the courts when taxpayers and the IRS face off. Should it be the job of judges in nontax cases?

Arguably no, but what's to be done? In the annals of tax lore, one can find numerous cases in which it might seem that the employer is a mere stakeholder, stuck between the plaintiff and the IRS. The IRS, it might seem, is the real party in interest.

There is no indication in the *Josifovich* opinion that the IRS was consulted. Yet it is common knowledge (among tax lawyers, at least) that the IRS *will not join* in litigation, even when a plaintiff and defendant are facing off over tax issues that *should* concern the IRS. Employers such as Secure, who face disputes over withholding from employees and former employees, can rarely count on the IRS for assistance.

In any event, the magistrate judge had to decide what to do. The court started with a thorough review of the authorities on what constitutes income. The judge then turned to the more nuanced question of what kinds of remuneration constitute wages. One of the seminal cases is *Social Security Board v. Nierotko*.[4]

In that classic tax case, the Supreme Court held that a back pay award constituted wages subject to withholding and employment tax. More recently, the Third Circuit held that early retirement benefits given to the faculty of

[3]2009 U.S. Dist. Lexis 67092 (D.N.J. July 31, 2009), *Doc 2009-17641, 2009 TNT 148-7*.

[4]327 U.S. 358 (1946).

an educational institution represented wages, even though, in effect, the faculty member would no longer be rendering any services.[5] Some decisions have said that *Nierotko* means that wages (in the form of back wages or future wages) are all just wages, and therefore are always subject to withholding.[6]

However, the results are not uniform, and some courts have declined to apply employment taxes to front pay. Back pay, those cases reason, is for work that was done or should have been done. That makes them wages for services *actually* rendered. In contrast, front pay seems to be for work that will *never* be conducted.

Whether that line drawing makes sense, it has adherents.[7] Yet, most courts have applied *Nierotko* to front and back pay alike. When an employer seeks to withhold taxes from settlement proceeds and the settlement constitutes compensation for either back or front pay, withholding will generally be upheld.[8] Thus, in *Gerbec v. United States*,[9] the court held that both back and front pay are subject to withholding.

With considerable determination, however, Josifovich contended that *none* of the settlement proceeds to be paid by Secure should be subject to withholding. She was not merely arguing that the front pay should not be subject to withholding, but contending that *no* withholding of *any* of her settlement was justified.

Withholding Judgment

The court had no difficulty in finding that Josifovich was incorrect that no portion of the settlement was subject to withholding. The applicability of withholding to the front pay, however, was a touchier question. The court acknowledged that it may have been true that Josifovich did not actually *perform* services during the front pay period.

Yet the bulk of the tax authorities suggest that, whether or not a plaintiff is reinstated, settlement proceeds allocated to future wages are (like back pay) subject to employment taxes. *Nierotko* remains the leading authority. Having concluded that front pay and back pay paid to Josifovich should be subject to withholding, the court turned to the thorny question of *just how much* should be allocated to each category.

The parties continued to disagree about how the proceeds should be allocated to each claim. Josifovich made claims for breach of contract, promissory estoppel, equitable estoppel, misrepresentation, breach of the implied covenant of good-faith and fair dealing, and two statutory claims under two state employment laws. Emotional distress damages, the court pointed out, were being sought by Josifovich only in one of those counts.

Unfortunately, Josifovich and Secure had merely arrived at a lump sum for all claims, with no allocation of amounts among them. In retrospect, considering how important tax issues in a settlement can be, this term sheet wasn't much of a term sheet at all. Clearly, divvying up the money and determining tax consequences was not this court's job, but there was no one else to do it.

To try to resolve the dispute over the missing terms and enforce the settlement the parties had made, the court had to wade into tax questions up to its neck. The court cites some of the predictable authorities that attempt to allocate settlement proceeds.[10] Sensibly, the court reviewed the plaintiff's economic expert report, among other documents.

Nevertheless, the court said that before it could make a determination of the appropriate amount in each category, it would conduct another hearing. In it, each counsel would be asked to present arguments limited to which actual amounts should be allocated to each element of damages.

Grossing-Up

The court next had to turn to the "tax on tax" issue, also known as a tax gross-up. Josifovich had argued that if the court did determine that any portion of her settlement was subject to withholding, she was entitled to an equitable gross-up of her award. Josifovich relied on the Third Circuit decision in *Eshelman v. Agere Systems, Inc*.[11]

Eshelman is an important case, and one I've covered previously.[12] *Eshelman* may represent a watershed, signaling a new era in the availability of damage gross-ups. Nevertheless, it does not mean one will always prevail in seeking a tax gross-up.

Besides, as the *Josifovich* court recognized, *Eshelman* was about the negative tax consequences of a lump sum. Eshelman was receiving pay in one year that should have been payable over multiple years. The court was persuaded that Eshelman needed extra damages to make up for the bad tax hit she would take on a lump sum payment, as compared with the lower taxes she would have paid on each annual salary amount.

One could easily decide that Eshelman deserved a tax gross-up, and that Josifovich did not. Also, *Eshelman was not about* withholding. The court was therefore not persuaded by Josifovich's position, and denied her request for a tax gross-up.

In the last analysis, the court said it would require Secure to withhold applicable employment taxes from the portion of Josifovich's settlement allocated to back

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[5]*See University of Pittsburg v. United States*, 507 F.3d 165 (3d Cir. 2007), *Doc 2007-24551*, *2007 TNT 214-33*.

[6]*See Appoloni v. United States*, 450 F.3d 185 (6th Cir. 2006), *Doc 2006-10998*, *2006 TNT 110-14*.

[7]*See Dotson v. United States*, 87 F.3d 682 (5th Cir. 1996), *Doc 96-20362*, *96 TNT 140-8*, in which the Fifth Circuit held that only the back pay portion of a settlement was wages for FICA tax purposes.

[8]*See Rivera v. Baker West Inc.*, 430 F.3d 1253 (9th Cir. 2005), *Doc 2005-25068*, *2005 TNT 239-11*. *See also Amalgamated Transit Union Local 880 v. New Jersey Transit Bus Operations, Inc.*, 385 New Jersey Super. Ct. 298 (App. Div. 2006).

[9]164 F.3d 1015 (6th Cir. 1999), *Doc 1999-2311*, *1999 TNT 11-26*.

[10]*See Francisco v. United States*, 267 F.3d 303 (3d Cir. 2001), *Doc 2001-27013*, *2001 TNT 208-8*; *Peaco v. Commissioner*, 48 Fed. Appx. 423, 425-426 (3d Cir. 2002), *Doc 2002-23371*, *2002 TNT 202-18*.

[11]554 F.3d 426 (3d Cir. 2009), *Doc 2009-2478*, *2009 TNT 23-7*.

[12]*See* Robert W. Wood, "Getting Additional Damages for Adverse Tax Consequences," *Tax Notes*, Apr. 27, 2009, p. 423, *Doc 2009-6560*, or *2009 TNT 79-11*.

pay and front pay. Those wage amounts would be reported on a Form W-2. Any settlement proceeds allocated to emotional distress claims, attorney fees and costs, however, would not be subject to withholding, reported instead on a Form 1099.

All of that makes sense. However, how does one implement that requirement and do the necessary line drawing? The court said it would hear (further) oral arguments limited to the proper allocation of the lump sum settlement.

Ruminations

I've long thought the IRS should focus more attention on the wage versus nonwage dichotomy. This is not necessarily because I believe everything in the employment context should be wages. Many payments to settle litigation involving employees are not wages — at least not exclusively.

Yet I have discerned a disturbing tendency for too many people to play fast and loose with this divide. I have no problem with principled allocations, and in fact recommend them, but fast and loose is another matter.

Recently, the IRS said it is looking much more in depth at those issues. In July 2009 the IRS released a memorandum entitled "Income and Employment Tax Consequences and Proper Reporting of Employment-Related Judgments and Settlements."[13] Although it was released in July 2009, it bears the date of October 22, 2008.

The memorandum is 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.[14]

One unfortunate part about the wage versus nonwage issue is that often it is not tax lawyers or tax accountants who are doing the advising. Perhaps that was one factor producing the problems in *Josifovich*. It may be a business person, plaintiff, defendant, or litigation lawyer. The latter may be especially likely to lobby with a kind of knee-jerk reaction for little or no wages.

That can be a big mistake. Apart from the defendant's liability for failure to withhold employment taxes, consider the inconvenience and cost of the plaintiff and defendant having to argue about withholding issues when one or both of them thought the case was resolved. There are some famous examples of litigants tied up for years in separate postdispute litigation about whether they should or should not have withheld.[15] Don't be one of them.

Conclusion

Josifovich clearly does not change the landscape of income and employment tax withholding. However, the case serves as a reminder of an issue that has serious consequences. Issues of tax characterization and allocation should be explicitly addressed in settlement negotiations.

Often, however, when these issues are not addressed and the parties do not agree, the latent tax issues can become a serious impediment to a final resolution of the case. If lawyers and their clients bear this in mind and consider tax issues as an integral part of settlement negotiations, everyone should be better off.

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[13]"Service Explains Tax Consequences and Reporting Obligations for Employment-Related Settlement Payments," Program Manager Technical Advice, 2009-035 (Oct. 22, 2008), *Doc 2009-15305*, *2009 TNT 129-19*.

[14]For full discussion of this IRS memo, see Wood, "IRS Speaks Out on Employment Lawsuit Settlements," *Tax Notes*, Sept. 14, 2009, p. 1091, *Doc 2009-18678*, or *2009 TNT 175-4*.

[15]*See Redfield v. Ins. Co. of North America*, 940 F.2d 542 (9th Cir. 1991).