

Employers' Responsibilities When Making Settlements in Employment-Related Claims

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Employee litigation alleging discrimination or unfair pay practices remains a major potential legal liability for any employer, despite the increasing use of mediation and other negotiated means to settle many such claims without trial. Perhaps only five percent of all employment cases filed are tried to resolution, and an employer's decision to settle generally comes down to economic considerations – particularly given that, once employers are in the courtroom, they often encounter juror mistrust and skepticism when employee claims are heard. Statistics compiled annually by Jury Verdict Research[®] on jury award trends in employment litigation indicate the financial consequences involved:

- Employee lawsuits have risen 400% in the past 20 years to the current annual level of 6.5 claims per 1,000 employees
- In any employment case filed in federal court, there is a 16% chance the award (excluding attorney fees) will exceed \$1 million and a 67% chance that the award will exceed \$100,000
- The average compensatory award in all federal court employment cases (excluding punitive damages or attorney fees) was more than \$490,000 and reflects a 45% increase since 2000
- The cost to settle an employment lawsuit has tripled during the past five years, to an average of more than \$300,000.

The claims that give rise to these sums are often brought by former employees who file wage and hour lawsuits (for missed meal or rest breaks, off-the-clock work, fraud), discrimination and/or harassment lawsuits (based on race, age, disability, or sex), retaliation lawsuits or wrongful termination lawsuits. The most common types of claims in these lawsuits involve wage damages (including lost wages, benefits, front pay, back pay, severance pay), non-wage damages (including emotional distress, loss of enjoyment of life, shame, humiliation, anxiety, worry, loss of self-esteem, injury to reputation), punitive damages, liquidated damages, injunctive relief, statutory penalties, interest, and attorney fees and costs. When an employer settles a case, it is inevitably to avoid greater cost should the claims proceed to trial.

Payment Policy

All employers face the potential risk of an employee lawsuit. That's why it is essential that employers have a policy in place so that every settlement agreement explicitly states the purpose for all payments – for example, as payments in lieu of wages, damages, attorney fees and so on. This lessens the risk that the Internal Revenue Service (IRS) will argue that the claimant and the employer/taxpayer that settled the claims "colluded" to structure the settlement with the most favorable tax status (typically with very little allocation to wages). Such a policy is important because it is generally the case that all of a settlement amount paid to an employee claimant is considered to be taxable income to the claimant – which means that the employer must file either a Form W-2 or Form 1099 for all taxable amounts.

If there is no such specific policy shaping the settlement agreement, any allocation of amounts between multiple claims generally will be determined by reference to the underlying nature of the claims alleged, as well as to evidence of the parties' intent in settling those claims. After-the-fact allocations are inherently more susceptible to attack by the IRS, but can be sustained in some cases where there is evidence in attorney notes, interrogatory responses or versions of the settlement offer supporting the allocation.

Attorney Fees

One of the trickiest settlement payments to address is attorney fees. It is typical in most lawsuits filed for the claimant to request reimbursement of attorney fees and costs. Of course, claimants are free to enter into whatever arrangement with their lawyer that they wish, paying either a flat amount, an hourly rate or a contingent fee based on the resolution of the case. If an employer specifically designates an amount to be paid as attorney fees, it may be paid to the claimant, the claimant's lawyer, or to both of them jointly. However, given the general presumption that all settlement payments are taxable to the employee who receives them, attorney fees are also taxable to the claimant – even if they are paid directly to the attorney. Such fees are not, however, considered wages and thus are not subject to FICA withholding.

That attorney fees are taxable to the claimant in an employment lawsuit settlement is explicitly stated in Treas. Reg. § 1.6041-1(f). The Supreme Court has also specifically held that when a claimant recovers taxable damages and is obligated to pay contingent attorney fees, those fees are "as a general rule" included in the taxable income of the claimant (*Commissioner of the Internal Revenue v. Banks*, 543 U.S. 426, 430 (2005)). This is consistent with the idea that even if the claimant never actually receives the attorney fee payment, he still receives the benefit of the payment, making the amount part of gross income. The law regarding the taxability of attorney fees paid under a "fee shifting" statute

is not clear. The Supreme Court in *Banks* noted that cases involving fee shifting statutes as well as injunctive relief raise additional issues, but declined to address them.

Reporting Settlement Payments

As noted earlier, settlement payments made must be reported on the applicable tax reporting form. All payments attributable to wage-related claims must be reported on a Form W-2 issued to the claimant. This includes payments for salary, wages, back pay, front pay, overtime pay, severance pay, and benefits. An employer making such payments should issue a Form W-2 to the claimant for the total amount, even if the check is issued directly to the claimant's attorney (or to the attorney and the claimant jointly) and even if a separate Form 1099 is issued to the claimant's attorney for some or all of the amount. Only payments attributable to wage claims are reportable on Form W-2. All other taxable payments are reportable on Form 1099. For example, both punitive damages and attorney fees are reportable on Form 1099, not Form W-2.

Once these reporting obligations are met, the employer must also determine its reporting obligations to the claimant's attorney. That means issuing a Form 1099 to the attorney whenever the check is written in a manner that gives the attorney the right to cash the check, regardless of the nature of the payment. All information reporting to a claimant's attorney is made on Form 1099. The claimant's attorney should never be issued a Form W-2, even if part of the settlement is for wage-related claims.

Multi-Step Process

Obviously the settlement payment issue is a complex one, with important ramifications for everyone involved in the process – claimant, employer, attorney – with requirements that are sometimes less than clear. There is some recent clarification available, but it is less than satisfactory in some areas. In an internal memorandum dated October 22, 2008, but released only in July of this year, the IRS Office of Chief Counsel has outlined some information necessary to determine the correct tax treatment of employment-related settlement payments. The IRS Counsel [Memorandum](#) outlines both the income and employment tax consequences, as well as the appropriate reporting, of settlement payments and contains useful information that will enable companies to decide how to define the reporting process. Companies that have not already implemented their own policies for handling settlement payments will find the guidance useful, as it outlines a multi-step method for determining the character of the payment being made (based on the nature of the employee's claim), the extent to which the payment is taxable, and the determination of how the payment should be reported. Here is a look at the method in more detail.

- Step one is to determine the character of the payment being made in order to conclude whether a payment is ultimately taxable and whether it constitutes "wages" for employment tax purposes (the next two steps in the process). The IRS Counsel Memorandum describes the most common types of judgment and settlement payments (such as severance pay, back pay, front pay, compensatory damages and punitive damages) and offers some classification help by giving examples of the statutes under which lawsuits could result in these payments, including Title VII of the Civil Rights Act, the Age Discrimination in Employment Act, the Americans With Disabilities Act, the Fair Labor Standards Act and the Equal Pay Act.
- Step two involves determining the taxability of payments and whether they should be reported on Form W-2 or Form 1099-MISC. This is a somewhat straightforward process, because Internal Revenue Code § 104(a)(2), 26 U.S.C. § 104(a)(2), offers the only grounds under which payments might not be taxable – that is, if they are certain types of judgment or settlement payments made to a claimant on claims for physical injury. The guiding factor here is that most payments fail to qualify for the Code § 104(a)(2) exclusion because they are made, not for tort-like physical injuries, but for emotional injury and distress that are covered in (taxable) punitive awards. The Memorandum takes the administrative position that observable or documented bodily harm, such as bruising, cuts, swelling or bleeding is evidence of personal physical injury. Since these are rare in employment litigation, the Memorandum specifically notes that payments made in employment-related disputes will generally not qualify for the exclusion.
- Steps three and four again look at the most common types of settlement payments and discuss the appropriate reporting for each payment, giving helpful case law cites as authority for the treatment of various payments as wages. On the important issue of attorney fees, the Memorandum cites Rev. Rul. 80-364 (1980-2 C.B. 294) which provides three examples, and the practice point that a settlement agreement should expressly allocate a portion of the payment to attorney fees in order for that amount to be excludible from the claimant's taxable wages.

Potential Implications

Although helpful, the IRS Counsel Memorandum is not complete in determining the correct tax treatment of settlement payments. Notably absent is guidance relating to:

- The implications surrounding employment-related settlement payments for physical injury (since the Memorandum presumes such payments are unlikely)
- The implications of settling a lawsuit by agreeing to perform certain actions or agreeing to stop certain activities (such as through injunctive relief)

- The implications surrounding class action lawsuits (including payment of attorney fees)
- The implications of using qualified settlement funds in conjunction with making employment-related settlement payments.

There also remain gray areas when a judgment or settlement payment includes multiple elements, each of which may or may not be wages. The Memorandum acknowledges that a court award may break down the amount of the award into its elements (back pay, emotional distress, interest), which makes it easier to determine what constitutes wages. More typical, however is that the parties to a settlement determine the elements of the settlement amount, by considering all the facts and circumstances, including the remedies available for the particular claim. The Memorandum offers no definitive help, but says the IRS *generally* decides whether to accept the parties' allocation by considering whether there was a bona fide adversarial settlement that allocates payment between types of recoveries, and whether the terms are consistent with the true substance of the underlying claims.

Finally the Memorandum is specifically lacking in its discussion of attorney fees. It fails to acknowledge the strong indications by the Supreme Court in *Banks* that attorney fees awarded pursuant to a fee-shifting statute might not be taxable to a claimant. In addition, the memorandum only superficially addresses the nuances surrounding the tax information reporting for payments to attorneys. There are a variety of circumstances in which an employer may need to issue one Form 1099-MISC to the claimant and another to the attorney, and might be required to issue Forms 1099-MISC totaling more than the amount of the judgment or settlement actually received by the claimant.

Such issues may leave the door open to future clarification by the IRS. Meanwhile, given the likelihood that employment-related litigation will continue to result in significant settlements, the IRS Counsel Memorandum offers employers helpful assistance to determine their responsibilities, and ultimately to develop settlement practices that reflect IRS policy.

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