

Legal Alert: IRS provides guidance on the taxation of employment-related settlement payments

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The Office of Chief Counsel at the **Internal Revenue Service** has outlined information necessary to determine the correct tax treatment of employment-related settlement payments. **The IRS Counsel Memorandum** summarizes both the income and employment tax consequences, as well as the appropriate reporting, of settlement payments and contains useful information for companies settling employment-related lawsuits.

The internal memorandum, which was released to the public this summer, sets forth a four-step process for determining the correct treatment of employment-related settlement payments. First, the taxpayer should determine the character of the payment being made and the nature of the claim giving rise to the payment. Second, the taxpayer should determine whether the payment is taxable to the claimant (i.e., an item of gross income). Third, the taxpayer should determine whether the payment is wages. Fourth, the taxpayer should determine the appropriate tax reporting for the payment, whether it is on IRS Form 1099-MISC or Form W-2.

Step One: Determine the character of the payment being made

Determining the character of the payment being made (the first step in the four-step process) is important in deciding whether a payment is ultimately taxable and whether a payment constitutes “wages” for employment tax purposes (steps two and three in the four-step process).

The IRS Counsel Memorandum gives a helpful overview of the most common types of judgment and settlement payments made in connection with employment-related disputes (such as severance pay, back pay, front pay, compensatory damages and punitive damages). In addition, the memorandum lists and describes some of the statutes under which employees (or former employees) might bring lawsuits.

Step Two: Determine whether the payment is taxable

The determination of the taxability of the payments is important because the company must file an information return (Form W-2 or Form 1099-MISC) for all amounts taxable to the claimant. The memorandum first gives an overview of the Internal Revenue Code §104(a)(2), which provides a limited exception to taxability for certain types of judgment or settlement payments made to a claimant on claims for physical injury.

The memorandum specifically notes that payments made in employment-related disputes will generally fail to qualify for the exclusion from

taxation under IRC §104(a)(2), because such payments are generally not made for tort-like physical injuries.

With regard to attorneys’ fees, the document cites the 2005 Supreme Court of the United States decision in *Commissioner v. Banks* (543 U.S. 426 (2005)) for the rule that a claimant generally must include the entire amount of a taxable judgment or settlement payment in gross income, including any portion paid to an attorney as a contingent fee.

The IRS Counsel Memorandum reiterates the government’s fairly aggressive position that attorneys’ fees awarded pursuant to a federal or state fee-shifting statute are also taxable to the claimant. The post-Banks Tax Court decision in *Vincent v. Commissioner* (T.C. Memo 2005-95) provides at least substantial authority for the government’s position. However, this discussion ignores further analysis of the treatment of settlement payments by the Supreme Court in *Banks*.

In *Banks*, the Supreme Court specifically acknowledged that it might have ruled differently had either the contingent fee agreement or the settlement agreement expressly referenced the application of a state fee-shifting provision and indicated that the payment was “in lieu of statutory fees.”

Steps Three and Four: Determine attorneys’ fees and appropriate reporting

Here, the IRS Counsel Memorandum again looks at the most common types of settlement payments made in connection with employment-related disputes, and discusses the appropriate reporting for each payment, giving helpful case law cites as authority for the treatment of various payments as wages.

Importantly, the guidance discusses at length an often misunderstood area of the law—whether the payment of attorneys’ fees out of the proceeds of a settlement (rather than a judgment formally structured by a court) constitute “wages,” for employment tax purposes. The IRS discussion 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 attorneys’ 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 as compre-

hensive as one would like in looking for a “one-stop-shopping guide” to determining the correct tax treatment of employment-related settlement payments. Notably absent is guidance relating to:

- The implications surrounding employment-related settlement payments for physical injury (since the IRS Counsel Memorandum presumes such payments are unlikely to exist).
- The implications of settling a lawsuit by agreeing to perform certain actions or agreeing to stop certain activities (i.e., injunctive relief).
- The implications surrounding class action lawsuits (including the payment of attorneys’ fees). The implications of using qualified settlement funds in conjunction with making employment-related settlement payments.

The IRS Counsel Memorandum also is not a well-balanced discussion of the authorities, because it fails to acknowledge the strong indications by the Supreme Court in *Banks* that attorneys’ fees awarded pursuant to a fee-shifting statute might not be taxable to a claimant. The *Banks* decision leads to the practice point of clearly documenting either the allocation of a portion of a court-ordered judgment to statutory attorneys’ fees, or expressly documenting in the terms of a settlement agreement that an amount paid

to the claimant’s attorney was “in lieu of statutory fees.”

In addition, the memorandum only superficially addresses the nuances surrounding the tax information reporting for payments to attorneys. Generally, a company will be required to issue a Form 1099-MISC to an attorney whenever a judgment or settlement payment check is written in a manner that gives the attorney the right to cash the check (i.e., whether the check is written as payable jointly to the attorney and his client, or payable solely to the attorney), regardless of the nature of the payment.

This applies even if the check is for more than just attorneys’ fees, and even if all or a portion of the payment is arguably not taxable to the claimant. As a result, in some circumstances, a company will be required to issue two Forms 1099-MISC (one to the claimant and one 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.

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