

TAX CONSEQUENCES OF EMPLOYMENT CASES

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Employment-related litigation is not only a major business concern—it involves substantial tax ramifications because of the size of the awards that claimants may receive. Statistics compiled annually by Jury Verdict Research® on jury award trends in employment litigation indicate the dimensions of the sums that can be involved, based on 2007 data. In any employment case filed in fed-

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eral court, there is a 16% chance that a successful award will exceed \$1 million, and a 67% chance that the award will exceed \$100,000. Moreover, the average compensatory award in all federal court employment cases was nearly \$500,000 (a 45% increase since 2000), while state court compensatory awards are up 39%.

Whether an employment-related dispute is concluded by settlement or by judgment, or after verdict and appeal, there are significant tax consequences to be considered. The principal question in applying these tax rules turns upon whether a settlement or award is taxable income to the claimant, and if so, whether it constitutes a wage payment or some other form of taxable income. Of course, a wage payment would also be subject to income and Social Security and Medicare (“FICA”) tax withholding.

A related issue is the tax treatment of judgments or settlements for compensatory damages associated with emotional distress and pain and suffering, which

are often claimed by plaintiffs in employment discrimination cases. Based on Section 104(a)(2) of the Internal Revenue Code (IRC), the Internal Revenue Service (IRS) and many courts have held that such payments are generally taxable, but the guidance has been less than definitive. Finally, there is the issue of attorney fees and how they should be treated in the context of either a settlement or compensatory awards. These latter two considerations in particular illustrate the complexity that is involved in tax reporting of settlements.

TAX TREATMENT OF COMPENSATORY SETTLEMENTS

The issues raised by IRC Section 104(a)(2) center on a limited exception to taxability for certain limited types of payments made to an employee claimant in settlement of claims for a physical injury, including:

- Payments for personal physical injury or physical sickness

- Emotional distress (only when accompanied by physical sickness)
- Out of pocket medical expenses
- Attorney fees and costs associated with the recovery of nontaxable physical injury payments.

Under Code section 104(a)(2), all damages (other than punitive damages) that flow from a personal physical injury or physical sickness are not taxable to the claimant, including amounts for lost wages/earnings that would otherwise be taxable but for the physical injury. As a result, it is not necessary in these cases to separately state how much of the award represents wages, or other damages, in the settlement agreement because no tax reporting documents, such as the Form W-2 or Form 1099-MISC will be issued to the claimant. However, an employer should issue a Form 1099-MISC to the attorney if the check is written in a manner that gives the attorney the right to cash the check.

TAX TREATMENT OF ATTORNEY FEES PAID FROM JUDGMENT OR SETTLEMENT PROCEEDS

The overall issue of attorney fees is quite complex. As a general rule, attorney fees are taxable to the claimant, even if the claimant owes these amounts to another or the payment is made jointly or separately to the claimant and another person. The thinking behind this is simple: when an employment claim settlement is made, including the obligation to a third party like an attorney in the claimant's gross income can be justified

even if the claimant never receives or even sees the attorney fee reimbursement. This is because the claimant receives the benefit of the payment, and the amount is therefore gross income. Nevertheless, there is a wide range of subcategories within the general attorney fee award, and some of these have unique tax considerations. The following are among the key fee payment examples:

Attorney fees for physical injury cases. Just as there is a narrow exception to the general rule that settlement payments are taxable to the claimant unless they compensate the claimant for a physical injury, attorney fees and costs associated with the recovery of nontaxable physical injury payments also are not taxable to the claimant.

Attorney fees under a fee shifting statute. Guidance in this area is contradictory. In *Sinyard v. Commissioner*¹ the Ninth Circuit affirmed the Tax Court in holding that statutory attorney fees awarded under the fee shifting provision of the Age Discrimination in Employment Act in an "opt-in" class action suit were taxable to the claimant as income. In contrast, that same year in *Flannery v. Prentice*, the Supreme Court of California ruled that an award made under the California Fair Employment and Housing Act, a fee shifting statute, was the property of the client or the lawyer because, without proof of an enforceable agreement to the contrary, the attorney fees belonged the attorneys who worked for them.

In *Commissioner v. Banks*,² the U.S. Supreme Court strongly indicated that it would consider treating the payment of attorney's fees as nontaxable if attor-

neys' fees were paid under either a court order pursuant to a fee-shifting statute, or if a contingency fee agreement or settlement agreement was being paid in lieu of statutory fees.³

However, in the post-Banks decision of *Vincent v. Commissioner*,⁴ the Tax Court ruled that an award of attorneys' fees pursuant to a California fee-shifting statute was not excludible from the plaintiff's taxable income. In a footnote, the Tax Court asserted that it was not bound by the state court holding in *Flannery v. Prentice*.⁵ Several California tax practitioners have had noted success, both at the examination and appeals levels of the IRS, relying upon the holding in *Flannery v. Prentice*.⁶

Given such ambiguity, it is probably safest for an employer to treat attorney fees awarded under fee-shifting statutes as taxable to the claimant under the general rule of inclusion.

Attorney fees in class actions. The IRS has ruled that legal fees paid directly to class counsel out of a settlement fund are not income to a taxpayer-class member if: (i) the taxpayer-class member did not have a separate contingency fee arrangement or retainer agreement with the class counsel; and (ii) the class action was an "opt-out" class action. Outside of these specific factual circumstances, however, it is probably the safest course for an employer to treat attorney fees paid in class action lawsuits as taxable to the claimant under the general rule of inclusion.

OTHER ATTORNEY FEE TAX CONSIDERATIONS

From these examples it can be seen that attorney fees should in the great majority of instanc-

es be treated as gross income to those who receive an employment settlement. One of the few rare exceptions is where the fees are actually expenses of another person or entity, rather than expenses of the claimant receiving the judgment or settlement. An example is when a union files claims on behalf of its members against a company. Subsequently, the union and the company enter into a settlement agreement, from which the union pays a certain percentage for attorney fees and returns the rest to its members represented in the case. In this instance the union member employees do not have to include any part of the attorney fees in their gross income, because they represent an expense incurred by the union.

A final complexity in attorney fee reporting is that, in some types of litigation, employees receiving a settlement may be able to deduct from their taxes the attorney fees that they must report as income. Specifically, IRC Section 62(a)(20) permits individuals to deduct attorney fees paid for claims in certain types of actions. This “above-the-line” deduction, while very broad, will not apply in every case, but it can apply in cases that involve:

- Unlawful discrimination
- The enforcement of civil rights
- Any provision of federal law prohibiting discharge, discrimination, or other forms of retaliation or reprisal against an employee for asserting rights or taking actions permitted under federal law (popularly known as whistleblower protection provisions)

- Any provision of federal, state, or local law, or common law claims that provide for the enforcement of civil rights, or regulate any aspect of the employment relationship (including claims for wages, compensation, or benefits) or prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee.

NEW IRS GUIDANCE

Because the whole issue of taxing employment settlements, particularly in regard to attorney fees, is so complex, the IRS recently issued administrative guidance to provide some needed clarification to this area. In an internal memorandum dated October 22, 2008, but released only in July of this year, the IRS Office of Chief Counsel has outlined information necessary to determine the correct tax treatment of employment-related settlement payments. The IRS Counsel memorandum (formally titled “Income and Employment Tax Consequences and Proper Reporting of Employment-Related Judgments and Settlements”) outlines 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 memorandum lays out a four-step process for determining the correct treatment of employment-related settlement payments. Steps one and two analyze the character of the payment, and the required tax treatment. Steps three and four analyze whether the payment constitutes “wages,” for em-

ployment tax purposes, and the required tax information reporting in connection with the payment.

Step 1: Determine the nature of the payment and claim

The taxpayer must determine the character of the payment being made and the nature of the claim that gave rise to the payment. This is the starting point for determining whether the payment is taxable, and whether it constitutes wages for employment tax purposes. The memorandum details 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). It also lists and describes some of the statutes under which employees (or former employees) might bring lawsuits, including:

- The Back Pay Act
- Title VII of the 1964 Civil Rights Act
- The Age Discrimination in Employment Act (ADEA)
- The Americans With Disabilities Act (ADA)
- Fair Labor Standards Act (FLSA)
- The Equal Pay Act of 1963
- Any other applicable state statutes or common law remedies (as in wrongful termination).

Note that not included in this list is the Lily Ledbetter Fair Pay Act of 2009, which was enacted by Congress after the stated date of the IRS memorandum. Given that this Act amends the statute of limitations in the 1964 Civil Rights Act for filing an equal-pay lawsuit regarding pay discrimination, it

likely will not in itself be a cause of action in employment settlements.

Step 2: Determine whether the settlement is taxable income

The respondent (and the party making the settlement payment) must next determine whether the payment is subject to income taxation. This determination is important because the respondent generally must file an information return (Form W-2 or Form 1099-MISC) reporting any taxable payment(s) to the claimant. This component of the IRS discussion provides a detailed overview of the rules under IRC Section 104(a)(2) governing the income tax treatment of lawsuit settlement or judgment payments, which provides a narrow exception to the from income taxation for settlement or judgment payments to reimburse for actual physical injuries. The memorandum contends that payments made in employment-related disputes will generally fail to qualify for the exclusion from taxation under this section, because such payments are generally not made for tort-like physical injuries.

The IRS memorandum also reiterates the government's fairly aggressive position that the entire amount of contingent attorneys' fees awarded pursuant to a federal or state fee-shifting statute are also taxable to the claimant and must be included in gross income. The basis for this position is the 2005 U.S. Supreme Court decision in *Commissioner v. Bank*⁷ as well as the post-Banks Tax Court decision in *Vincent v. Commissioner*.⁸

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."

Step 3: Decide the reporting requirements for each type of payment

The memorandum looks at the most common types of settlement payments made in connection with employment-related disputes and the appropriate reporting for each payment. Examples of the payments covered include:

- Back pay other than lost wages received for personal physical injury or illness
- Front pay
- Dismissal/severance pay
- Compensatory damages paid for emotional stress and suffering
- Punitive damages
- Interest
- Overtime

Each of these types of legal settlement payment is typically subject to income taxation, and must, therefore, be reported either on IRS form W-2 or 1099-MISC, depending upon whether the taxable settlement payment is also considered as "wages," for employment tax purposes. The only types of legal settlement payments which are not typically considered to be taxable are compensatory or consequential damages paid on account of personal physical injuries or physical sickness, and related medical expenses. However,

it is rare that a legal settlement payment for employment-related claims is being made in connection with actual physical injuries.

The memorandum makes the point that a judgment or settlement payment may comprise multiple elements, each of which may or may not be wages. A court may break down the amount of the award into various elements, such as back pay, emotional distress damages, and interest, which facilitates determining which elements constitutes wage. However, in the case of a settlement payment, the parties must determine the elements of the settlement amount by considering the facts, circumstances and available remedies for the various elements, some of which may not be taxable as noted earlier. The memorandum notes that the general IRS position in deciding whether to accept an allocation of damages in a settlement agreement or in a final judgment is to examine whether there was a bona fide adversarial settlement allocating payment between types of recoveries, and whether the allocation terms are consistent with the true substance of the underlying claims.

Step 4: Determine the reporting requirements of attorneys' fees

The IRS Counsel Memorandum 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) constitutes "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.

IMPLICATIONS OF THE IRS MEMORANDUM

Although providing helpful guidance for the issues which it covers, the IRS Counsel Memorandum fails to address several important issues concerning the tax treatment of employment-related settlement payment. For example, the memorandum does not provide guidance on the tax consequences of settling a lawsuit by agreeing to perform or stop certain activities (for example, through injunctive relieve), of class action lawsuits (including attorneys' fees), or of using qualified settlement funds in conjunction with making employment-related settlement payments.

The IRS memorandum is particularly deficient in its failure to discuss the tax treatment of the payment of the claimant's attor-

neys' fees out of the settlement proceeds. The memorandum 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. 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 a respondent may need to issue one Form 1099-MISC to the claimant and another to the claimant's attorney, and might be required to issue Forms 1099-MISC reporting amounts totaling more than the amount of the settlement payment(s) actually received by the claimant.

It is unclear whether these issues will receive separate discussion in future IRS guidance. However, employers, tax practitioners and attorneys should scrutinize carefully the guidance as now provided in order to ensure that they meet all tax reporting and payment obligations in con-

nection with employment-related legal settlement payments.

NOTES

1. *Sinyard v. C.I.R.*, 268 F.3d 756, 86 Fair Empl. Prac. Cas. (BNA) 1417, 81 Empl. Prac. Dec. (CCH) P 40747, 2001-2 U.S. Tax Cas. (CCH) P 50645, 88 A.F.T.R.2d 2001-6034 (9th Cir. 2001).
2. *C.I.R. v. Banks*, 2005-1 C.B. 850, 543 U.S. 426, 125 S. Ct. 826, 160 L. Ed. 2d 859, 94 Fair Empl. Prac. Cas. (BNA) 1793, 2005-1 U.S. Tax Cas. (CCH) P 50155, 95 A.F.T.R.2d 2005-659 (2005).
3. *C.I.R. v. Banks*, 2005-1 C.B. 850, 543 U.S. 426, 439, 125 S. Ct. 826, 160 L. Ed. 2d 859, 94 Fair Empl. Prac. Cas. (BNA) 1793, 2005-1 U.S. Tax Cas. (CCH) P 50155, 95 A.F.T.R.2d 2005-659 (2005).
4. *Vincent v. C.I.R.*, T.C. Memo. 2005-95, T.C.M. (RIA) P 2005-095, 89 T.C.M. (CCH) 1119 (2005).
5. *Vincent v. C.I.R.*, T.C. Memo. 2005-95, T.C.M. (RIA) P 2005-095, 89 T.C.M. (CCH) 1119 (2005), note 11.
6. See, for example, Robert Wood, "Will the IRS Pursue Attorney Fees Post-Banks?" 108 Tax Notes 319 (July 2005); John True, "Bad News on Taxation of Settlements and Judgments in Employment Discrimination Cases," California Employment Law Reporter (Matthew Bender, 2003).
7. *C.I.R. v. Banks*, 2005-1 C.B. 850, 543 U.S. 426, 125 S. Ct. 826, 160 L. Ed. 2d 859, 94 Fair Empl. Prac. Cas. (BNA) 1793, 2005-1 U.S. Tax Cas. (CCH) P 50155, 95 A.F.T.R.2d 2005-659 (2005).
8. *Vincent v. C.I.R.*, T.C. Memo. 2005-95, T.C.M. (RIA) P 2005-095, 89 T.C.M. (CCH) 1119 (2005).

