

**Office of Chief Counsel  
Internal Revenue Service  
memorandum**

CC:TEGE:EOEG:ET2:SLHartford  
FILES-102495-07

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subject: Income and Employment Tax Consequences and Proper Reporting of Employment-Related Judgments and Settlements

The purpose of this memorandum is to outline the information necessary to determine the income and employment tax consequences, and appropriate reporting of employment-related judgments or settlement payments made by the Service. For your convenience, the memorandum includes charts that can be used as reference tools. This memorandum supersedes the memorandum issued to you dated September 9, 2004. It reflects comments and suggestions received from FSLG and GLS, as well as recent case law and amendments to the Code.

This advice may not be used or cited as precedent.

**PMTA 2009-035**

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- I. **Overview.** Determining the correct treatment of employment-related settlement payments is a four-step process. First, determine the character of the payment and the nature of the claim that gave rise to the payment. For example, a payment could be for a lost wages claim brought under Title VII of the Civil Rights Act of 1964. Second, determine whether the payment constitutes an item of gross income. Third, determine whether the payment is wages for employment tax purposes (Federal Insurance Contributions Act (FICA), and income tax withholding). Fourth, determine the appropriate reporting for the payment and any attorneys' fees (Form 1099 or Form W-2).
  
- II. **Character of the payment and nature of the claim.** Whether a payment is includable in gross income and whether it is wages for purposes of employment taxes depend upon the character of the payment. The following describes the types of settlement payments or awards that may be received in connection with an employment-related dispute.
  - A. **Character of the payment**
    1. **Severance pay.** Severance pay is a payment made by an employer to an employee upon the involuntary termination of employment. The right to receive severance pay and the amount of severance pay are usually based on the employee's length of service.
    2. **Back pay.** Back pay is compensation paid to an individual to compensate the individual for remuneration that would have been received up to the time of settlement or court award but for the employer's wrongful conduct. For example, back pay is awarded to an employee if the employee is illegally terminated by an employer, or to an applicant for employment who is not hired for illegal reasons. Under those circumstances, the back pay relates to a period when no services for the employer were performed. Certain federal statutes, e.g., Title VII of the Civil Rights Act of 1964, and the Age Discrimination in Employment Act (ADEA) of 1967, specifically authorize the recovery of back pay as a remedy for unlawful agency conduct.
    3. **Front Pay.** Front pay is paid to an individual to compensate the individual for remuneration that would have been received after the settlement date or court award but for the employer's wrongful conduct and the circumstances – e.g., extreme animosity between the employer and employee – which make it impracticable to place the employee in the position.

4. **Compensatory damages.** Compensatory damages include compensation for physical injury and non-physical injury, *e.g.*, humiliation and defamation, and for the intangible elements of personal injury such as emotional distress and pain and suffering.
5. **Consequential damages.** Consequential damages are compensation for damage, loss, or injury that do not flow directly and immediately from the act of the party, but are consequences or results of such act.
6. **Punitive/liquidated damages.** Generally, liquidated and punitive damages are not directly related to the actual loss incurred. Liquidated damages are amounts that parties agree to pay in the event of a breach of an agreement as a substitute for compensatory damages. Liquidated damages may also be imposed by statute, *e.g.*, the Fair Labor Standards Act of 1938 and the Equal Pay Act of 1963. Punitive damages punish the wrongdoer for wrongful conduct. An award of punitive damages against the government is possible only when the government waives its sovereign immunity, *e.g.*, the Civil Rights Act and the Americans with Disabilities Act, below.
7. **Restoration of benefits.** Restoration of benefits may include the payment of health insurance premiums, Thrift Savings Plan employer and employee contributions, and other retirement contributions.

**B. Nature of the claim**

1. **Back Pay Act** (5 U.S.C. § 5596(b)(1)). The Back Pay Act covers employees of federal government agencies and other employees of the federal government. Under the Back Pay Act, back pay is awarded to an employee who is found by the appropriate authority under applicable law, rule, regulation, or collective bargaining agreement to have been affected by a wrongful personnel action that resulted in the withdrawal or reduction of all or part of the employee's pay, allowances, or differentials.
2. **Title VII of the Civil Rights Act of 1964**, 42 U.S.C. § 2000e, as amended by **the Civil Rights Act of 1991**, 42 U.S.C. § 1981a. Title VII of the Civil Rights Act of 1964, as amended by the Civil Rights Act of 1991, prohibits discrimination in employment based on race, color, sex, religion, and national origin, and provides for the award of back pay and attendant benefits, compensatory damages, compensation for emotional distress, and punitive damages.

3. **Age Discrimination in Employment Act (ADEA) of 1967** (29 U.S.C. § 621). As made applicable to the federal government under 29 U.S.C § 633a, the ADEA provides for an award of back pay and other equitable relief, but does not provide for the recovery of compensatory damages of a tort-like nature (e.g., emotional distress) or liquidated damages.
4. **Americans with Disabilities Act of 1990 (ADA)**. Employing the remedial scheme of Title VII and the Civil Rights Act of 1991, the ADA authorizes the recovery of back pay, compensation for noneconomic damages such as emotional distress, and punitive damages.
5. **Fair Labor Standards Act of 1938 (FLSA)** (29 U.S.C. § 201). The FLSA requires the payment of minimum wages and overtime pay. The FLSA provides for recovery of unpaid wages, unpaid overtime compensation, and non-punitive liquidated damages, but not compensatory damages of a tort-like nature (e.g., for emotional distress).
6. **Equal Pay Act of 1963 (EPA)** (29 U.S.C. § 206(d)). The EPA is an amendment to the FLSA, prohibiting discrimination on account of gender in the payment of wages by employers. The EPA provides for recovery of unpaid wages, unpaid overtime compensation, and liquidated damages.
7. **State statutes**. State statutes often parallel federal workers' rights statutes, but may provide for broader remedies. The remedies available under a particular state statute under which a suit is brought or could have been brought determine whether a claim thereunder sounds in tort (see discussion of IRC § 104(a)(2) below).
8. **Common law wrongful termination**. As for any tort under the common law, a broad range of remedies are available.

### III. **Income taxation of judgment/settlement payments.**

- A. **IRC § 104(a)(2)**. This section excludes from gross income the amount of any damages (other than punitive damages) received on account of personal physical injuries or physical sickness. Standing alone, emotional distress is not considered a physical injury or a physical sickness for purposes of § 104(a)(2). However, recoveries paid for medical care described in § 213(d)(1)(A) and (B) attributable to emotional distress are excludable under § 104(a)(2). The § 104(a)(2) exclusion does not apply to amounts previously deducted as medical expenses under § 213.
- B. **Is there a settlement?** Section 104(a)(2) and the regulations thereunder

require that the payment be in settlement of a claim in order to be excluded from gross income. Section 1.104-1(c) of the Income Tax Regulations provides that the damages must have been received through prosecution of a legal suit or in a settlement agreement in lieu of prosecution of a suit. This requirement means that a colorable claim under a workers' rights statute or under the common law must have been asserted. A general release of claims against the employer, e.g., under a termination plan or severance package, is not a claim for § 104 purposes. See, e.g., *Abrahamsen v. United States*, 44 Fed. Cl. 260 (1999), *aff'd*, 228 F.3d 1360 (Fed. Cir. 2000).

- C. What was the payment for?** For the payment to be excluded under § 104(a)(2), the claim must be for a tort or tort-like injury. The remedies available under the statute or common law determine whether the claim is tort-like in nature. If back pay and liquidated damages are the only remedies available, then the payment is an item of gross income because the recovery is not for a tort-like physical injury. In order for the amount to be excluded from gross income under § 104(a)(2), the taxpayer must demonstrate that the amount was received on account of personal physical injuries or physical sickness, or as reimbursed expenses for medical treatment for emotional distress. See, e.g., *Prasil v. Commissioner*, T.C. Memo. 2003-100, applying the two tests set forth in *Commissioner v. Schleier*, 515 U.S. 323, 336-37 (1995), to the current version of § 104(a)(2), i.e., under current law (1) a claim must be based upon tort or tort-type rights, and (2) the taxpayer must show that the damages were received on account of personal physical injuries or physical sickness.
- D. What is a personal physical injury?** Our administrative position is that observable or documented bodily harm, such as bruising, cuts, swelling or bleeding is evidence of personal physical injury. If there has in fact been a personal physical injury, compensatory damages for consequential emotional distress related to the injury are also excludable from gross income.

In Rev. Rul. 85-97, 1985-2 C.B. 50, *amplifying* Rev. Rul. 61-1, 1961 C.B. 14, the Service considered a situation where an individual received a lump sum payment in settlement of an action against a bus company for negligent operation of a bus that caused him serious bodily injury and the concomitant loss of wages and earning capacity. The ruling holds that the entire recovery was for personal injuries excludable from gross income, including the portion allocable to lost wages.

**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).

#### IV. Income taxation of attorneys' fees.

- A. Taxable awards or settlements.** In *Commissioner v. Banks*, 543 U.S. 426 (2005), the Supreme Court resolved a conflict among the circuits and agreed with the Commissioner that, under the anticipatory assignment of income doctrine, a taxpayer must include in gross income the entire amount of a judgment or settlement, including the portion paid to the attorney as a contingent fee. The Court rejected suggestions that the lien law of a particular state controls the federal tax consequences of a fee arrangement between a client and an attorney or that such an arrangement constitutes a joint venture for tax purposes.

In *Biehl v. Commissioner*, 351 F.3d 982 (9<sup>th</sup> Cir. 2003), *cert. denied*, 543 U.S. 1145 (2005), the Court of Appeals for the Ninth Circuit held that attorneys' fees paid by a former employer in settlement of a wrongful termination suit were not received pursuant to a reimbursement or other expense allowance arrangement within the meaning of § 62(a)(2)(A) and the implementing regulations. The payment of fees by the employer, the court reasoned, does not satisfy the business connection requirement of § 62(a)(2)(A). Thus, the fees were includible in the taxpayer's gross income.

In the American Jobs Creation Act of 2004 (AJCA), Congress added § 62(a)(19)[20]<sup>1</sup> to the Code to ameliorate the result in *Biehl*. Under this provision, employees may reduce gross income by attorneys' fees and court costs paid to pursue a claim of unlawful discrimination (as defined in § 62(e)) and certain other claims. This reduction in any given year is limited to the amount of the award includible in the taxpayer's income for the year. Employees who receive recoveries not described in § 62(a)(19)

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<sup>1</sup> The AJCA changed the definition of adjusted gross income by providing for the deduction at § 62(a)(19). Subsequent legislation redesignated § 62(a)(19) as § 62(a)(20). See Pub. L. No. 109-135, § 412(q)(1)(A)-(B).

[20] can deduct the attorneys' fees only on Schedule A as miscellaneous itemized deductions, which are subject to the two percent floor of § 67.<sup>2</sup>

**Caution:** Section 62(a)(20) is a deduction provision; it does not affect whether an amount is included in gross income, whether an amount is wages for employment purposes, or the information return reporting of an amount.

- B. Nontaxable awards or settlements.** If an award or settlement payment is excluded from gross income under § 104(a)(2), the entire payment is excluded from gross income regardless of whether the taxpayer uses a portion of the excludable payment to pay his attorney under a contingent fee or other arrangement. However, § 265(a)(1) of the Code prohibits the taxpayer from taking a deduction for the fees paid to the attorney.

See the discussion below for proper reporting of attorneys' fees.

- C. Fees recovered under fee-shifting statutes.** A statute that includes a provision allowing a court to award attorneys' fees to the prevailing party is commonly referred to as a fee-shifting statute. 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, *reh'g denied*, 476 U.S. 1179 (1986). We construe *Banks* and the AJCA 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. 543 U.S. at 438-39. Moreover, in *Vincent v. Commissioner*, T.C. Memo. 2005-95, the Tax Court, agreeing with the Commissioner, held that the taxpayer was required to include in gross income attorneys' fees awarded under a state fee-shifting statute. The Tax Court held that it was not bound by an opinion of the California Supreme Court holding that under state law, the fees belonged to the attorney and not to the client. *Accord, Green v. Commissioner*, T.C. Memo. 2007-39.

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<sup>2</sup> IRC § 67(a) provides that individuals are allowed miscellaneous itemized deductions for any taxable year only to the extent that the aggregate of such deductions exceeds two percent of adjusted gross income, where § 62 defines adjusted gross income.

**V. Employment tax treatment (FICA tax and income tax withholding).**

**A. General rules.**

1. **FICA.** FICA tax is owed on all remuneration paid by an employer to its employees. See IRC §§ 3101; 3111. One-half of the applicable FICA taxes are imposed against the employee; the remaining one-half are imposed against the employer. The employer is required to withhold from the employee's pay the employee half of FICA taxes. FICA taxes consist of the Old-age, survivors, and disability insurance portion (OASDI or social security) (IRC §§ 3101(a); 3111(a)), and the Hospital Insurance portion (HI or Medicare) (IRC §§ 3101(b); 3111(b)). The OASDI portion is applied to wages paid up to a dollar amount which is set annually (e.g., \$102,000 for 2008). The Medicare portion is not capped. The OASDI and Medicare portions of FICA tax are imposed separately against the employee and employer at the rate of 6.2 percent and 1.45 percent respectively (totaling 12.4% and 2.9% respectively). IRC §§ 3101; 3102; 3111.

**Note for Federal Government Employees:** Employees covered under the Civil Service Retirement System who have continuously performed services since December 31, 1983, are generally not subject to social security taxes. IRC § 3121(b)(5). Employees covered under the Federal Employees' Retirement System (FERS), however, are generally subject to social security taxes. Remuneration for services paid to federal employees is generally subject to Medicare taxes. IRC § 3121(u)(1).

2. **Income Tax Withholding.** An employer is required to withhold income tax on remuneration for employment (wages) paid to its employees. IRC § 3402(a).
  3. **FUTA.** Payments made by federal agencies are not subject to the Federal Unemployment Tax Act (FUTA) tax. IRC § 3306(c)(6).
- B. If not income, then not wages.** Amounts excludable from gross income under § 104(a)(2) and non-economic damages are not wages for FICA and income tax withholding purposes.
- C. Severance Pay.** Section 31.3401(a)-1(b)(4) of the Employment Tax Regulations provides that any payments made by an employer to an employee on account of dismissal, *i.e.*, involuntary separation from the service of the employer, constitute wages for income tax withholding

purposes regardless of whether the employer is legally bound by contract, statute, or otherwise, to make such payments. Severance pay, like the pay it replaces, is includible in gross income and is wages for FICA and income tax withholding purposes. See, e.g., *Abrahamsen v. United States*, 228 F.3d 1360 (Fed. Cir. 2000).

- D. Back pay.** The Service and the courts agree that back pay is wages for FICA and income tax withholding purposes, except where received on account of a personal physical injury or physical sickness. *Social Security Board v. Nierotko*, 327 U.S. 358 (1946). See also *Tanaka v. Dep't of Navy*, 788 F.2d 1552, 1553 (Fed. Cir. 1986); Rev. Rul. 96-65. 1996-2 C.B. 6.

The Service's position is that back pay awarded for an illegal refusal to hire is wages for federal employment tax purposes. Rev. Rul. 78-176, 1978-1 C.B. 303. Rev. Rul. 78-176 holds that amounts paid in settlement of a Title VII action to job applicants who were wrongly refused employment on the basis of race are wages for employment tax purposes. The ruling reasons that *Nierotko* applies to this situation because the individuals could not be made whole unless they received social security credit for the back pay.

Rev. Rul. 78-176 was cited with approval in *Melani v. Board of Higher Ed.*, 652 F. Supp. 43 (S.D.N.Y. 1986), *aff'd*, 814 F.2d 653 (2d Cir. 1987). However, in *Newhouse v. McCormick & Co.*, 157 F.3d 582 (8th Cir. 1998), the Eighth Circuit rejected the Service's position in Rev. Rul. 78-176. The court held that FICA tax and income tax withholding do not apply unless an actual employer-employee relationship existed. The Eighth Circuit has jurisdiction over causes of action arising in Minnesota, the Dakotas, Iowa, Nebraska, Missouri, and Arkansas. If the cause of action arose in the Eighth Circuit, contact CC:TEGE:EOEG:ET2 for guidance.

- E. Front pay.** The Service's position is that front pay constitutes wages for FICA purposes. Most appellate courts addressing the issue have agreed. *Gerbec v. United States*, 164 F.3d 1015, 1026 (6th Cir. 1999); *Mayberry v. United States*, 151 F.3d 855, 860 (8th Cir. 1998); and *Hemelt v. United States*, 122 F.3d 204, 209 (4th Cir. 1997). However, in *Dotson v. United States*, 87 F.3d 682, 689 (5th Cir. 1996), the 5th Circuit held that only the back pay portion of a settlement was wages for FICA tax purposes. The Fifth Circuit includes Texas, Louisiana, and Mississippi. If the cause of action arose in the 5th Circuit, contact CC:TEGE:EOEG:ET2 for guidance.

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- F. Restoration of benefits.** Contact CC:TEGE:EOEG:ET2 for questions on the appropriate tax and reporting treatment of such payments.
- G. Emotional distress damages.** Amounts paid for medical care described in § 213(d)(1)(A) and (B) on account of emotional distress are excluded from gross income under § 104(a)(2) if the expense has not been previously deducted under § 213, and are not wages for employment tax purposes.
- H. Are employment taxes calculated based on the year of payment or when the wages would have been payable absent the wrongful conduct?** In *United States v. Cleveland Indians Baseball Co.*, 532 U.S. 200 (2001), the Supreme Court agreed with the Service'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.
- I. Allocation of payments.** A judgment or settlement payment may comprise multiple elements, each of which may or may not be wages. A court award may break down the amount of the award into its elements such as back pay, emotional distress damages, and interest, making it much easier to determine which portion(s) constitutes wages. However, in the case of a settlement payment, the parties must determine the elements of the settlement amount. This determination is made by considering all the facts and circumstances, including the remedies available for the particular claim. For example, a settlement payment may have to be allocated between back pay and other compensatory damages (e.g., emotional distress). As discussed, back pay is wages subject to employment taxes, but emotional distress damages are not. Proper allocation is also necessary to ensure proper reporting of the payment (Form W-2 or Form 1099).

**Note:** The Service 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:

1. Whether there was a bona fide adversarial settlement as to the allocation of payment between types of recoveries. *Robinson v. Commissioner*, 102 T.C. 116 (1994), *aff'd*, 70 F.3d 34 (5<sup>th</sup> Cir. 1995), *cert. denied*, 519 U.S. 824 (1996).
2. Whether the terms are consistent with the true substance of the underlying claims. For example, compensatory damages in the

nature of tort-like remedies (e.g., emotional distress) are not available for ADEA claims. Thus, for such a claim it would not be appropriate to allocate recovery amounts to emotional distress.

**J. Attorneys' fees and interest.**

1. **Court awards.** Rev. Rul. 80-364, 1980-2 C.B. 294, considers whether attorneys' fees and interest awarded with back pay are wages for employment tax purposes. The ruling describes three situations.

In Situation 1, after termination of employment by a company, an individual filed a complaint for back pay. The court awarded the individual \$8X in back pay, \$1X in attorneys' fees, and \$1X in interest. The ruling holds that although the entire \$10X is includible in gross income, only the back pay award of \$8X is wages for federal employment tax purposes; the interest and attorneys' fees were excluded from wages because they were separately identified.

In Situation 2, an individual sues the individual's employer for \$15X for back pay. Pursuant to a court order, the employer paid the individual \$10X. The court order did not indicate that a portion of the award was for attorneys' fees or interest. The employee paid \$1X in attorneys' fees. The ruling holds that the entire \$10X is income to the employee and is also wages for federal employment tax purposes even though \$1X was spent on attorneys' fees.

In Situation 3, a union files a claim for breach of a collective bargaining agreement on behalf of its members against a company. The union and the company entered into a settlement agreement, later approved by a court, which provided that the company would pay the union \$40X in settlement of all claims. The union paid \$6X of the settlement for attorneys' fees and returned \$34X dollars to the employees for back pay owed to them. The back pay was distributed to the employees in proportion to their claims. The ruling holds that the \$6X paid by the union in attorneys' fees is not remuneration for employment and thus is not wages. In addition, the \$6X is not includible in the employees' gross income. Although not stated, the \$34X paid from the union to the employees would be wages subject to federal employment tax.

An award of attorneys' fees under a fee-shifting statute would not be wages under Situation 1 of the ruling. By contrast, as described in Situation 2, the payment of attorneys' fees by the employee (e.g., contingent attorneys' fees) from a court award consisting solely of back pay would not affect the characterization of the recovery, or some part thereof, as back pay (and thus wages).

Note that in *Biehl*, discussed above, the Tax Court and the Ninth Circuit held that attorneys' fees paid from a court award could not be excluded from income as a payment under an "accountable plan" within the meaning of §§ 62(a)(2)(A), 62(c), and the regulations thereunder. Likewise, the accountable plan rules cannot serve to remove the portion of a settlement owed as attorneys' fees from wages if the settlement amount would otherwise be properly characterized as wages. *Biehl*, 351 F.3d at 985-86, *aff'g* 118 T.C. 467 (2002). Although attorney's fees may be deductible under § 62(a)(20), this provision does not affect whether a recovery of attorney's fees is gross income, or whether such amount is wages for employment tax or information reporting purposes.

2. **Settlement payments.** Most employment-related disputes are settled administratively rather than through litigation. 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. In *Banks*, the Supreme Court indicated that the taxpayer did not receive an award of attorneys' fees under a fee-shifting statute when the attorneys' fees were paid pursuant to a settlement agreement rather than a court award, notwithstanding that the statute under which the taxpayer sued provided for awards of attorneys' fees. If this issue arises, contact CC:TEGE:EOEG:ET2 for guidance.

- VI. **Third Party Payors.** An agency other than the employing agency may in some cases pay an amount to an employee in satisfaction of a court award or in settlement of an employment-related dispute. In such cases, the agency having control of the payment of wages is responsible for income tax withholding. See IRC § 3404 ("If the employer is the United States . . . , or any agency or instrumentality [of the United States], the return of the amount deducted and

withheld upon any wages may be made by any officer or employee of the United States . . . , or of such agency or instrumentality, . . . having control of the payment of such wages . . .”). Similarly, the agency having control of the payment of wages must withhold and pay FICA taxes. See IRC § 3122 (“In the case of [FICA taxes] with respect to service performed in the employ of the United States [or in the employ of an instrumentality of the United States]. . . , the determination of the amount of remuneration for such service, and the return and payment of the taxes imposed by this chapter, shall be made by the head of the Federal agency or instrumentality having the control of such service, or by such agents as such head may designate.”). A third-party payor responsible for employment taxes under §§ 3404 and 3122 is also responsible for the related Form W-2 reporting requirements under § 6051(a).

## VII. Reporting requirements.

- A. Wage reporting.** Under § 6051, the employer is required to furnish information returns (Form W-2, Wage and Tax Statement) to employees reporting the amount of wages, withholding, and other information. Copies of these information returns are also required to be filed by the employer with the Social Security Administration (SSA). Treas. Reg. § 31.6051-2(a). Thus, an amount paid as back pay to an employee is generally reportable by the employer to the employee and to the Social Security Administration on a Form W-2. The wage reporting requirement applies regardless of whether the payment is also reportable to the employee’s attorney under § 6045(f) (see discussion below).
- B. Special reporting requirements for back pay.** With respect to payments to employees of back pay under a statute, there are procedures for reporting to SSA (in addition to the Form W-2 reporting) that are described in Social Security Publication 957, Reporting Back Pay and Special Wage Payments to the Social Security Administration. These procedures could apply in the case of an employee who received a back pay award in one year that related to several prior years in which the wages should have been paid. Back pay is allocated to the periods in which the wages should have been paid for social security benefit purposes only, not the computation of FICA tax. This reporting treatment is based on *Nierotko*, 327 U.S. at 358. See also *Cleveland Indians Baseball Co.*, 532 U.S. at 200. The Treasury Financial Manual indicates that federal agencies are required to do the reporting required by Publication 957. See TFM Volume I, Part 3, Chapter 4000, section 4050.40. Note that this may benefit employees by providing them with needed quarters of coverage for social security benefit purposes.

- C. Form 1099 reporting.** If a settlement or judgment payment is income but does not constitute wages, the payment will be subject to reporting under § 6041 on Form 1099-MISC. If the payment is excludable from gross income pursuant to § 104(a)(2) or any other section, there is no reporting required.
- D. Payments to attorneys.** Under § 6045(f), every person making a payment in the course of his trade or business "to an attorney in connection with legal services" is required to report the payment on Form 1099, regardless of whether the payment constitutes income to the attorney.

The following charts describe the reporting requirements for payments made to employees and attorneys. The first chart describes the income and employment tax consequences and proper reporting of payments made to employees as compensation for various types of damages. The four charts that follow address the reporting treatment of attorneys' fees for employees and attorneys.

**Tax and Reporting Treatment of Judgment/Settlement Payments to Employees**

<b>Payment Character</b>	<b>Income Taxable?</b>	<b>Wages (FICA and ITW)?</b>	<b>Reporting Requirement</b>
<b>Back pay (other than lost wages received on account of personal physical injury or physical sickness)</b>	Yes	Yes <sup>1</sup>	W-2
<b>Front pay</b>	Yes <sup>2</sup>	Yes	W-2
<b>Dismissal/severance pay</b>	Yes	Yes	W-2
<b>Compensatory or consequential damages paid on account of personal physical injuries or physical sickness</b>	Generally, no	No	None
<b>Compensatory damages not paid on account of personal physical injuries or physical sickness (e.g., emotional distress)</b>	Generally, yes	No	1099-MISC, Box 3
<b>Consequential damages not paid on account of personal physical injuries or physical sickness</b>	Yes	No	1099-MISC, Box 3
<b>Punitive/Liquidated damages</b>	Yes	No	1099-MISC, Box 3
<b>Interest</b>	Yes	No	1099-INT, Box 1 (if \$600 or more)
<b>Costs</b>	Yes	No	1099-MISC, Box 3
<b>Medical expenses</b>	Generally, no	No	None
<b>Overtime</b>	Yes	Yes	W-2

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<b>Restoration of benefits: Health Premiums, TSP employee and employer contributions, and retirement contributions</b>	To be determined	To be determined	To be determined
<b>Taxes—employee income tax or employee portion of FICA</b>	Yes	Yes. See Publication 15-A	W-2
<b>Travel—if requirements of § 62(c) (accountable plan) are met</b>	No	No	No
<b>Travel—if requirements of § 62(c) are not met</b>	Yes	Yes	W-2

<sup>1</sup> If the case is in the 8<sup>th</sup> Circuit, and involves an illegal refusal to hire, contact CC:TEGE:EOEG:ET2 for guidance.

<sup>2</sup> If the case is in the 5<sup>th</sup> Circuit, contact CC:TEGE:EOEG:ET2 for guidance.

**Tax and Reporting Treatment of Attorneys' Fees**

**Total Employer Payment Made Jointly to Attorney and Employee:**

<b>Nature of Payment</b>	<b>Income Taxable to employee?</b>	<b>Reporting to Employee</b>	<b>Reporting to Attorney</b>
<b>Court award designating attorneys' fees<sup>1</sup></b>	Yes—attorneys' fees generally taxable to employee.	Attorneys' fees reportable in Box 3 of 1099-MISC (not W-2). Treas. Reg. § 1.6041-1(f)(1) and (2).	Box 14 of 1099-MISC in the amount of the check payable jointly to employee and attorney. Treas. Reg. § 1.6045-5(a), and (f) Ex. 1.
<b>Court award without designation of attorneys' fees</b>	Yes—attorneys' fees generally taxable to employee.	The total award is reportable, as appropriate (on 1099-MISC or W-2).	Box 14 of 1099-MISC in the amount of the check payable jointly to employee and attorney. Treas. Reg. § 1.6045-5(a), and (f) Ex. 1.
<b>Settlement payment</b>	Yes—attorneys' fees generally taxable to employee.	To be determined, based on the nature of the action. If wages, reportable on W-2. If not wages, reportable in Box 3 of 1099-MISC.	Box 14 of 1099-MISC in the amount of the check payable jointly to employee and attorney. Treas. Reg. § 1.6045-5(a), and (f) Ex. 1.

**Separate Employer Payments to Employee, and to Attorney for Attorneys' Fees:**

<b>Nature of Payment</b>	<b>Income Taxable to Employee?</b>	<b>Reporting to Employee</b>	<b>Reporting to Attorney</b>
<b>Court award designating attorneys' fees</b> <sup>1</sup>	Yes—attorneys' fees generally taxable to employee.	Attorneys' fees reportable in Box 3 of 1099-MISC (not W-2) even though paid separately to attorney. Treas. Reg. §1.6041-1(f)(1) and (2).	Box 14 of 1099-MISC to attorney in the amount of check payable to attorney. Treas. Reg. § 1.6045-5(a), and (f) Ex. 3.
<b>Court award without designation of attorneys' fees</b>	Yes—attorneys' fees generally taxable to employee.	The total award is reportable, as appropriate (on 1099-MISC or W-2) even though attorneys' fees paid separately to attorney. Treas. Reg. §1.6041-1(f)(1) and (2).	Box 14 of 1099-MISC to attorney in the amount of check payable to attorney. Treas. Reg. § 1.6045-5(a), and (f) Ex. 3.
<b>Settlement payment</b>	Yes—attorneys' fees generally taxable to employee.	To be determined, based on the nature of the action. If wages, reportable on W-2. If not wages, reportable in Box 3 of 1099-MISC.	Box 14 of 1099-MISC to attorney in the amount of check payable to attorney. Treas. Reg. § 1.6045-5(a), and (f) Ex. 3.

<sup>1</sup> Workers rights statutes, such as Title VII, generally include fee-shifting provisions.

**Total Employer Payment to Employee:**

<b>Nature of Payment</b>	<b>Income Taxable to Employee?</b>	<b>Reporting to Employee</b>	<b>Reporting to Attorney</b>
<b>Court award designating attorneys' fees<sup>1</sup></b>	Yes—attorneys' fees generally taxable to employee.	Attorneys' fees reportable in Box 3 of 1099-MISC (not W-2). Treas. Reg. § 1.6041-1(f)(1) and (2).	None. See, e.g., Treas. Reg. § 1.6045-5(a), (d)(4), and (f) Ex. 4.
<b>Court award without designation of attorneys' fees</b>	Yes—attorneys' fees generally taxable to employee.	The total award is reportable, as appropriate (on 1099-MISC or W-2).	None. See, e.g., Treas. Reg. § 1.6045-5(a), (d)(4), and (f) Ex. 4.
<b>Settlement payment</b>	Yes—attorneys' fees generally taxable to employee.	To be determined, based on the nature of the action. If wages, reportable on W-2. If not wages, reportable in Box 3 of 1099-MISC.	None. See, e.g., Treas. Reg. § 1.6045-5(a), (d)(4), and (f) Ex. 4.

<sup>1</sup> Workers rights statutes, such as Title VII, generally include fee-shifting provisions.

**Total Employer Payment to Attorney:**

<b>Nature of Payment</b>	<b>Income Taxable to Employee?</b>	<b>Reporting to Employee</b>	<b>Reporting to Attorney</b>
<b>Court award under fee-shifting statute designated as attorneys' fees<sup>1</sup></b>	Yes—attorneys' fees generally taxable to employee.	Attorneys' fees reportable in Box 3 of 1099-MISC (not W-2). Treas. Reg. § 1.6041-1(f)(1) and (2).	Total amount of check reported on 1099-MISC, box 14. Treas. Reg. § 1.6045-5(a) and (d)(4).
<b>Court award without designation of attorneys' fees</b>	Yes—attorneys' fees generally taxable to employee.	The total award is reportable, as appropriate (on 1099 or W-2).	Total amount of check reported on 1099-MISC, box 14. Treas. Reg. § 1.6045-5(a) and (d)(4).
<b>Settlement payment</b>	Yes—attorneys' fees generally taxable to employee.	To be determined, based on the nature of the action. If wages, reportable on W-2. If not wages, reportable in Box 3 of 1099-MISC.	Total amount of check reported on 1099-MISC, box 14. Treas. Reg. § 1.6045-5(a) and (d)(4).

<sup>1</sup> Workers rights statutes, such as Title VII, generally include fee-shifting provisions.