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The tax implications of settlement payments are usually an afterthought when negotiating the resolution of a lawsuit. Yet, tax liabilities are an important consideration, especially in the context of employment cases. Most employment claims are governed by statutory causes of action, which can allow for a host damages: compensatory, back/front pay, punitive, and/or attorneys' fees. When resolving an employment lawsuit, it is important to understand tax implications of these different damage categories, and how each is treated for purposes of settlement.

In employment cases, plaintiffs often request defendant employers to designate settlement payments in such a way to avoid income tax withholdings. While this may result in a larger settlement check for the plaintiff—and perhaps an easier settlement negotiation for the employer—doing so could subject both parties to substantial tax liability down the road. If settlement proceeds are misclassified to avoid income taxes, the plaintiff-employee might be held responsible for all taxes, including the employer’s unpaid portion. And if the employee is unable to satisfy the tax burden, the IRS can look to the employer to foot the bill.

Moreover, where an employer fails to deduct and withhold taxes for wage payments made to an employee, the employer may be subject to additional liability, penalties, and interest. See 26 U.S.C. § 3509. Because of the potential exposure to employees and employers for inaccurate tax reporting, all parties should make it a priority to allocate settlement payments accurately based on the facts and circumstances of the settled claims.

Allocating Settlement Proceeds

Settlements are taxed according to the potential damages available to the employee. It is wise to designate the settlement proceeds during negotiations, instead of leaving that determination to post-settlement discussion. Soon after the determination is made, it should be memorialized in a signed settlement agreement, which is generally given deference by the IRS, as long as the agreement was negotiated at arms' length and in good faith. See, e.g., Bagley v. Comm'r, 105 T.C. 396, 406 (1995), aff'd 121 F.3d 393 (8th Cir. 1997).
Still, a settlement allocation is not binding on the IRS, and the IRS may disregard an agreement if the facts and circumstances indicate that the parties actually intended the payments to be made in compensation for different damages. *Robinson v. Comm'r*, 102 T.C. 116 (1994). An inquiry into the tax treatment of settlement funds generally hinges on the employer’s primary reason for making the settlement payment. Thus, the settlement agreement should set forth the rationale for any allocation of damages.

**Tax Implications**

As a general rule, almost all settlement payments in an employment lawsuit are includable in the plaintiff’s taxable income (subject to limited exceptions for physical injuries and medical expenses)—but this does not mean that the settlement funds are subject to income tax withholdings. The settlement agreement should specify which payments are made for lost wages (both back and front pay), which are subject to income tax withholdings and reported via a Form W-2, and which payments are made for non-wage recoveries (e.g., payments for emotional distress or attorneys’ fees) that are not subject to income tax or withholding.

Monies received for physical injuries (*i.e.*, observable or documented bruises, cuts, swelling or fractures) are excluded from the plaintiff’s income. All damages that flow from a physical injury or physical sickness are also excludable, even if the recipient of the damages is not the injured party (e.g., damages received by an individual on account of a claim for loss of consortium due to the physical injury of that individual’s spouse). Payments for medical expenses, whether incurred to treat physical or non-physical injuries, are also not considered income. Note, however, that unlike other tort actions, physical injuries are generally not present in employment cases, except perhaps where there is a claim for unwanted physical contact resulting in physical injury (*i.e.*, a battery-like offense).

Emotional distress and other nonphysical injuries are deemed income to a plaintiff but are not subject to payroll taxes. These awards should be reported as “other income” (box 3) on Form 1099-MISC. This is true even if the emotional distress produces physical symptoms. (However, emotional distress damages attributable to personal physical injuries are excludable from income.)

Like emotional distress, punitive damages are taxable income to the plaintiff but are not subject to payroll taxes. Punitive damages, including punitive damages received on account of physical injuries or physical sickness, are reported on Form 1099-MISC.

Whether attorneys’ fee awards are considered income or not for the plaintiff depends upon the nature of the underlying claims. Generally, attorneys’ fees are considered income of the plaintiff if they relate to a payment/award that is deemed income, and vice versa. In other words, if the payments made to the employee are includable as income, the related attorneys’ fees will be considered income to the employee. This is true whether the attorney was paid via a contingency arrangement or pursuant to a fee-shifting statute. See *Comm'r v. Banks*, 543 U.S. 426 (2005). As mentioned above, because most employment claims do not relate to physical injuries/sickness, most attorneys’ fee awards are includable as income of the plaintiff. Attorneys’ fee payments are reported on Form 1099 with respect to the attorney and Form 1099-MISC with respect to the employee. If the entire settlement amount is made payable in one check to the plaintiff and his/her attorneys jointly, then the employer will need to issue a Form 1099-MISC to the attorneys and to the plaintiff for the entire amount.
Lastly, prejudgment interest is considered income to a plaintiff, but it is not subject to payroll taxes. *Greer v. Comm'r*, TC Memo 2000-25 (Jan. 19, 2000). Prejudgment interest is reported on Form 1099-MISC.

Because it is important that all parties report the payments consistently on their tax returns, the settlement agreement should specify whether a Form W-2 or Form 1099 will be issued to the recipient. It is important to consult with a tax professional to ensure proper tax reporting.

**Penalties for Failure to Withhold**

If an employer fails to withhold proper payroll taxes from its payments to an employee (or former employee), the employer is liable for the amount that should have been withheld. 26 U.S.C. § 3403; Treas. Reg. § 31.3102-1 (d); Treas. Reg. § 31.3403-1. An employer who fails to withhold payroll taxes may be served a notice and demand for payment by the IRS; failure to pay within ten days of notice can result in an additional assessment equal to 0.5% of the amount of the tax for each month the tax remains unpaid, up to 25% of the amount due. 26 U.S.C. § 6651(a)(2) and (3). An additional penalty can be imposed for failure to deposit employment taxes, unless such failure is due to reasonable cause and not due to willful neglect. 26 U.S.C. § 6656(a). Interest on unpaid taxes or penalties continues to accrue if any amount is not paid when due.

It is wise for an employer to include indemnification language in the settlement agreement in the event that the IRS challenges the settlement allocation. But because such a clause will not prevent the IRS from seeking to recoup unpaid taxes from the employer, the employer should insist that the settlement allocation accurately reflect the realities of the settled claims and the plaintiff’s actual damages.

If you have any questions regarding employment practice liability, please feel free to contact one of our Employment Practices Liability Group Members.

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