

Tax Considerations When Settling an Employment Claim

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The time has finally come where you and opposing counsel seem to come to an agreement on a dollar amount to settle the employment dispute at hand; but how should the actual payment be made? How should it be reported—on a W2 or 1099-MISC? Should taxes be applied to the settlement proceeds? How many checks should be written? Should you separate attorney's fees for the plaintiff? There are a number of issues to consider before writing up a settlement agreement and making sure all parties involved know what their obligations are for reporting and paying the proper amount of taxes.

In most instances, the plaintiff/employee is seeking the biggest payout and wants to avoid or delay paying taxes from the settlement. Plaintiff's counsel often finds itself in the difficult position of trying to lay out a settlement that reduces the amount of taxes owed to appease their client, while the defendant's counsel wants to make sure the case is resolved accurately with as little ongoing risk as possible. No matter how one particular party would like to label the settlement, the Internal Revenue Service (IRS) has been very clear in their interpretation of the taxability of these settlement proceeds.

DETERMINING IF THE PAYMENT IS TAXABLE

The first step to determine the taxability of the settlement proceeds is to determine what exactly is being paid out. As a general rule, nearly all settlement payments in an employment lawsuit are included in the plaintiff's taxable income. This includes payments for back pay, front pay, emotional distress damages, punitive and liquidated damages, and interest awarded. The only exception to this rule is for payments intended to compensate the plaintiff for damages "on account of personal physical injuries or physical sickness" that would not be covered by a worker's compensation claim. I.R.C. § 104(a)(2).

To qualify for the physical injury/sickness exception, the plaintiff must show that the settlement payment was received as a result of their observable or documented bodily harm, such as bruising, cuts, swelling, or bleeding. If these observable injuries did not occur as a result of the conduct in question, then they are not eligible to exclude any portion of the settlement proceeds under IRC Section 104(a)(2). It is important to note that physical symptoms that result from emotional distress unrelated to any physical injuries are also not excludable under this same section.

SETTLEMENT AGREEMENTS

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Since the settlement the plaintiff is about to receive is likely going to be taxable, the next step is to lay out how they should be paid through the settlement agreement. As a general rule, the settlement agreement should require that there be at least two checks written—one to the attorney for their fees and another to the plaintiff. If the settlement results in a series of payments to the plaintiff over a period of time, these checks should be made payable directly to the plaintiff as well.

If the plaintiff is going to attempt to claim that the settlement proceeds are excludable from their taxable income, the burden falls on them to prove this position to the IRS. *Getty v. Commissioner*, 913 F.2d 1486 (9th Cir. 1990). If the settlement is to compensate a plaintiff for physical injury/sickness, then it is important that the settlement agreement expressly allocate what portion of the proceeds are intended as a result of the physical damages. The IRS will accept the settlement agreement as binding for tax purposes if the agreement is entered into in an adversarial context, at arm's length, and in good faith. *Bagley v. Commissioner*, 105 T.C. 396, 406 (1995), aff'd 121 F.3d 393 (8th Cir. 1997). The key inquiry from the IRS regarding the taxability of the settlement is determining the intent of the employer when a settlement is made.

REPORTING REQUIREMENTS

The payment of the settlement requires consideration for the reporting obligations and taxes to be withheld from the payments accordingly. The settlement agreement should also explicitly provide for how the settlement will be reported as well. The two primary methods to report the settlement to the IRS are either on a Form W-2 or a Form 1099-MISC. IRC § 3402(a)(1) provides, generally, that every employer making payment of wages shall deduct and withhold federal income taxes. Even if an employee is no longer employed at the time of the settlement payment, the payment is still deemed to be wages subject to tax withholdings. These payments would need to be reported on a W-2 and the check should be processed as if it was a payroll check allowing for deductions of income tax, FICA and state withholdings. The employer will also be subject to their share of the FICA taxes. If the employer fails to withhold and remit the proper amount of taxes, they may be subject to additional liabilities, penalties, and interest. See 26 U.S.C. § 3509.

Any portion of the proceeds that are not subject to payroll taxes would be reported on a Form 1099-MISC. The types of payments that would be included on this form include attorney's fees, punitive damages, emotional distress and other nonphysical injuries, and prejudgment interest. The amounts listed on Form 1099-MISC are paid to the plaintiff (or plaintiff's counsel) and does not have taxes taken out of the initial payment.

ATTORNEY'S FEES

Attorney's fees received in a settlement in an employment dispute are taxable to the plaintiff, even if the fees are paid directly to the attorney. There are a number of exceptions to this rule to consider. First, attorney's fees are not included in a plaintiff's gross income if the recovery is associated with physical

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injury/ sickness payments. Second, attorneys' fees paid directly to class counsel out of a settlement fund are not included in a class member's gross income if (1) the class member did not have a separate contingency fee arrangement or retainer agreement and (2) the class action was an opt-out class action.

The third exception for when attorneys' fees are not included in a plaintiff's income is when the fees are the expenses of another person or entity such as when a union files a claim against a company. And one last item to consider, and advise a plaintiff on, is that while payments for attorney's fees are typically included in plaintiff's gross income, they can often be deducted 'above the line' when calculating the plaintiff's adjusted gross income. To qualify for an above the line deduction, the settlement of the claim should be made under one of the statutes listed under IRC § 62(e).

INDEMNIFICATION CLAUSE

One additional consideration for an employer to protect themselves regarding the taxability of a settlement is an indemnification clause. If the settlement is ever challenged by the IRS, the employer can request an indemnification clause be part of the settlement agreement. However, this can only protect them so far. If the plaintiff does not properly report the income on their tax returns, the IRS will first attempt to collect from the plaintiff. If they are deemed to not be collectible, then the employer will be on the hook for the portion of taxes the IRS believes they should have withdrawn from a settlement payment. This is why it is so important that the parties allocate the payments correctly and take the tax considerations into account to avoid further risk.

Lastly, if you are not sure what taxes should be paid or how a transaction should be reported, consult a tax attorney familiar with the rules for guidance. *For more information about this topic, [click here for expanded and updated coverage](#).*