Tax Notes

Viewpoint

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ARE EMPLOYMENT SETTLEMENTS SUBJECT TO EMPLOYMENT TAXES?

Robert W. Wood practices law with Robert W. Wood, P.C., in San Francisco. He is the author of the book Taxation of Damage Awards and Settlement Payments (1991 with 1996 Supplement), published by Tax Institute (800/852-5515).

As most practitioners know by now, section 104 was amended by the Small Business Job Protection Act of 1996 (H.R. 3448) to provide that both punitive damages and damages for nonphysical injuries are taxable. The latter provision had been the controversial one, since it may be difficult to draw a line between physical and nonphysical injuries.

Whatever line drawing may be made (and the legislation does attempt to draw some), one aspect of the provision that has now begun to concern settling employers, employees, former employees, and their counsel is what the employment tax consequences of this taxable characterization are. The new legislation now calls for most emotional distress damages to be includable in income. To be sure, the amendments to section 104 have an impact far beyond the employment context. However, one of the areas that the Internal Revenue Service (and ultimately Congress) especially wished to affect was employment litigation. The fact that much of the impact of the section 104 amendments will be felt in the daily grist of employment litigation underscores the importance of what now appear to be thorny employment tax issues arising out of the taxable characterization of amounts.

Will amounts that are now taxable (for example, a recovery for emotional distress attributable to race or gender discrimination) also be subject to income tax withholding by the employer? Will they be subject to social security tax payable by both employer and employee? If an amount is paid and the subject of a Form 1099 (with no withholding), will self-employment tax be imposed on the recipient?

One of the most apparent points about the section 104 amendments concerns the difference between physical and nonphysical injuries. The Conference Committee report to H.R. 3448 attempts to draw a clear line, indicating that now an action must have its origin in a physical injury or physical sickness. If it does, then all damages that flow from that physical injury or physical sickness will be excludable, whether or not the recipient of the damages is actually the injured party. The only exception would be punitives, which would be taxable under the other amendments H.R. 3448 made to section 104.

Because the Conference Committee report states clearly that an exclusion under section 104 is still appropriate for any damages received based on a claim of emotional distress attributable to physical injury or physical sickness, the underlying and initial harm seems elevated to extreme importance. If there is a personal physical injury, and it produces various physical harms as well as emotional distress, exclusion for the entire recovery (except punitives) seems clear. A good deal less clear is what should happen if there is an injury that is by itself not physical, but ultimately does produce physical harm.

The now famous footnote to the Conference Committee report does state that "it is intended that the term emotional distress includes physical symptoms (e.g., insomnia, headaches, stomach disorders) which may result from such emotional distress." This list, which is itself not exhaustive, will give the Internal Revenue Service fuel to argue that physical consequences (at least of this sort!) will not be enough to lead to exclusion. However, one can expect taxpayers to argue that in a case without an underlying touching, if the resulting injuries include physical consequences, then the origin of the claim must subsume those physical consequences and should therefore lead to exclusion.

Allocations for Employment Tax Reasons

Apart from the incentives that litigants may now have to allege physical harm as a way of attempting to exclude all or a portion of their recovery under section 104, there now may be a similar incentive for litigants to continue allocating recoveries. This is not a taxable vs. excludable allocation, but rather a wages vs. nonwages allocation. For example, even when there is no physical harm, it would seem that a plaintiff would be better off if only a portion of the recovery is allocated [P. 618] to wage-like elements. If one portion of the recovery, say 50 percent, could be allocated to emotional distress damages, then that portion would seem to be outside the traditional scope of "wages."

After all, there is support for the proposition that one should analyze the reason for a payment. If the payment does not relate to the performance of services, and is not even calculated by reference to back pay formulas, wage rates, etc., then how can it be treated as wages? In a recent letter ruling, LTR 9635013, Doc 96-24213 (6 pages), the Service considered the tax treatment of settlement payments distributed by a collective bargaining agent to a company's former employees. Although the facts in the ruling are somewhat complicated, it seems significant that at least as to one element of the recovery involved, the union argued that distributions to union members were not made because of the group's performance of services and therefore were not wages. The union argued that the amount paid to this group of persons was the premium a settling company paid to end the dispute with the union. According to the union, this amount should therefore not be treated as wages.

Nonetheless, the Service in LTR 9635013 concluded that a premium was inherent in settling any dispute. According to the Service, there was no distinction between payments made to the various groups of employees involved in the dispute. The IRS said that the amounts for all of these groups came from money the company paid to settle claims. The lack of a specific back-pay formula or dispute relating to those particular distributees was irrelevant to the IRS in determining wage status. Consequently, the ruling holds that as to all of the amounts paid, the amounts are wages for FICA, FUTA, and income tax withholding purposes.

Practical Allocation Quandry

Let us suppose we are settling a typical employment discrimination or wrongful termination matter. Assume there was no physical injury. If 50 percent of the settlement amount is treated as wages (back pay, front pay, or whatever), and the other 50 percent is treated as a taxable emotional distress award, should the employer insist on withholding on this second portion, too?

Unfortunately, I do not believe the answer is clear. In fact, how you view the matter may depend upon whom you represent. Defendants that are settling claims will often want the protection of knowing that an amount has been paid and that there can be no further employment tax liability (for failure to withhold or for FICA). If an amount is paid in the employment context, the employer may feel reluctant to rely on a mere statement in the settlement agreement that the recovering plaintiff will pay any and all taxes that may be occasioned by the settlement.

Likewise, a mere indemnity obligation on the part of the recovering plaintiff to hold the defendant harmless in the event failure to withhold or employment tax penalties are imposed on the defendant may ring hollow. In many employment cases, one assumes that the recovering (former) employee will be long gone by the time any such claim under an indemnity provision would be made. True, settling employers generally ask for the indemnity, and it can be of some value. But I have rarely seen an employer treat the indemnity as having salutary effect in the face of likely penalties.

Of course, a settling employer may be less concerned about withholding and payroll taxes if the employment relationship has long ago ceased, as contrasted to a situation in which a termination is negotiated and the relationship between the employee and the company is therefore more recent. Part of the issue, too, may hinge on how strong one believes the allocation between the wage elements and the "emotional distress" elements to be. If the allocation to emotional distress seems quite strong, then both plaintiff and defendant may feel considerably more comfortable in treating the emotional distress payment as merely taxable income (and the subject of a Form 1099), but not the subject of withholding or employment taxes.

For example, if an amount is awarded by a judge or jury for emotional distress, the allocation may be particularly strong. On the other hand, the fact that an amount is indisputably for emotional distress may assist the employer in feeling more comfortable in not withholding. However, it does not resolve the question whether the amount in the hands of the former employee should be subject to self- employment tax.

As a preliminary matter, practitioners are already scrambling to look for authority dealing with these issues. Unfortunately, there does not seem to be very much out there of relevance. For example, Revenue Ruling 57-55, 1957-1 C.B. 304 (amplified by Revenue Ruling 75-64, 1975-1 C.B. 16), ruled that a payment made by an employer to an employee who was reinstated and granted back pay under an NLRB order did constitute wages. On the other hand, that ruling concluded that if the NLRB award for an illegal discharge was imposed against a labor organization, the payment would merely be income (but not wages) to the recipient.

This seems to draw a line between the employer/employee relationship, with characterization as wages of any amount received in the employment context. That characterization seems quite a bit too broad, since one certainly can receive an amount from an employer that is not wages (a slip and fall settlement, for example).

Of course, it is at least an easy line to draw. In LTR 9347028, 93 TNT 242-39, a dispute between a regional mass transportation authority and a transportation workers union resulted in a settlement agreement under which the transportation authority made payment to the union. The IRS ruled that the payments were not subject to employment taxes or withholding because there was no employer/employee relationship between the transportation authority and the union.

From an employer's perspective, perhaps the most distressing trend is the appearance of actions in which the IRS is not a party. For example, in Slotta v. Texas A&M University System, 863 F. Supp. 412 (S.D. Tex. 1994), an employment contract dispute involving a university professor was settled. When the university **[P. 619]** tendered a check less the withholding amounts, the professor refused to settle the matter. Although the IRS was not a party, the federal district court held that the amount was not subject to withholding. Significantly, the court stated that the settlement agreement clearly called for the defendants to pay a certain dollar amount without any qualification. The court then stated that if the settlement agreement exposed the university to any tax liability, the university, through its silence, assumed this responsibility.

In another case not involving the IRS, Lisec v. United Airlines, 10 Cal. App. 4th 1500 (Sept. 2, 1992), a state court considered whether withholding was necessary on a damage award for breach of contract and various torts (wrongful termination, intentional infliction of emotional distress, etc.). The court in the case (in which the taxing authorities were not parties) did not decide whether the recovery was income, but solely focused on the question whether withholding was required. The court concluded that, although some of the award may be gross income to the plaintiffs, none of it constituted wages for employment tax purposes so withholding was not required.

Of course, there have been some cases in which the IRS was a party. In George D. Prewitt, Jr., et ux. v. Commissioner, T.C. Memo. 1995-24, 95 TNT 12-14, the taxpayer received back pay from his improper termination from the Postal Service. His wife, during the same year, also received back pay from her employer, the Mississippi Department of Public Welfare. Interestingly, the infractions that led to both back pay awards occurred in 1990, but the husband and wife actually received the cash in 1991. They did not report the cash in 1991, and instead filed amended returns for 1990 to report the awards for that year. The IRS asserted that the back pay was taxable in 1991 and the Tax Court agreed. However, the Tax Court ruled that under section 111(a), the Prewitts could exclude from their 1991 income a state tax refund that they received during 1991.

Revenue Ruling 74-252, 1974-1 C.B. 287, concluded that amounts paid by a company to a former employee did constitute wages for purposes of FICA, FUTA, and income tax withholding. The ruling notes that the regulations provide that remuneration for employment, unless specifically excepted, constitutes wages, even though at the time paid, the individual is no longer an employee. See reg. sections 31.3121(a)-1(i), 31.3306(b)-1(i), and 31.3401(a)-1(a)(5).

In Norman D. Erickson v. Commissioner, 64 T.C.M. 963, 92 TNT 199-16 (1992), aff'd 1 F.3d 1231, 93 TNT 181-20 (1st Cir. 1993), amounts received by a terminated insurance salesman under a settlement agreement with his employer were held to be self- employment income subject to the self-employment tax. However, it is noteworthy that the settlement agreement superseded another agreement, which had provided fluctuating payments regarding future renewal commissions on previously sold insurance policies. Thus, the payments under the new agreement were given the same character as the payments under the old agreement.

Conclusion

In my view, it is too soon to draw any hard and fast conclusions about how this area will develop. However, both employers and employees (as well as their various advisors) must be cautious about this new minefield. While the safest approach may be for employers to treat all settlements as wages, this may be overinclusive. After all, if an amount is truly a tort settlement, regardless of whether it is now taxable income by virtue of the H.R. 3448 amendments, then there should be no employment taxes. And, given current rates, there can be a lot of money involved to settling employers, and especially settling employees and former employees. Therefore, both have an incentive to argue for nonwage treatment as long as there is a factual basis for doing so.

Nonetheless, hopefully before too long there will be guidance to insulate employers and employees, as well as their advisors from liability in this field.

Tax Analysts Information

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