

IRS Speaks Out on Employment Lawsuit Settlements

By Robert W. Wood

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Claims for wrongful termination, sexual harassment, and various forms of discrimination (especially race, gender, age, and disability) have burgeoned over the last few decades. To a lesser (but still significant) extent, litigation over the tax treatment of the resulting settlements and judgments has also been active. Several tax cases in this field have even gone to the U.S. Supreme Court.¹

In 1996 Congress amended section 104 to require a "physical" injury or "physical" sickness for its exclusion from income to be available. The legislative history to this 1996 law makes it clear that the primary target of this amendment was employment litigation.² In the 1980s and early 1990s, it had become commonplace for most discrimination (and other types of employment) recoveries to be largely allocated to nontaxable emotional distress damages rather than to taxable income.

The case law was mixed, with some taxpayers succeeding in excluding their damages from income and others failing. Still, exclusions from income under the auspices of section 104 were rampant. All that changed in 1996 with the tightening of section 104. Or did it?

The IRS and taxpayers have struggled with the changes to section 104 and the sometimes metaphysical qualities of just what is physical.³ To some extent, the IRS

has been hoist with its own petard. Indeed, although the statute itself was changed 13 years ago, the IRS has still not revised its regulations under section 104.⁴ Moreover, the IRS has not issued notices or announcements even though that form of guidance is easier to churn out than regulations.

The IRS has failed to give its views (save in private letter rulings) for how section 104 in this context should be applied. Those really in the know may know, but many tax advisers and taxpayers need better and clearer guidance. All these years later, the (to my mind) best evidence of the Service's views of section 104 remains the "bruise" ruling, LTR 200041022 (July 17, 2000), *Doc 2000-26382*, *2000 TNT 201-10*. This ruling bifurcates a sexual harassment recovery into the pre-physical and post-physical parts, the latter being excludable.⁵

New Dawn

The IRS has released a memorandum titled "Income and Employment Tax Consequences and Proper Reporting of Employment-Related Judgments and Settlements." Although it was released in July 2009,⁶ it bears a date of October 22, 2008. It is a memorandum addressed to various IRS employees from John Richards, senior technician reviewer in Employment Tax Branch 2.

Noting that the memorandum cannot be used or cited as precedent, its stated purpose is to outline the information necessary to determine the income and employment tax consequences (and appropriate reporting) of employment-related settlements and judgments. It states that it supersedes a memorandum dated September 9, 2004.

Party Line

The memo is 20 pages long, and should be useful reading for employment lawyers (both plaintiff and defendant) as well as tax lawyers and accountants. The IRS lays out the predictable references to the origin of the claim doctrine, the nature of severance pay, back pay and

Oct. 20, 2008, p. 281, *Doc 2008-19673*, or *2008 TNT 204-27*; "Physical Sickness and the Section 104 Exclusion," *Tax Notes*, Jan. 3, 2005, p. 121, *Doc 2004-24100*, or *2005 TNT 2-41*.

⁴In fact, in one of the ill-fated *Murphy* opinions decided by the D.C. Circuit, the court stopped short of castigating the IRS and Treasury, but the court's displeasure over the lack of regulatory attention was palpable. See *Murphy v. IRS*, 460 F.3d 79, 83 (D.C. Cir. 2006), *Doc 2006-15916*, *2006 TNT 163-6*, 493 F.3d 170 (D.C. Cir. 2007), *Doc 2007-15777*, *2007 TNT 129-4*.

⁵See Robert W. Wood, "What Litigation Recoveries Are Excludable as 'Physical'?" *TaxPractice*, Feb. 19, 2001, p. 230, *Doc 2001-3922*, or *2001 TNT 28-58*.

⁶"Service Explains Tax Consequences and Reporting Obligations for Employment-Related Settlement Payments," Program Manager Technical Advice (PMTA), 2009-035, Oct. 22, 2008, *Doc 2009-15305*, *2009 TNT 129-19*.

¹See *United States v. Burke*, 504 U.S. 229 (1992); *Commissioner v. Schleier*, 515 U.S. 323 (1995); and *Commissioner v. Banks*, 543 U.S. 426 (2005).

²H.R. Conf. Rep. No. 104-737, 104th Cong., 2d Sess., 300 (1996).

³See Robert W. Wood, "It's All About the Proof," *Tax Notes*, May 25, 2009, p. 1007, *Doc 2009-9514*, or *2009 TNT 98-9*; "Getting Physical: Emotional Distress and Physical Sickness," *Tax Notes*,

(Footnote continued in next column.)

front pay (all wages), the nature of punitive damages (always taxable), etc. The memo even includes a helpful list of different causes of action, including those arising under the Back Pay Act (5 U.S.C. section 5596(b)(1)), Title VII of the Civil Rights Act of 1964, the Age Discrimination in Employment Act (ADEA), the Americans with Disabilities Act, the Fair Labor Standards Act (FLSA), and many others.

Concerning our old friend section 104, the memorandum predictably specifies that for an exclusion to be available, the claim must be for a tort or tort-like injury. Naturally, the memo cites *Commissioner v. Schleier*.⁷ It goes on to address what constitutes physical injury.

Here, the memo disappoints. It merely cites Rev. Rul. 85-97.⁸ That old saw involved a bus accident. The memo states:

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).⁹

Attorney Fees

The memo spends a brief two pages on attorney fees and *Commissioner v. Banks*.¹⁰ Interestingly, the memo states that *Banks* resolved a conflict in the circuits, the Supreme Court agreeing with the commissioner that taxpayers must include contingent fees in income. There is no mention of the fact that the Supreme Court enunciated this as a "general rule," nor that the Supreme Court identified exceptions it was not addressing.

Nevertheless, regarding attorney fees and so-called fee-shifting statutes, the memo states:

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).¹¹

Indeed, the Service notes:

We construe *Banks* and the AJCA [the American Jobs Creation Act of 2004 provision allowing an above-the-line deduction] 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.¹²

⁷515 U.S. 323 (1995), *Doc 95-5972*, 95 *TNT* 116-8.

⁸1985-2 C.B. 50, amplifying Rev. Rul. 61-1, 1961 C.B. 14.

⁹See *supra* note 6, at 6.

¹⁰543 U.S. 426 (2005).

¹¹See PMTA 2009-035, *supra* note 6, at 7.

¹²*Id.*

Employment Taxes

The IRS's memo does a credible job of dealing with FICA and FUTA taxes, and with the authorities detailing back pay and front pay. There has been some litigation (which the Service notes) concerning front pay, with the Fifth Circuit holding that only the back pay portion of a settlement was wages for FICA purposes.¹³ The IRS notes (with evident glee) that most appellate courts have disagreed with the Fifth Circuit.

The employment tax discussion also notes such important decisions as *United States v. Cleveland Indians Baseball Co.*¹⁴ Here again, the IRS is able to state that 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."¹⁵

One of the most interesting discussions in the memo concerns allocations of payments. Arguably, this is the elephant in the room. The memo notes that settlements and judgments can comprise multiple elements, each of which may or may not be wages. The IRS seems to think this allocation issue is only a wage versus nonwage one. Indeed, the IRS does not confront the issues associated with the allocation of excludable and taxable amounts, although presumably the same principles should apply.

The memo notes that a court award may break everything down piece by piece. In the case of a settlement payment, however, the IRS notes that "the parties must determine the elements of the settlement amount."¹⁶ But how do we do this? The IRS says one should consider all the facts and circumstances.

More particularly, the Service notes that it 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:

- whether there was a bona fide adversarial settlement concerning the allocation of payment between types of recoveries (for this the IRS cites *Robinson v. Commissioner*¹⁷); and
- whether the terms are consistent with the true substance of the underlying claims.¹⁸

Attorney Fees as Wages

In what is so far a vanilla memo, I found the extent to which the IRS addresses Rev. Rul. 80-364 to be surprising.¹⁹ That 1980 ruling considers whether attorney fees and interest awarded with back pay are wages for employment tax purposes. After a recitation of the different factual situations analyzed in the revenue ruling, the memo addresses settlement payments, noting (quite

¹³*Dotson v. United States*, 87 F.3d 682 (5th Cir. 1986).

¹⁴532 U.S. 200 (2001), *Doc 2001-11045*, 2001 *TNT* 75-7.

¹⁵See PMTA 2009-035, *supra* note 6, at 10.

¹⁶*Id.*

¹⁷102 T.C. 116 (1994), *Doc 94-1439*, 94 *TNT* 23-18, *aff'd*, 70 F.3d 34 (5th Cir. 1995), *Doc 95-10932*, 95 *TNT* 238-7, *cert. denied*, 519 U.S. 824 (1996).

¹⁸See PMTA 2009-035, *supra* note 6, at 10-11.

¹⁹1980-2 C.B. 294.

correctly) that most employment-related disputes are settled rather than tried. The memo then states:

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.²⁰

The memo states that if this issue arises, the IRS National Office should be contacted for guidance.

In my experience, virtually no one in practice suggests that the plaintiff attorney fees in even a strictly wage case should be treated as wages. The IRS seemingly would also want to avoid this result.

In fact, in TAM 200244004 (June 19, 2002), *Doc 2002-24564*, 2002 TNT 213-18, the IRS addressed wage treatment for attorney fees related to an employment discrimination suit brought under the ADEA. The Service acknowledged that the ADEA contains a fee-shifting component. Not only that, but under the analysis in Rev. Rul. 80-364, had the employee prevailed in litigation under the ADEA, he would have received an award of attorney fees.

That would be in addition to the back wage award. Thus, TAM 200244004 concludes that the attorney fees paid under a settlement agreement in such an employment suit are not wages for federal employment tax purposes. That result (however one reaches it) seems appropriate.

Of course, the IRS has said — in this very same memo — that the presence of a right to a statutory fee as a means of avoiding gross income to the client is not necessary. The above-the-line deduction (for employment cases) takes care of that problem, the memo says. Here, of course, the Service is talking not of income, but of wage characterization, something the above-the-line deduction would not fix.

To state the pure analytical case, consider a lawsuit (brought by one person or many) which seeks only wages, with no other types of damages. Such suits are rare, but they do occur (some FLSA cases, for example, are of this ilk). If the plaintiff will receive 100 percent wages, and the lawyer is being paid a contingent fee of 40 percent, how is the employment and income tax withholding to be accomplished?

The choices would seem to be:

1. Withhold on the client's share only, and pay the lawyer his gross 40 percent fee with no withholding;
2. Withhold on 100 percent, thus shorting the lawyer, and doubtless requiring continued relations between client and lawyer at least into the next tax year, with the lawyer having a claim on monies withheld and paid over to the IRS; or

3. Withhold only on the client's 60 percent, but at a rate (for both income and employment tax purposes) that takes into account the 40 percent being paid to the lawyer with no withholding. The idea of this new math would be to attribute the income (as wages) to the client, as if the client were really receiving the full 100 percent.

If anyone were to pick choice 2 or choice 3 (both non-choices as far as I'm concerned), there are interesting analytical issues. For example, query how the plaintiff would deduct the legal fees. Even an above-the-line deduction would not make the plaintiff whole.

Quite apart from the timing problem created by withholding, how could the plaintiff recover his share of the employment taxes on the lawyer's 40 percent contingent fee? These are interesting questions, but they are purely academic.

After all, would *anyone* select choice 2 or choice 3? In my experience, no. I can count on one hand the number of times in 30 years of tax practice I've heard an employer in a wage case bristle about the potential need to withhold on the lawyer's share of the funds. In the paucity of cases in which I have heard such bristling, it has uniformly (and quite easily I might add) been dispelled.

It might be dispelled by someone like me arguing that there is a right to a statutory fee, so that TAM 200244004 provides some comfort. Alternatively, it might be dispelled by plaintiff's counsel saying unabashedly to the employer: "If you withhold on the lawyer fees too, this case will not settle." That can be pretty convincing, even if it isn't overly analytical.

It seems that such stonewalling by the plaintiff's counsel (if you want to call it that) is likely to have the desired effect. Surely, most companies are not too concerned about their exposure to failure to withhold penalties (even in a 100 percent wage case) if they don't withhold on the attorney fees. Put differently, in all likelihood, the companies are far more afraid of failing to settle the lawsuit than they are of being accused of failing to withhold on the attorney fees.

I will admit that this is a messy area. How to treat contingent legal fees in a 100 percent wage case represents an interesting analytical conundrum. But as a practical matter, I've found it to be a nonissue. If the IRS's "call the National Office" admonition means that the Service is thinking differently on this, I foresee a mess, one that probably won't end up gaining the IRS either revenue or friends.

Third-Party Payors

An interesting (although brief) discussion in the memo concerns third-party payors. The IRS correctly notes that an agency other than the employing agency may, in some cases, pay an amount to an employee in satisfaction of a settlement or judgment. When this occurs, the Service notes, the agency having control of the payment of wages is responsible for withholding.

Reporting

Finally, the memo discusses reporting requirements, including wage reporting, special requirements for back pay, Form 1099 reporting, and payments to attorneys. These topics are only briefly noted, with no detail.

²⁰See PMTA 2009-035, *supra* note 6, at 12.

TAX PRACTICE

Helpfully, however, the memo does include several charts. Tax rules rarely seem to lend themselves to charts, and for that reason, these charts are worth a look. As fun as it is to have some charts, they may give the illusion of precision. In the area of the taxation of employment settlements, it is an understatement to say that the current state of the law is not precise.

Conclusion

There has not exactly been an outpouring of guidance from the IRS on the tax issues arising in employment litigation since 1996. That's too bad. We badly need more guidance on the section 104 issues; and we need more guidance on fringe and pension benefit issues. It is a step in the right direction that the Service has issued some guidance in the memo, but it isn't all that helpful.

In some ways, it is good that the IRS may be focusing on the wage versus nonwage issue. I have long thought

that the Service does not give it enough attention. Indeed, it seems to me that practice regarding wage versus nonwage allocations in settlements varies too wildly. Sometimes the wage versus nonwage issue is addressed without fair regard to the causes of action and the facts. The IRS probably should look at such issues more closely.

However, the suggestion that attorney fees may be subject to wage withholding is frightening, at least to me. I admit I may be overreacting. After all, perhaps the IRS might respond to calls to the National Office with "don't worry, don't require withholding on the attorney fees."

In any case, if you are an employment lawyer, tax practitioner, plaintiff, or defendant in an employment dispute, this memo is worth reading. Given that not too much guidance is being issued on these matters, you have to take what you can get.

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