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Qualified Settlement Funds Facing Employment Taxes

by Robert W. Wood

Robert W. Wood

Robert W. Wood practices law with Wood LLP (www.WoodLLP.com) and is the author of *Taxation of Damage Awards and Settlement Payments* and other books available at www.TaxInstitute.com.

In this article, Wood explores how employers often settle employment class actions by paying into a qualified settlement fund that handles wage withholding and reporting, and he explains why the mechanics of that arrangement and determining the identity of the employer can be surprisingly complex.

This discussion is not intended as legal advice.

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Many lawsuits are settled with the defendants paying into a qualified settlement fund (QSF). The case may not be a class action, but for ease of reference, I will refer to plaintiffs and class members as "claimants." The defendant gets a complete release, and the tax obligations generally become the QSF's. The defendant also gets an immediate tax deduction, even if the QSF takes years to distribute funds.

The QSF handles payments to claimants and lawyers, which can be a big and messy job with lots of recordkeeping. That is so even if all the claimants have been located and are responsive. In employment cases, who is the employer for tax purposes? It sounds like a silly question. The defendant employer surely is. The tax law is clear that an employer has employment tax responsibilities even if wages, including severance payments, are paid many years after termination of employment.

Despite the defendant's employer role, however, the QSF tasked with distributing wages to claimants may be a statutory employer. If the employer-defendant would have been required to withhold on paying wages,[1] a QSF disbursing wages is, too.[2] A QSF must obtain its own employer identification number,[3] so questions of identity can arise.

A QSF is generally either: (1) a statutory employer under section 3401(d) or (2) an agent under section 3504. In either case, the third-party payer uses its own EIN in reporting employment taxes for wages paid on behalf of another person.[4] However, in most cases, the QSF can use the employer-defendant's wage base limits, rather than starting the wage base calculation anew.

Common Law Employer

A common law employer is "any person who has the status of employer under the usual common law rules applicable in determining the employer-employee relationship."[5] A relationship exists when there is a right to control the service

[1]Reg. section 1.468B-2(l)(2)(ii)(A).

[2]*See* reg. section 1.468B-2(l)(2)(i). Technically, the QSF rules impose the withholding requirements only on the QSF, and do not impose the requirement to pay the employer's share of the employment taxes. However, the QSF may be liable for the employer's share of the taxes under other rules not specific to QSFs.

[3]Reg. section 1.468B-2(k)(4). Technically, of course, the administrator of the QSF must obtain an EIN for the QSF.

[4]Internal Revenue Manual section 5.1.24.3.2.2(1) provides that a statutory employer under section 3401(d) should use its own EIN in withholding, reporting, and paying employment taxes. IRS Publication 15 (Circular E), "Employer's Tax Guide," 16 (2016) provides that an agent under section 3504 must also use its own EIN in fulfilling employment tax obligations.

[5]IRM section 5.1.24.3.1(1).

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provider, not only as to the result to be accomplished, "but also as to the details and means by which that result is accomplished."[6] A QSF paying wages to claimants is generally not a common law employer of the claimants.

Instead, the employer-defendant is generally the common law employer. In determining whether the wage base limit has been reached, the common law employer is the employer.[7] In *Cencast Services*,[8] the Federal Circuit held that FUTA and FICA wage base caps should be calculated by reference to the employment relationships with the common law employers. Cencast provided payroll services to motion picture and television studios.

The production workers generally earned wages from several production companies in a given year. Although production companies selected and supervised the workers, Cencast paid them and administered payroll and employment tax obligations. Cencast treated the workers as its own employees, aggregating wages it paid on behalf of all production companies in calculating the FICA and FUTA wage bases. This resulted in lower amounts of FICA and FUTA taxes.

Cencast was not the common law employer; the production companies were. The Federal Circuit and Federal Court of Claims held that the FICA and FUTA wage base limits should be calculated for each production company separately.[9] Unfortunately, IRS guidance does not clearly confirm that the holding of *Cencast* and the IRS's general rules regarding third-party payers apply to a QSF disbursing wages in settlement of an employment action. The QSF paying wages is a form of third-party payer whose actions are described in large part in the existing guidance.[10]

QSF as Statutory Employer

An employer includes "the person having control of the payment of such wages," often referred to as a statutory employer.[11] Although section 3401(d)(1) by its terms applies to income tax withholding, the courts and the IRS have applied it to FICA and FUTA taxes.[12] A statutory employer is generally liable for the employer's portion of FICA and FUTA, and must withhold the employee's portion of FICA taxes.[13]

Once the employer-defendant has funded the QSF, the QSF is typically in sole control of the payment of the wages. However, whether a QSF is

[6]IRM section 5.1.24.3.1(3).

[7]IRM section 5.1.24.3.2.2. The way the code effectuates the wage base limitation is to consider as "wages" subject to taxation only the amount below the wage base limitation. Thus, if the wages paid to an employee have surpassed the relevant wage base limitation, those amounts above the limitation are not considered "wages" for purposes of calculating the employment tax due. *See* sections 3121(a) and 3306(b).

[8]*Cencast Services LP v. United States*, 729 F.3d 1352 (Fed Cir. 2013), *aff'g Cencast Services LP v. United States*, 62 Fed. Cl. 159 (2004). *See also Blue Lake Rancheria v. United States*, 653 F.3d 1112 (9th Cir. 2011) ("It is the common-law employment relationship that triggers the FUTA tax.").

[9]Interestingly, Congress modified the rule of *Cencast*, essentially overturning it. Effective January 1, 2016, new section 3512 allows payroll service providers that pay motion production workers, and meet the other requirements of section 3512, to use an aggregated wage base limit for purposes of calculating FICA and FUTA tax liability.

The result in *Cencast* was to increase the amount of employment tax due. But its reasoning clearly indicates that only the common law employment relationship counts. Thus, a third-party payer should generally not be subject to a new wage base limit, and the use of a third-party payer should generally not increase the employment taxes due.

Of course, section 3512 reduces the employment tax liability. Thus, the effect of section 3512 is in some sense consistent with a QSF using the reasoning of *Cencast* to reduce employment tax liability, even if section 3512 overturns *Cencast* as to some situations.

[10]IRS Publication 15 and IRM section 5.1.24 discuss third-party payer arrangements for employment taxes. QSFs are not specifically mentioned in these discussions, and there also appears to be no specific mention of QSFs in the authorities that underlie the guidance. Nevertheless, because the rules regarding third-party payer arrangements are of a general nature, and do not specifically exclude QSFs, they would appear to be applicable to QSFs.

[11]Section 3401(d)(1). *See Cencast Services*, 729 F.3d 1352.

[12]IRM section 5.1.24.3.2.

[13]*See, e.g.*, *Cencast Services*, 62 Fed. Cl. 159 ("Beginning with the Supreme Court's decision in *Otte v. United States*, 419 U.S. 43 . . . (1974), courts have incorporated the Section 3401(d) definition of 'employer' into FICA and FUTA. . . . Therefore, statutory employers having control of the payment of wages are responsible for withholding, paying and reporting not only federal income taxes, but FICA and FUTA taxes, as well."). *See also Winstead v. United States*, 109 F.3d 989 (4th Cir. 1997) (applying *Otte* to FUTA taxes); *In re Armadillo Corp.*, 561 F.2d 1382 (10th Cir. 1977) (applying *Otte* to FUTA taxes and the employer's FICA tax); *In re The Laub Baking Co. v. United States*, 642 F.2d 196 (6th Cir. 1981) (applying *Otte* and *Armadillo* to FUTA taxes and the employer's FICA tax).

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considered a statutory employer is a facts and circumstances determination.[14] Depending on the facts, it may be possible to argue that in some cases, a QSF is not a statutory employer.

According to the Internal Revenue Manual, "if the payment of wages is contingent on, or proximately related to, the common law employer's transfer of funds to the third party, the Service considers the common law employer to be in control of the payment of wages."[15] A QSF should assume it is liable as a statutory employer, but the common law employer (the defendant) can still be liable if the statutory employer fails to pay the taxes.[16]

QSF as Designated Agent

Even if the QSF is not a statutory employer, the QSF may be designated an agent under section 3504, making it liable for employment taxes. Either the employer-defendant or the IRS can make the designation. An employer-defendant uses Form 2678 to request authorization to appoint the QSF as an agent to perform payroll-related functions on behalf of the employer. If a Form 2678 has not been filed, the IRS can designate an agent as a payer liable under section 3504.

Reporting Wages

A QSF paying wages can use the employer-defendant's wage base limits. Even so, to avoid any underwithholding claim, the QSF may want to withhold the maximum amount of the employee's portion of the Social Security tax, as if the QSF were a separate common law employer. The employee can then claim a credit or refund if there has been overwithholding of FICA taxes.

However, if the full amount of the employee's portion of the Social Security tax is withheld, there could be problems with reporting a lower (but correct) amount of the employer's portion of the Social Security tax. This reporting would be done on Form 941, "Employer's Quarterly Federal Tax Return," or Form 944, "Employer's Annual Federal Tax Return." Forms 941 and 944 each include only one space for "taxable social security wages."

Accordingly, both the employee's Social Security tax and the employer's Social Security tax reported on these forms should be based on the same wage amounts. Coordination may also be needed between the QSF and the employer-defendant about who benefits from the wage-base limitation being reached. Suppose that the wage payment is made simultaneously, with the QSF and employer-defendant paying in the same month, with these payments causing the wage base limitation to be met. Which entity should be exempted from remitting the employment tax?

These issues are not unique to QSFs, and arise for third-party payers using their own EINs. If the third-party payer is not the common law employer, and the common law employer separately pays additional wages to the employee, there may be an overpayment of employment taxes that involves an employer-specific wage base limitation. The issue may also arise in the case of multiple third-party payers.

Yet, the problem does not seem to be addressed in the available guidance on third-party payers — a larger category of taxpayers. Until there is IRS guidance on how to handle overpayments, here is one possible solution to this problem.

Overpaying and Filing for Refund

The QSF could treat the wage payment as if it were the common law employer. The QSF could pay the employer's employment taxes and withhold the employees' employment taxes for the wage payment. Then, the employer-defendant (or the QSF) could file claims for refund if too much tax had been paid.

Arguably, the employer-defendant, rather than the QSF, should be the entity that files for the refund claim. The employer-defendant is the entity that would have benefited from the refund if the wages were directly paid by it. It should

[14] *See* IRM section 5.1.24.3.2.1(3).

[15] IRM section 5.1.24.3.2.1(2).

[16] *See* IRS Field Service Advisory, 2002 WL 1315735 ("If a party other than the common law employer has control of the payment of wages, the common law employer can be liable for FICA and FUTA taxes in addition to the party in control of the payment of wages.").

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arguably not be different if the QSF is paying the wages.

The QSF may be tasked with paying the employment tax liability for the wages. However, if there is an overpayment of employment taxes, there is ultimately no employment tax liability in the amount of the overpayment. The employer-defendant may want an agreement with the QSF to clarify that beneficial ownership of the employment tax refund should reside with the employer-defendant.

Alternatively, if the employer-defendant wants to walk away from the case as much as possible, the employer-defendant could allow the QSF to claim the refund and keep its proceeds for its own use.[17] Whoever claims it, there may be administrative requirements. Before an employer can claim a refund for the employer's FICA tax, the employer must make reasonable attempts to reimburse the employees for the corresponding overwithholding of their FICA taxes.[18] The employer should also issue corrected Forms W-2 to employees to reflect the correct amount of FICA wages.[19]

If the employer-defendant seeks a refund relating to overpayments of employment tax made by the QSF, the IRS may find it helpful to see that the overpayments are tied to the EIN of the employer-defendant. But if the QSF is paying the taxes under its own EIN, how does the employer-defendant's EIN become associated with the payment?

Credit to Employer-Defendant

One way is by using a Form 2678.[20] An employer uses this form to request authorization to appoint an agent to perform employment tax functions on its behalf. An agent with a Form 2678 is authorized to use its own EIN to pay FICA taxes on behalf of an employer. The agent files a Schedule R with its Form 941 to attribute the FICA tax payments to the employer and the employer's EIN.[21]

An agent with an approved Form 2678 is also generally allowed to report the employer-defendant's EIN on Form W-3.[22] Form W-3 is used to transmit copies of Form W-2 to the IRS. In this way, the wage payments can be attributed to the employer-defendant. The agent with a Form 2678 and the employer are jointly liable for the employment taxes and related tax duties the agent is authorized to perform. The agent is liable under section 3504 and reg. section 31.3504-1.

It is unclear if the third-party payer must file a Schedule R, or must report the employer-defendant's EIN on Form W-3, for the employer-defendant to obtain a refund for overpaid employment taxes. Arguably, a properly filed Schedule R and Form W-3 showing the employer-defendant's EIN would clarify to the IRS that the QSF's payments of FICA taxes are on account of the employer-defendant.[23]

However, it is unclear whether Form 2678 or Schedule R is meant for the situation of a QSF paying wages. It is also unclear whether a third-party payer must be an agent approved under Form 2678 to report the common law employer's EIN on Form W-3.[24] It may be prudent for the

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[17] However, there may be some complications if a QSF were to claim a refund for FUTA taxes. As explained by ILM 200017041,"under section 3306(g), contributions (for which the [third-party payer] may take credit under section 3302) include only payments required by a State law to be made by a person on account of having individuals in his employ. We believe that State unemployment laws generally require contributions to be made by the common law employer. Thus, even if the [third-party payer] made contributions to the State fund, the [third-party payer] is not entitled to the credit unless the [third-party payer], rather than the common law employer, is liable for contributions under State law."

[18] *See* IRM section 21.7.2.4.6.4.1; ILM 200017041 (citing *Atlantic Department Stores Inc. v. United States*, 557 F.2d 957 (2d Cir. 1977), and Rev. Rul. 81-310).

[19] ILM 200017041. In this scenario, the employer or QSF is claiming a refund. Thus, the IRS will have been given an explanation why the corresponding Forms W-2 show lower FICA wage amounts than the lower of the FICA wage base limit and the total wages paid.

[20] As in the case of other IRS guidance for third-party payers, QSFs are not specifically mentioned in the instructions for Form 2678. The IRS could clarify whether an employer may use Form 2678 to appoint a QSF as an agent for some employment tax purposes.

[21] Schedule R is apparently not available for Form 944.

[22] *See* general instructions for Form W-2 and Form W-3 (2016).

[23] The IRS could modify Form W-2 and its instructions to also allow the EIN (and not just the name, as the instructions currently allow) of the common law employer to appear on the Form W-2 issued by the agent. This would help connect the wage payment to the correct employer for purposes of determining whether a wage base limitation has been reached.

[24] The instructions for Form W-3 state that the agent with an approved Form 2678 can report the principal's EIN on Form W-3. However, the instructions do not indicate that an agent without an approved Form 2678 cannot also include the common law employer's EIN on Form W-3.

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employer-defendant to use Form 2678 to appoint the QSF as an agent, and for the QSF to attribute the payments to the employer-defendant on Schedule R and Form W-3.

In this way, the employer-defendant may be more easily credited with the employment taxes the QSF pays. However, Form 2678 is limited in the functions allowed to an agent. According to Form 2678, "Generally you cannot appoint an agent to report, deposit, and pay tax reported on Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return, unless you are a home care service recipient." The regulations agree.[25]

Thus, in most situations, a QSF with a Form 2678 apparently cannot, in its own name, pay FUTA taxes or file FUTA tax returns for the wages it is disbursing. Whether or not a Form 2678 can be used for a QSF, this limitation suggests other problems a QSF may face when paying wages. The amount of state (and thus net federal) unemployment taxes due may depend on the identity of the employer. Some states provide differing rates for "new employers."

Thus, allowing FUTA and SUTA tax liability to be determined and paid by a party different from the party actually employing the employee may cause problems for the proper calculation of unemployment taxes.[26] One reason Form 2678 bars a taxpayer from authorizing a third party to pay unemployment tax may be to avoid the mismatch that arises if the payer is subject to a different unemployment tax rate. In fact, many states do not want the QSF to be considered the employer and do not want the QSF to be reporting the wages. Instead, these states require the employer-defendant to report the wages for unemployment tax purposes.[27]

Employment Taxes Make It Hard to Walk Away

An employer-defendant may find it difficult to completely delegate employment tax compliance to a QSF. It may be particularly difficult for unemployment taxes. Even with tax items that a QSF could report under a Form 2678 (such as FICA taxes), the employer-defendant may need to remain involved. This would be so if the employer-defendant is to file refund claims for overpaid employment taxes.

For federal employment taxes, employment tax rates and wage bases are determined with reference to the rates and bases in effect in the year of actual payment to the employee.[28] The QSF may not be paying the wages to the claimants immediately. Thus, the employment taxes eventually due may be greater than what was expected when the QSF was formed and funded.

The QSF may conceivably have insufficient funds to pay all the employment taxes if the initial funding of the QSF was calculated at the lower rates.[29] In that situation, the QSF may need to look to the employer-defendant for payment of the greater taxes due. If the QSF does not pay the employment taxes, the IRS may hold the employer-defendant liable for them.

[25] *See* reg. section 31.3504-1(a) (omitting Chapter 23 (unemployment) taxes from coverage).

[26] *See supra* note 17 for possible complications relating to crediting SUTA taxes if the QSF makes the SUTA tax payment.

[27] *See, e.g.*, California Employment Development Department, "FAQs — Payroll Taxes General Information"; and Wisconsin Department of Workforce Development, "Unemployment Insurance Handbook for Employers." ILM 200017041 notes that, "We believe that State unemployment laws generally require contributions to be made by the common law employer."

It arguably should be possible for a third-party payer to pay the state unemployment taxes as an initial matter, perhaps at the rate of the common law employer if it is known, and then for a refund claim to be filed if there is an overpayment. The administration of the tax, including the refunding and recalculations of amounts due, just becomes a step more complicated when differing tax rates are involved. The complications may explain why states are reluctant to allow third-party payers to pay the unemployment tax on behalf of the common law employers.

[28] *See United States v. Cleveland Indians Baseball Co.*, 532 U.S. 200 (2001). It is for a future project to determine which states follow *Cleveland Indians* in determining that the rate to be applied is the rate of the year of payment, rather than the year in which the services were rendered. One might also query whether using a QSF may change the applicability of *Cleveland Indians*, although it would appear unlikely.

[29] The employment tax could be greater or less in a later year, owing to changes in the tax rate, the tax base, or the employment status of the claimant. Thus, the parties may be advised to take into account the timing of the payment, to reduce the taxes due.

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Conclusion

Employers resolving employment litigation may pay a combination of wage and non-wage damages. Non-wage elements such as penalties rarely cause difficulties, being reported on a Form 1099. But wages are different, and many defendants do not want to run their own payroll. Some plaintiffs' counsel also do not want the defendants involved.

QSFs have emerged as the usual solution, but QSFs are clearly more than mere payroll processors. QSFs are distinct legal entities and are themselves subject to tax. And the settlement administration firms that often handle this work through a QSF face many pressures to do it all quickly, efficiently, and at low cost. The law seems relatively clear that a third party paying wages in an employment action should not be subject to separate employment tax wage base limitations.

The case law and IRS guidance presumably apply to QSFs, although the authorities have not made this explicit. Even less clear is how the shared employment tax wage base limitations should be reflected administratively, so taxpayers do not pay more employment tax than is necessary. In the absence of clear guidelines, defendant employers, QSF administrators, and even plaintiffs' counsel, should be sensitive to the choices and the range of liabilities the payment of wages can present. ■

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