Attorney Comments on Employment Lawsuit Settlements Article

To the Editor:

It was with great interest that I read the recent article by Mr. Robert W. Wood titled, ''IRS Speaks Out on Employment Lawsuit Settlements,'' (*Tax Notes*, Sept. 14, 2009, p. 1091, *Doc 2009-18678, 2009 TNT 175-4*). As many of your readers already know, Wood is the preeminent expert on the taxation of settlements and judgments. His books and articles are *must reads* for those that practice in this area.

I would like to add an additional perspective on one of the examples addressed by Wood in his article. In particular, Wood addresses a frequent issue that those of us who practice in this area must confront, namely the proper withholding on employment settlements. The relevant excerpt from the article is set forth below:

> 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 [Fair Labor Standards Act] 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?
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> The choices would seem to be:
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> 1. Withhold on the client's share only, and pay the lawyer his gross 40 percent fee with no withholding;
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> 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
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> 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.
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> 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.
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> 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.
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> 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.

Wood goes on to state that the choice that occurs most often is choice 1, whether because that is the technically correct way to treat the payment (in the case where the legal fees are paid pursuant to a fee-shifting statute) or because the plaintiff will insist on that treatment or not settle.

In my practice, I often represent the employer in situations like the above. From my perspective, the analysis may be different.

Threshold Question. Under Rev. Rul. 80-364 and TAM 200244004, the threshold question is whether the legal fees can be paid to plaintiff under an available fee-shifting statute? Since most of these matters are settled, I think from a practical perspective the relevant inquiry is whether the litigation attorneys can say, with a straight face, that legal fees would have (or at least could have) been awarded by a judge to the plaintiff. If so, I agree with Wood and would follow choice 1.

No Available Legal Fee-Shifting Statute. If, however, there is not a fee-shifting statute available (e.g., in many state wage claims there may not be) or no one really thinks a judge would award legal fees to the plaintiff, then I don't think the above authorities can lead us to choice 1. Instead, I think choice 3 is the answer.

Stated another way, I believe that the employer would be required to withhold on the plaintiff's share of the settlement assuming withholding is required on the entire 100 percent. The 40 percent is being paid to the plaintiff's attorney as a matter of convenience to the plaintiff (more accurately, convenience to the plaintiff's attorney), and that fact should not impact the withholding. Yes, I understand that at least as to income tax withholding it is quite strange to withhold based on 100 percent to the plaintiff when the plaintiff has an above-the-line deduction for the 40 percent of legal fees (section 62(a)(20)). But, employers are not allowed to, and don't, factor these individualized aspects of an employee's tax situation into the amount of withholding. An employer would not withhold less and pay less employment taxes in a case where the employee had substantial losses, deductions, or credits that could offset the wage income- . . . why should section 62(a)(20) be any different? The deduction in each case is personal to the plaintiff and not a matter that impacts the employer.

I understand why choice 3 is not popular among the parties. Let's assume a flat 25 percent withholding rate. Here's the math: (i) plaintiff's attorney receives 40 percent, (ii) IRS receives 25 percent (of 100 percent), and (iii) plaintiff receives the remaining 35. That is a tough sell even for the best plaintiff's attorney.

With all of this said, I agree that this is an area where choice 1 is the most frequent route taken. Nevertheless, it does impose some risk (typically not a huge risk, but a risk nonetheless) on the employer. Just maybe, the IRS will expand the rationale in Rev. Rul. 80-364 and TAM 200244004 to cover all legal fees paid in employment lawsuits (whether or not a legal fee-shifting statute exists).

Regards,

Jared D. Mobley
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