Beware 12 Tax Myths in Employment Suit Settlements

by Robert W. Wood

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In this article, Wood points out some common myths about how taxes apply to employment case legal settlements.

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Lawsuit settlements and judgments are taxed based on the origin of the claim, essentially the item for which the plaintiff is seeking recovery. The basic idea is that if you didn't have to sue but had been paid in the ordinary course of events, your taxes should be the same. Claims arising in and about employment are one of the most common kinds of legal disputes.

Some go to verdict, but many more eventually settle. Perhaps an even greater number of disputes are resolved before filing and never make it to court. Disputes may be resolved with demand letters, draft complaints, or in mediation. But no matter how the dispute is resolved, there is going to be a settlement agreement. And no matter what, both the employer and the employee will have tax issues.

Ideally, each side thinks about taxes in advance and tries to implement what they want in the settlement agreement. But that doesn't always happen, and even if the parties try, they often fail to hammer out how they want the arrangement to be taxed. The parties may misunderstand the tax issues or fail to consider them entirely until the following year, when IRS Forms 1099 arrive. Most employees know that they will receive IRS Forms W-2 for their wages in January for the prior year.

But January is also when Forms 1099 arrive. Many litigants panic when tax forms they did not expect land in their mailboxes. Here are some common myths about how taxes apply to employment case legal settlements.

Myth No. 1: Plaintiffs can only be taxed on their net recoveries, after legal fees.

This is a big issue, not just for employment cases. Most plaintiffs use contingent-fee lawyers, and many assume that they are only responsible for the *net* money they collect, after contingent legal fees. If you settle for $1 million, and your lawyer takes $400,000 off the top, isn't your tax problem *always* limited to $600,000?

Hardly. Just because a portion of your recovery is paid to your attorney doesn't mean you don't owe tax on that portion. In *Banks*,[1] the U.S. Supreme Court ruled that plaintiffs must include contingent legal fees in their gross income. Maybe they can find a way to deduct or offset the fees, which in some kinds of cases can be tough.[2]

Fortunately, in employment cases, you shouldn't need to pay taxes on the legal fees your lawyer receives if you use a contingent-fee lawyer. But you still must report the fees on your tax return as gross income, or the IRS will think you are shorting it. After all, the *Banks* case on legal fees is from the Supreme Court.

The mechanics of claiming the deduction have been tough until recently. For 2021 tax returns, the form was improved, so there will likely be fewer

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[1] *Commissioner v. Banks*, 543 U.S. 426 (2005).

[2] *See* Robert W. Wood, "12 Ways to Deduct Legal Fees Under New Tax Laws," *Tax Notes Federal*, Oct. 7, 2019, p. 111.

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problems with claiming the deduction.[3] However, if you are using an hourly lawyer and the case spans multiple tax years, there's no easy answer to avoid paying tax on the legal fees.[4] Historically, most legal fees could be claimed as a miscellaneous itemized deduction even if there was no related income. But miscellaneous itemized deductions were suspended by Congress starting in 2018 and continuing through the end of 2025.[5]

Myth No. 2: Employment settlements are exclusively wages.

Not really. A better statement would be that most — perhaps *nearly* all — involve *some* wages. But that doesn't mean that 100 percent of the money is wages. Usually, a portion of the claim is for lost wages, back pay, front pay, or both. But some amount usually represents a payment for emotional distress or other non-wage damages.

The IRS recognizes this, making clear in its instructions to Form 1099-MISC that non-wage damages should be reported on a Form 1099, not on a Form W-2. Some employers seem surprisingly unconcerned about withholding, despite the clarity of their withholding obligation for at least some of the funds. At the other extreme, some employers insist on withholding on most or even all of a settlement, even though a big share of the settlement arguably shouldn't be subject to withholding.

In my experience, if there is something reasonable in the wage category, the IRS rarely disturbs it. That is one reason it is wise for plaintiff and defendant to reach an agreement. In 2009 the IRS released a memorandum titled "Income and Employment Tax Consequences and Proper Reporting of Employment-Related Judgments and Settlements."[6] It's not technically authority, but it's still interesting reading on how the IRS views employment-related settlements and judgments.[7]

[3] *See* Wood, "Writing Off Legal Fees Just Got a Little Easier," *Tax Notes Federal*, Feb. 7, 2022, p. 835.

[4] *See* Wood, "Can Employment Plaintiffs Deduct Legal Fees Paid in Prior Years?" *Tax Notes Federal*, Aug. 17, 2020, p. 1263.

[5] *See* Wood, "New Tax on Litigation Settlements, No Deduction for Legal Fees," *Tax Notes*, Mar. 5, 2018, p. 1387.

[6] PTMA 2009-035.

[7] For full discussion of this IRS memo, see Wood, "IRS Speaks Out on Employment Lawsuit Settlements," *Tax Notes*, Sept. 14, 2009, p. 1091.

Myth No. 3: All employment settlements have tax withholding.

Not necessarily. The fact that the case arises out of an employment setting doesn't necessarily mean that some of the settlement must represent wages. Even if the case is between an employer and a current or former employee, it might not be about wages. The parties may agree that all wages have been paid. If you sue your employer for defamation and receive a settlement or judgment, the fact that your employer is the defendant (rather than some third party) should not necessarily make the payment wages.

However, 99 percent of the time, treating a portion of the settlement as wages is wise, and an agreed allocation is best. Plaintiff and defendant should arrive at a wage figure that is large enough to make the employer comfortable that it is complying with its withholding obligations. But the wage component shouldn't be so large that it causes the plaintiff to refuse to settle. In a $1 million settlement, a plaintiff and defendant might agree that $300,000 are wages subject to employment taxes, while $700,000 are non-wage damages. The split might be 50-50, 80-20, 90-10, or any other figure. It all depends on the facts and the relative bargaining power of the parties.

Myth No. 4: Emotional distress damages are tax-free.

Be careful with this one. Section 104 shields damages for personal physical injuries and physical sickness. The exclusion used to be much broader. Before 1996 personal injury damages were tax free, so emotional distress, defamation, and many other legal injuries also produced tax-free recoveries. That changed in 1996, and since then, an injury or sickness must be physical to give rise to tax-free money.

Unfortunately, in the more than 25 years since section 104 was amended, there is still substantial confusion. In large numbers of cases, the IRS and the courts continue to struggle with exactly what "physical" means. It's clear that emotional distress alone isn't enough. In fact, emotional distress damages — even with physical consequences such as headaches, stomachaches, and insomnia — are taxable.

In contrast, if there are physical injuries or physical sickness first that produce related

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emotional distress damages, those emotional distress damages are also entitled to tax-free treatment. Many plaintiffs struggle with the chicken-or-egg issue of what comes first. But theoretically, once you have a qualifying physical injury or physical sickness, all the compensatory damages can be tax free, even though most of the damages may be for emotional distress.

Claims of post-traumatic stress disorder are increasingly common in employment litigation, and PTSD arguably should be viewed as physical sickness. There is no definitive tax authority stating that PTSD is or isn't within the scope of the section 104 exclusion. However, there is now reliable medical evidence that PTSD is a type of readily observable physical sickness and not merely a variety of emotional distress. A diagnosis of PTSD and the appropriate assertions of PTSD claims should be enough for the parties to treat it as within the section 104 exclusion.

Myth No. 5: Tax-free damages in employment settlements are impossible.

Not true. Even in employment cases, some plaintiffs win on the tax front. For example, in *Domeny*,[8] Julie Domeny suffered from multiple sclerosis, which worsened because of workplace problems, including an embezzling employer. As her symptoms intensified, her physician determined that she was too ill to work. Her employer terminated her, causing another spike in her symptoms.

Domeny settled her employment case and claimed some of the money as tax free. The IRS disagreed, but she won in Tax Court. Her health and physical condition clearly worsened because of her employer's actions, so portions of her settlement were tax free.

In *Parkinson*,[9] a man suffered a heart attack while at work. He reduced his hours, took medical leave, and never returned to work. He filed suit under the Americans with Disabilities Act (ADA), claiming that his employer failed to accommodate his severe coronary artery disease. He lost his ADA suit, but then sued in state court for intentional infliction of emotional distress and invasion of privacy.

[8] *Domeny v. Commissioner*, T.C. Memo. 2010-9.

[9] *Parkinson v. Commissioner*, T.C. Memo. 2010-142.

His complaint alleged that the employer's misconduct caused him to suffer a disabling heart attack at work, rendering him unable to work. He settled and claimed that one payment was tax free. When the IRS disagreed, he went to Tax Court. He argued that the payment was for physical injuries and physical sickness brought on by extreme emotional distress.

The IRS said that it was just a taxable emotional distress recovery, and the fact that the state court case was brought for intentional infliction of emotional distress gave the IRS good arguments. But the Tax Court said that damages received on account of emotional distress attributable to physical injury or physical sickness are tax free. The court distinguished between a "symptom" and a "sign."

The court called a symptom a "subjective evidence of disease of a patient's condition." In contrast, a "sign" is evidence perceptible to the examining physician. The Tax Court said the IRS was wrong to argue that one can never have physical injury or physical sickness in a claim for emotional distress. The court said intentional infliction of emotional distress can result in bodily harm.

Myth No. 6: It is better for plaintiffs to have little or no wages.

It depends. Many plaintiffs want little or no wages. In part, it may be to save their share of employment taxes. After all, employment taxes are partially borne by the employee and partially by the employer. For the employee, the taxes at stake are 7.7 percent of the pay (for the entire year) up to the wage base of $147,000, and 1.45 percent of any amount exceeding $147,000.

Another reason a plaintiff may favor reduced wages is to get a bigger net check at settlement time. If the check isn't reduced by tax withholdings, the settlement may look better. Sometimes the lawyers are the ones pushing for little or no withholding. If the plaintiff is upset that he is settling for only $400,000 when he thinks he should get more, his lawyer may push for little or no withholding as a way to make the current check larger.

Some plaintiffs sense that they are better off if they receive gross pay rather than net pay. Sometimes they even think the wage-versus-non-wage fight is about tax versus no tax. The plaintiff

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may also want to pay his own taxes, later. But the plaintiff may end up worse off at tax return time the following year if he has trouble paying his taxes. A plaintiff who has always been a wage earner may never have made estimated tax payments and may be undisciplined when it comes to financial management.

Finally, getting a Form 1099 may allow for more opportunities to claim an exclusion for physical injury or physical sickness damages. It is not easy to take this position with a Form 1099, but it is vastly easier to claim it with a Form 1099 than with a Form W-2. It is effectively impossible with a Form W-2. Sometimes the wage allocation issue comes down to the plaintiff trying to position physical sickness money.

Myth No. 7: If you receive a Form 1099, you must treat it as taxable.

Not necessarily. You certainly should address the Form 1099 on your tax return, but on the right facts, you can explain that the payment was nontaxable. I have occasionally even seen serious physical injury cases for compensatory damages reported on a Form 1099. In such a case, it is easy to explain that the payment shouldn't be taxable. Many payments are reported on Form 1099 as part of the general default reaction that companies have when making payments.

If a payment is $600 or more, most businesses will issue the form. Indeed, if the settlement agreement isn't explicit on the point, someone in the defendant's accounting department is likely to send out a Form 1099 in January. Plaintiffs routinely object to Forms 1099 once issued, but if the settlement agreement doesn't expressly say that the form will not be issued, the odds of getting the defendant to correct it (with a corrected Form 1099 that zeroes out the income) are slim.

In the employment context, many plaintiffs argue that their employer caused them physical injuries or physical sickness. Sometimes there is a physical or sexual assault, severe or minor, in the workplace. Sometimes the employee claims that the employer caused physical sickness or exacerbated an existing physical sickness. Sometimes the employee claims that the workplace gave her PTSD.

The evidence from the pleadings and correspondence, and the medical documentation of such claims, varies widely, from voluminous to nonexistent. Employer responses vary widely, too. Often, the employer and employee reach a compromise on the wording of the settlement agreement.

That wording may stop short of a clear agreement that a payment is for physical injuries and physical sickness. However, a compromise on wording may be the best the plaintiff can do at the time. The issuance of a Form 1099 is another matter. The Form 1099 regulations and instructions say that a payment of compensatory damages for physical injuries or physical sickness shouldn't be reported on a Form 1099.

However, the employer may not agree with that characterization. Even the settlement agreement may be inconsistent. The employer might agree to physical injury or sickness wording in the settlement agreement, but still insist on issuing a Form 1099. The issuance of the form certainly doesn't help the plaintiff's tax position. But the issuance of the form doesn't foreclose the plaintiff's argument that it shouldn't be taxed.

Myth No. 8: You don't need to agree on tax treatment.

As a legal matter, it is true that a settlement agreement isn't required to address taxes.

A few courts have suggested that taxes are such an essential part of the legal settlement that an agreement may fail if it doesn't include it.[10] In general, however, a legal settlement agreement can be enforceable even if it doesn't say whether there will be tax withholding on some or all of the funds, and even if the agreement doesn't say anything about the specific IRS forms that will be issued.

Some defendants may like that, if talking about taxes before the plaintiff signs a release seems like asking for trouble. That way, the theory goes, the defendant can handle taxes however it wants, withholding on some or all or issuing Forms 1099 for some or all, for example. But why would any plaintiff or defendant want to sign a settlement agreement only to have yet another

[10] *See Josifovich v. Secure Computing Corp.*, 104 A.F.T.R.2d (RIA) 5807 (D.N.J. 2009); and *Sheng v. Starkey Laboratories Inc.*, 53 F.3d 192 (8th Cir. 1995), *after remand, rev'd in part and aff'd in part*, 117 F.3d 1081 (8th Cir. 1997).

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dispute about taxes later, one that could go back to court?

The risk may seem worse for plaintiffs, but it might be no fun for the defendant, either. It isn't merely theoretical. In *Redfield*,[11] a man sued for age discrimination and wrongful termination. He won a judgment, affirmed on appeal. The company withheld taxes, so Fremont Redfield refused to sign a satisfaction of judgment. The employer brought an action for a judicial acknowledgment that the employer had satisfied its obligations under the judgment. The employer won in the district court, but Redfield appealed to the Ninth Circuit.

The appellate court reversed, saying that withholding wasn't proper. Because the employer withheld when withholding wasn't required under tax law, the employer had not yet satisfied the judgement. So after years of litigation and countless dollars of expense, Insurance Company of North America remained on the hook for the settlement for the time being. To obtain its satisfaction of judgment on remand, the employer would need to show that Redfield had gotten the improperly withheld amount refunded to it from the IRS and state tax authorities, or otherwise had the withheld amount credited to its account. There are a handful of other huge messes like this, too.

In *Josifovich*,[12] an employment settlement was put on the record. The idea, the parties agreed, was for these basic terms to later be embodied in a formal settlement agreement to be executed by Diane Josifovich and her employer. But while reducing the settlement to writing, the parties were unable to agree on tax withholding. The court later pointed out with frustration that neither party had mentioned taxes during a seven-hour settlement conference.

Josifovich contended that none of the settlement should be subject to withholding, and there was yet another hearing so that the parties could fully brief the court on how much of the settlement was wages. Would anyone be happy with their lawyers in such a mess? Consider the inconvenience and cost to the plaintiff and defendant for having to argue about withholding issues when one or both thought the case was resolved.

Myth No. 9: The IRS doesn't care about settlement agreement wording.

Nothing could be further from the truth. In fact, the IRS and the Tax Court both focus enormously on what the settlement agreement says. The "intent of the payer" is a phrase that features prominently in tax cases, and there is no better statement of the payer's intent in legal settlement than the wording of the settlement agreement. There are numerous cases in which bad or neutral wording doomed a plaintiff's tax claim.

For example, in *Blum*,[13] a woman sued her lawyer for allegedly botching her personal physical injury suit. As a practical matter, it appeared that Debra Blum was trying to get her lawyer to pay her money that she had failed to collect for her physical injuries because of the alleged legal malpractice. Even so, her malpractice recovery was held to be taxable.

The *Blum* case is a poignant reminder that settlement agreement wording is important, an opportunity a plaintiff should never let slip by. It is worth saying this again and again before the settlement agreement is signed. In IRS audits or queries, the IRS may well be satisfied with the settlement agreement and might not ask for additional documentation. If your wording is poor or even neutral, it is almost a certainty that the IRS will ask to see more information in an audit.[14]

Myth No. 10: If you don't receive a Form 1099, the payment isn't taxable.

This is a dangerous one. Most people know that if they receive a Form 1099 reporting a payment, they need to report it on their tax return. It is presumptively income, that's what the IRS will think. Sometimes you can explain if it isn't income, but you at least must deal with the Form 1099 on your return.

[11] *Redfield v. Insurance Co. of North America*, 940 F.2d 542 (9th Cir. 1991).

[12] *Josifovich v. Secure Computing*, 104 A.F.T.R.2d (RIA) 5807.

[13] *Blum v. Commissioner*, T.C. Memo. 2021-18.

[14] For other cases of failed section 104 arguments, see *Stassi v. Commissioner*, T.C. Summ. Op. 2021-5; and *Collins v. Commissioner*, T.C. Summ. Op. 2017-74.

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But what if you don't receive a Form 1099? Is it like a tree falling in the forest with no one there to hear it? Hardly. Many people seem to think that if there is no Form 1099, there is no income, but that's not true. Numerous kinds of payments aren't required to be reported on a Form 1099. And even if the payment is clearly required to be the subject of a Form 1099, the fact that the defendant fails to issue one doesn't mean that it isn't income.

There are hundreds of pages of tax rules about when companies must issue Forms 1099 for a wide array of payments. The forms come in many varieties, including for legal settlements. But if you don't receive the form, you still must consider whether it is income or capital gain, for example.

Even if you negotiate that the defendant won't issue a Form 1099 for physical sickness money, you should still evaluate issues like what evidence you have or whether you should disclose the payment on your tax return. The language of the settlement agreement doesn't bind the IRS or state taxing authorities.

Myth No. 11: Employers can withhold taxes on legal fees.

I have never seen this happen and have only heard it threatened a few times. If the cause of action brought by the plaintiff requests solely lost wages, and nothing else, it is harder to argue that the settlement isn't all wages. Specific claims under the Fair Labor Standards Act may be the best example of an all-wage case.

In *Banks*,[15] the Supreme Court held that legal fees are usually income to plaintiffs first, though they are income to lawyers, too. In a pure wage case, could that mean withholding on the lawyer money, too? Despite its age, the best guidance on this issue remains Rev. Rul. 80-364, 1980-2 C.B. 294. There, the IRS considered whether attorney fees and interest awarded with back pay are wages for employment tax purposes.

The ruling describes three situations, which are worth reading if you want to get into the weeds. In 2009 the IRS released more discussion in PTMA 2009-035.[16] Ominously, the memo states that if this issue (attorney fees as wages) arises, the IRS National Office should be contacted for guidance. More happily, in TAM 200244004, addressing an age discrimination claim, the IRS concludes that the fees are not wages.

In large part, the issue seems to be ignored by tax practitioners and certainly by employment lawyers. Over many years, I have heard only a small handful of defendants even argue for withholding on fees, and I have never seen one make good on the threat. In my view, no case will settle if the lawyers are going to be shorted fees and must try to get them back from the IRS or from their clients.[17]

Myth No. 12: Most plaintiffs get a tax gross-up for additional taxes.

Most plaintiffs *don't* get a tax gross-up for additional taxes. Tax gross-ups are commonly requested but not commonly awarded by courts or by agreement. Even so, some plaintiffs succeed. *Eshelman*[18] is an important case about the negative tax consequences of a lump sum. Joan Eshelman was receiving pay in one year that should have been payable over multiple years. The court was persuaded that Eshelman needed extra damages to make up for the bad tax hit she would take on a lump sum compared with the lower taxes she would have paid on each annual salary amount.

Conclusion

Many employment disputes are emotional and difficult, perhaps even more so than with many other kinds of legal disputes. Whenever possible, plan for the tax issues, especially if you are a plaintiff or plaintiff's lawyer. Whichever side you are on and whenever possible, be specific about taxes so there is no dispute later. And whenever possible, get some tax advice before signing the settlement agreement. ■

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[15] *Banks*, 543 U.S. 426.

[16] For further discussion, see Wood, *supra* note 7.

[17] For further discussion, see Wood, "Should Employers Withhold on Attorney Fees?" *Tax Notes*, Nov. 7, 2011, p. 751.

[18] *Eshelman v. Agere Systems Inc.*, 554 F.3d 426 (3d Cir. 2009). *See also* Wood, "Getting Additional Damages for Adverse Tax Consequences," *Tax Notes*, Apr. 27, 2009, p. 423.

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