Employment Legal Settlement Withholding and IRS Form 4669

by Robert W. Wood

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In this article, Wood examines wage withholding on employment legal settlements, in light of the odd nuances of IRS Form 4669, "Statement of Payments Received," which an employer may require a settling employee to sign.

This discussion is not intended as legal advice.

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 did not have to sue and were paid in the ordinary course of events, your taxes should come out the same. Suing (or threatening to sue) to recover should not fundamentally alter the nature of the payment.

Of course, many, if not most, lawsuits include a battery of claims, so it is sometimes hard to say that a case is about only one legal claim. Even so, claims arising in and about employment are one of the most common varieties of disputes. Employees receive wages for their work, but does that mean that all employment claims are solely about lost wages? Not hardly.

The fact that a case arises in an employment setting doesn't necessarily mean that all or even any of the settlement must represent wages. A case between an employer and a current or former employee might not be about wages. The parties may even 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 (rather than a third party) is the defendant should not necessarily make the payment wages. Given the appropriate facts and litigation documents, a plaintiff and defendant in an employment case may agree that all wages were previously paid, so no portion of the settlement payment represents wages.

Yet even when that can be justified on the facts, my personal preference is to put *something* in the wage category. The IRS is used to seeing it, and although the IRS has the power to alter any allocation it does not like, it is rare to see that in practice. Often, what the parties agree to in the settlement agreement is given great weight by the IRS.

Of course, most employment claim settlement agreements involve *some* wages. But that doesn't mean that 100 percent of a settlement is wages. Usually, a portion of the claim is for lost wages, back pay, front pay, or both. But some amount usually represents payment for emotional distress or other non-wage damages.

The IRS recognizes that, making clear in its instructions for Form 1099-MISC that non-wage damages should be reported on Form 1099, not on Form W-2. Many litigators, and some companies, have the impression that there is a safe harbor for employment suit settlements. According to that lore, the IRS is happy with 50 percent wages and 50 percent on a Form 1099.

In truth, the facts and claims should control, and 50/50 is not a safe harbor, nor is it always appropriate. Even so, 50/50 allocations do seem common, perhaps a kind of rough justice. 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 all of a settlement, even though a big share of the settlement arguably should not 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 a 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."[1] It is not technically authority, but it is still interesting reading on how the IRS views employment-related settlements and judgments. In most employment settlements, treating an agreed portion as wages is wise.

The plaintiff and defendant should arrive at a wage figure that is large enough to make the employer assured 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 relative bargaining power of the parties. Many plaintiffs want little or no wages, which might be partly to save their share of employment taxes. After all, employment taxes are borne partially 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 $160,200, and 1.45 percent of any amount exceeding $160,200.

Another reason a plaintiff may favor reduced wages is to get a bigger check at settlement time. If the check is not 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 to make the settlement check larger.

Some plaintiffs believe they are better off if they receive gross pay rather than net pay. Some may think the wage-versus-non-wage fight is about tax versus no tax. The plaintiff may also want to pay his own taxes, later. However, 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, avoiding withholding and getting a Form 1099 may allow for more opportunities to claim an exclusion for damages for physical injuries or physical sickness. It is easier to take this position with a Form 1099 than with a Form W-2. It is effectively impossible with a Form W-2. Thus, sometimes the wage allocation issue relates to the plaintiff trying to position physical sickness money for a later claim on the plaintiff's tax return that a portion should be excludable under section 104.

The IRS and the Tax Court both pay attention to what the settlement agreement says. The "intent of the payer" features prominently in tax cases, and there is no better statement of the payer's intent in a legal settlement than the wording of the settlement agreement. There are numerous cases in which bad or neutral wording has doomed a plaintiff's tax claim.

For example, in *Blum*,[2] a woman sued her lawyer for allegedly botching her personal physical injury suit. As a practical matter, it appeared that Debra Jean Blum was trying to get her lawyer to pay her money that she failed to collect for her physical injuries because of the alleged legal malpractice. Even so, her malpractice recovery was held to be taxable, in significant part because the settlement agreement failed to adequately connect the attorneys' alleged malpractice to the physical injury she suffered.

Blum is a poignant reminder that settlement agreement wording is important, an opportunity a plaintiff should never let slip by. In IRS audits or queries, the IRS may be satisfied with the

[1] *See* PMTA 2009-035.

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

settlement agreement and may 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.[3]

IRS Form 4669

How does IRS Form 4669, "Statement of Payments Received," fit into this? An IRS Form 4669 is a form signed by the recipient of a payment affirming that he has included the payment in income and paid self-employment tax on the amounts he received. The form is used by payers of payments to reduce or avoid liability if the IRS determines that the payer should have treated the payment as wages, having paid the employers' share of employment taxes and made income tax withholding.

In essence, Form 4669 is a "no harm, no foul" protection for payers. If the recipient recognizes the payment as taxable income and voluntarily pays self-employment tax on the payment, the payer's potential failure to treat the payment as wages costs the treasury nothing. Taxes were paid so there is no need to penalize the payer too harshly. A Form 4669 does not prevent the IRS from penalizing the employer for failing to withhold, but it may reduce the employer's direct liability for the underpayment of the employment tax and income tax to the IRS.

I have seen Form 4669 come up in an increasing number of employment suit settlement agreements. The employer might require the employee to sign the form and hand it over, a little like requiring a Form W-9, "Request for Taxpayer Identification Number and Certification." My suspicion is that some employers are now starting to require a Form 4669 when they settle employment cases because the employers may be facing increasing pressure to treat little or nothing as wages.

It is hard to see how this model fits most employment settlements. As the instructions for Form 4669 make clear, the purpose of a Form 4669 is to allow an employer to avoid penalties for failing to withhold taxes on wages by demonstrating that the employee *already paid* the taxes that the employer was required to pay.

That does not fit most employment cases. In most employment suit settlements, one amount is treated as wages, and another amount is reported on a Form 1099, implicitly or explicitly as non-wages. The universal expectation is that there will be wage withholding on the first part, and no withholding would be taken on the second part. So when an employer requires the settling employee to sign a Form 4669, is that appropriate?

It clearly is not appropriate if the primary concern is liability related to employment taxes. Employment taxes will be withheld on the wages, but the plaintiff will *not* be paying any payroll tax in connection with the non-wage portion on his tax return. In that case, if the plaintiff is required to provide Form 4669 to the employer, how could a plaintiff even fill out the form?

The Form 4669 instructions have a section, "Purpose of Form," which states that "a payor who fails to withhold *the required tax* from a payee, may be entitled to relief, under sections 3402(d), 3102(f)(3), 1463, or Regulations section 1.474-4, if the payor can show *that the payee reported the payments and paid corresponding tax*. Form 4669 is used by a payor to show that it is entitled to such relief." (Emphasis added.)

Most settlement agreements have a wage payment and a non-wage payment. The agreed position of the parties to the settlement is that the non-wage portion is *not wages* and is therefore not subject to withholding or payroll tax. Clearly, the plaintiff will *not* be paying payroll taxes in connection with the non-wage payment. Therefore, there is no voluntarily paid payroll tax for the plaintiff to identify on a Form 4669 in connection with the non-wage portion of the settlement.

When is Form 4669 appropriate? The classic context in which Forms 4669 are appropriate and in regular use are cases involving whether a recipient of a payment is an employee or an independent contractor. In those cases, there is no question that a payment represents compensation for services, and it is *either* wages or self-employment income. The only question is whether the payer must treat the payment as wages or as payments to an independent contractor.

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[3] For other examples 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.

The case of *Mescalero Apache Tribe* agrees.[4] The IRS had reclassified the tribe's independent contractors as employees. The IRS therefore determined that there was payroll tax due from the tribe. However, because the contractors believed themselves to be contractors, they had voluntarily paid self-employment tax on the same payments that effectively satisfied the tribe's payroll tax obligations.

Thus, the *Mescalero* case affirms that Form 4669 is appropriate and intended for situations in which a payment would be subject to either wage withholdings *or* self-employment tax, depending on whether the recipient is classified as an employee or a contractor. In those cases, the payer *can* properly obtain a completed and signed Form 4669 from a putative independent contractor. That way, even if the IRS challenges the employee or contractor status of the payee, the payer has proof that the employment tax or self-employment tax was already paid.

Most employment settlements do not entail a dispute about employee versus independent contractor status. Most involve a wage payment and a non-wage payment reported on Form 1099. Clearly, the non-wage payment is not wages and is therefore not subject to wage withholding and payroll tax.

It is also not a payment to an independent contractor for services rendered. It is rather a payment to a current or former employee for emotional distress, harassment, or physical injuries or physical sickness. It is outside the wage and self-employment context that Form 4669 was intended to address. Therefore, Form 4669 is simply inappropriate for addressing the employer-defendant's potential liability for employment taxes.

The only obvious potential benefit a Form 4669 might provide to a defendant in connection with a non-wage allocation relates to the defendant's potential for liability for *income* tax under section 3403. As a general rule, section 3402 requires employers to withhold a portion of the amounts paid to employees as income tax withholding. Section 3402's income tax withholding typically represents the largest portions withheld from taxpayers' paychecks each pay cycle.

Section 3403 provides that if an employer fails to withhold sufficient income tax from an employee's paycheck, the *employer* is directly liable to the IRS for the underpayment of tax, even though it is the employee's income and the employee's underpayment. In most contexts, the IRS generally goes after the employee directly if the employee underreports their income. However, section 3403 provides that the IRS can also go after the employer directly for the underpaid tax to the extent that the underpaid tax should have been withheld by the employer and remitted directly to the IRS.

Section 3402(d) provides *some* relief to an employer in this scenario. Section 3402(d) states that the IRS will *not* collect income tax from the employer if the employee has voluntarily paid the income tax. However, the IRS may still impose (potentially onerous) penalties under section 6672 on the employer for failing to withhold, even if the employee has voluntarily paid the tax.

A Form 4669 may help an employer establish that they qualify for relief under section 3402(d) by documenting that the recipient included the non-wage portion in income and paid some or all of the resulting income tax. That is a real benefit to the employer-defendant, to be sure, though hardly a panacea against all of the employer-defendant's potential liabilities in connection with a non-wage allocation. The employer-defendant would still have to be confident about their employment tax exposure on any non-wage allocation (which the plaintiff would not be self-reporting and paying) as well as potential penalties under section 6672 on *both* employment tax withholding *and* income tax withholding.

Ultimately, then, employer-defendants should make sure they are satisfied with the amount of any non-wage allocation. They should not expect a Form 4669 to provide complete protection against potential liability and tax penalties if the non-wage portion is later determined to be unreasonably high. They should also be aware that Form 4669 requires an employee to assert under penalties of perjury that a recovery has been reported as income and all taxes have been paid. This assertion cannot truthfully be made at the time the settlement is signed and, at the

[4] *Mescalero Apache Tribe v. Commissioner*, 148 T.C. 291 (2017).

earliest, could be made only after the plaintiff has already filed their tax returns and paid the resulting tax.

Some employers are still not persuaded, and some plaintiffs who are trying to get a settlement agreement completed and signed may be tempted to knuckle under and sign a Form 4669, even if they do so in blank. That seems unwise for several reasons. First, and fundamentally, if a plaintiff has not yet filed their tax return and paid any resulting tax, they should not sign forms under penalties of perjury that assert that they have done so.

Second, Form 4669 requires a plaintiff to state exactly how and where the income was reported on the relevant tax return. At the time a settlement is signed, the plaintiff may not know how best to report a settlement. That kind of discussion tends to happen closer to the tax return deadline, after consultation between the plaintiff and their tax counsel. Indeed, at the time of settlement, the IRS may not have even released the final versions of the tax forms for the upcoming filing season. Therefore, how could a plaintiff accurately identify at the time of settlement what lines on the unpublished tax forms will be used to report the recovery up to 21 months later (that is, assuming that a settlement is received in January, but the tax return is not filed, on extension, until October 15 of the following year)?

Instead, if a Form 4669 is required by a defendant, it may be best to position it as a promise of *future* cooperation. That is, a plaintiff may truthfully and reasonably agree to provide a Form 4669 to the defendant at a later date (after the plaintiff's returns are filed) *if* the defendant's tax reporting is examined and the IRS attempts to assert liability for income tax under section 3403. That would be a more reasonable request from a defendant, and it would essentially cost the plaintiff nothing to agree, particularly considering the low likelihood of the defendant ever needing to make the request for the Form 4669 at the later date.

Withholding on Attorney Fees

Finally, it is worth noting the situation present when a nervous employer settling an employment case proposes to also withhold income and employment taxes on the legal fees paid to the plaintiff's counsel. Most employment cases are brought via contingent fee lawyers. That naturally leads to the question: Might even the legal fee portion of the settlement be wages too?

That is a rare issue to encounter in practice, but it is not unheard of. If the cause of action brought by the plaintiff requests solely lost wages and nothing else, one can argue that the settlement is all wages, even if the defendant knows that some portion will likely be paid to the plaintiff's counsel for fees and expenses. Specific claims under the Fair Labor Standards Act may be the best example of an all-wage case. In *Banks*,[5] the Supreme Court held that legal fees are usually gross income to plaintiffs first, even though they are income to the lawyers, too.

It does not matter whether the lawyer is paid directly by the defendant or if the plaintiffs first receive 100 percent of the cash and then pay their lawyer. Either way, 100 percent of the recovery is attributed to the plaintiffs. Therefore, in a pure wage case, could that mean withholding income and employment taxes on the lawyer's money, too?

Despite its age, the best guidance on this issue remains Rev. Rul. 80-364, 1980-2 C.B. 294, in which 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 of this strange issue. The critical ruling in Rev. Rul. 80-364 for employment cases is that wage withholding is *not* required if there is a specific allocation for attorneys' fees in the settlement agreement. If the settlement agreement says that the employee will be paid $500,000 as wages and the employee's attorney will be paid $250,000 for fees, defendants are not required to withhold or to pay employment tax on the attorney's $250,000.

However, if the employee brought wage claims and the settlement merely says that the employee will be paid a total of $750,000, without a specific allocation for legal fees, the employer should treat all $750,000 as wages. That is the case even though the employer could intuit that *some*

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

of the $750,000 will likely be retained by the employee's lawyers for legal fees. This is another reminder that settlement agreement wording matters.

In 2009 the IRS released more discussion in PMTA 2009-035.[6] Ominously, this memo states that if this issue (attorney fees as wages) arises, the IRS National Office should be contacted for guidance. More positively, in TAM 200244004, in addressing an age discrimination claim, the IRS concludes that the fees are not wages when the settlement contains a specific allocation for legal fees.

In large part, the issue seems to be ignored by tax practitioners, employment lawyers and defendants. Over many years, I have seen only a handful of defendants argue for withholding on attorney fees, and I have never seen one actually do it. As a practical matter, I suspect that no case would settle when the lawyers are going to be shorted fees and must try to get them back from the IRS or their clients.[7] And, as Rev. Rul. 80-364 demonstrates, the issue can usually be avoided simply by stating in the settlement agreement how much of the settlement is for legal fees. ■

[6]PMTA 2009-035.

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