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Employment Settlement Tax Misconceptions

By Robert W. Wood

Lawsuit settlements and judgments are taxed based on the origin of the claim, essentially the item for which the plaintiff is seeking to recover. The basic idea is, 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 disputes go to verdict, but many more eventually settle. Perhaps an even greater number of disputes are resolved pre-filing and never make it to court. Disputes may be resolved with demand letters or a draft complaint, in mediation, etc. But no matter how the dispute is resolved, there will be a settlement agreement. And no matter what, there are going to be tax issues, for both the employer and the employee.

Ideally, each side thinks about taxes in advance and tries to implement what they want in the settlement agreement. That doesn't always happen, however, 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 they may fail to consider them entirely until the following year when IRS Forms 1099 arrive. Most employees know that they will receive an IRS Form W-2 for their wages in January for the previous calendar year.

But January is also when Forms 1099 arrive. Many litigants panic when unexpected tax forms land in their mailbox. Here are some common misconceptions about how taxes apply to employment case legal settlements.

MISCONCEPTION #1: PLAINTIFFS CAN ONLY BE TAXED ON THEIR NET RECOVERIES, AFTER LEGAL FEES

The idea that plaintiffs can only be taxed on net recoveries is a big issue, and 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 does not mean you do not owe tax on that portion. In *Banks v. Commissioner*,[1] the U.S.

Supreme Court ruled that plaintiffs must include contingent legal fees in their gross income. Hopefully 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 should not need to pay taxes on the legal fees your lawyer receives if you use a contingent fee lawyer. However, you still have to report them on your tax return as gross income, or the IRS will think you are shorting them. After all, the *Banks* case on legal fees is from the U.S. Supreme Court.

The mechanics of claiming the deduction have been tough until recently. For 2021 tax returns, the tax return form was improved so there will hopefully be fewer problems with claiming it.[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]

MISCONCEPTION #2: EMPLOYMENT SETTLEMENTS ARE EXCLUSIVELY WAGES

Not really. A better statement would be that most—perhaps *nearly* all—involve *some* wages. That does not mean that 100 percent of the money is wages, though. 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 not all of a settlement may be wages, 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, though their withholding obligation for at least some of the funds seems clear. On the other extreme, some employers insist on withholding on most or even all of a settlement, even though a big share of the settlement should arguably 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 plaintiff and defendant to come to an agreement. In 2009, the IRS released a memorandum entitled ‘‘Income and Employment Tax Consequences and Proper Reporting of Employment-Related Judgments and Settlements.’’[6] It is not technically authority, but it is still interesting reading about IRS views on employment-related settlements and judgments.[7]

MISCONCEPTION #3: ALL EMPLOYMENT SETTLEMENTS HAVE TAX WITHHOLDING

The fact that the case arises out of an employment setting does not necessarily mean that some of the settlement must represent wages. Even if the case is

between a current or former employee, the case may not be about wages. The parties may agree that all wages have been paid. If you were to 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. The wage component should not be so large to cause the plaintiff to refuse to settle. In a $1 million settlement, a plaintiff and defendant might agree that $300,000 is wages subject to employment taxes, while $700,000 is non-wage damages. The wages split might be 50-50, 80-20, 90-10, or any other figure. It all depends on the facts and on the relative bargaining power of the parties.

MISCONCEPTION #4: EMOTIONAL DISTRESS DAMAGES ARE TAX-FREE

Be careful with this one. Section 104 of the tax code 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 twenty-five years since section 104 was amended, there is still substantial confusion. In large numbers of tax cases that arise post-settlement, taxpayers, the IRS, and the courts continue to struggle with exactly what “physical” means. It is clear that emotional distress alone is not 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 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 (PTSD) are increasing common in employment litigation, and PTSD arguably should be viewed as physical sickness. There is no definitive tax authority stating that PTSD is or is not 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 is not merely a variety of emotional distress. A diagnosis of PTSD and the appropriate assertions of PTSD claims should enough for the parties to treat it as within the section 104 exclusion.

MISCONCEPTION #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 v. Commissioner*,[8] Domeny suffered from multiple sclerosis (MS). Her MS got worse because of workplace problems, including an embezzling employer. As her symptoms worsened, her physician determined she was too ill to work. Her employer terminated her, causing another spike in her MS symptoms.

She settled her employment case and claimed some of the money as tax free. The IRS disagreed, but Domeny 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 v. Commissioner*,[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.

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 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.

MISCONCEPTION #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 amount over $147,000.

Another reason plaintiffs may favor reduced wages is to get a bigger net check at settlement time. If the check is not reduced by tax withholdings, the settlement may look better. Sometimes, their 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 current check larger.

Some plaintiffs have the 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 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 they have trouble paying their 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 it is 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.

MISCONCEPTION #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 non-taxable. 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 should not 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 is not 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 does not 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 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 them PTSD.

The evidence from the pleadings and correspondence, and the medical documentation of such claims varies widely, from voluminous to non-existent. 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 form instructions say that a payment of compensatory damages for physical injuries or physical sickness should not 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 does not help the plaintiff's tax position, but the issuance of the form does not foreclose the plaintiff's argument that it should not be taxed.

MISCONCEPTION #8: YOU DON'T NEED TO AGREE ON TAX TREATMENT

As a legal matter, it is true that a settlement agreement is not *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 does not include it.[10] In general, however, a legal settlement agreement can be enforceable even if it does not say if there will be tax withholding on some or all of the funds, and even if the agreement does not say anything about the particular 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, issuing Forms 1099 for some or all, etc. But why would any plaintiff or defendant want to sign a settlement agreement only to have yet another 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 is not merely theoretical. In *Redfield v. Insurance Company of North America,*[11] a man sued for age discrimination and wrongful termination. Redfield won a judgment, affirmed on appeal. The company withheld taxes, so Redfield refused to sign a satisfaction of judgment. The employer brought an action in District Court for a judicial acknowledgment that the employer had satisfied its obligations under the judgment. The employer won in District Court, but Redfield appealed to the Ninth Circuit.

The appellate court reversed, saying that withholding was not proper. Because the employer withheld when withholding was not 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 v. Secure Computing Corporation*,[12] an employment settlement was put on the record. The idea, they agreed, was for these basic terms to later be embodied in a formal settlement agreement to be executed by Josifovich and Secure. But while reducing the settlement to writing, the parties were unable to reach agreement 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 yet another hearing was needed where the question of how much is wages could be fully briefed. Would anyone be happy with their lawyers in such a mess? Consider the inconvenience and cost of the plaintiff and defendant having to argue about withholding issues when one or both thought the case was resolved.

MISCONCEPTION #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 place enormous focus on what the settlement agreement says. The intent of the payor is a phrase that features prominently in tax cases, and there is no better statement of the payor's intent in legal settlement than the wording of the settlement agreement. There are numerous cases where bad or neutral wording doomed a plaintiff's tax claim.

For example, in *Blum v. Commissioner*,[13] a woman sued her lawyer for allegedly botching her personal physical injury suit. As a practical matter, it appeared that Blum was trying to get her lawyer to pay her money she 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 very 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 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.[14]

MISCONCEPTION #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 is not income, but you at least must deal with the Form 1099 on your return.

But what if you do *not* 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 are not 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 does not mean that it is not 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. However, if you do not receive the form, you *still* must consider whether it is income, capital gain, etc.

Even if you negotiate with the defendant for no Form 1099 for physical sickness money, you should still evaluate what evidence you have and whether you should disclose the payment on your tax return, etc. The language of the settlement agreement does not bind the IRS or state taxing authorities.

MISCONCEPTION #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 is not all wages. Specific claims under the Fair Labor Standards Act may be the best example of an all-wage case.

In *Commissioner v. Banks*, 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.[15] 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 ADEA 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 have to try to get them back from the IRS or from their clients.[17]

MISCONCEPTION #12: MOST PLAINTIFFS GET A TAX GROSS-UP FOR ADDITIONAL TAXES

Actually, the reverse is true. Tax gross-ups are commonly requested, but not commonly awarded by courts or by agreement. Even so, some plaintiffs succeed. *Eshelman v. Agere Systems, Inc.*[18] is an important case about the negative tax consequences of a lump sum. 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, as 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 ahead for the tax issues, especially if you are a plaintiff or plaintiff's lawyer. Whichever side you are on, whenever possible, be specific about taxes so there is no dispute later. And whenever possible, get some tax advice before the settlement agreement is signed.

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. This discussion is not intended as legal advice.*

1. 543 U.S. 423 (2005). ↥
2. *See* Wood, "12 Ways to Deduct Legal Fees Under New Tax Laws," Vol. 165, No. 1, *Tax Notes Federal* (October 7, 2019), p. 111. ↥
3. *See* Wood, "Writing Off Legal fees Just Got a Little Easier," Vol. 174, No. 6, *Tax Notes Federal* (2022), p. 835. ↥
4. *See* Wood, "Can Employment Plaintiffs Deduct Legal Fees Paid in Prior Years?," Vol. 168, No. 7, *Tax Notes Federal* (August 17, 2020), p. 1263. ↥
5. *See* Wood, "New Tax on Litigation Settlements, No Deduction for Legal Fees," Vol. 158, No. 10, *Tax Notes* (March 5, 2018), p. 1387. ↥
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. ↥
7. For full discussion of this IRS memo, *see* Wood, "IRS Speaks Out on Employment Lawsuit Settlements," Vol. 124, No. 11, *Tax Notes* (September 14, 2009), p. 1091. ↥
8. FN T.C. Memo. 2010-9. ↥
9. FN T.C. Memo. 2010-142. ↥
10. *See* Josifovich v. Secure Computing Corporation, 2009 U.S. District Lexis 67092 (D.N.J. July 31, 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). ↥
11. 940 F.2d 542 (9th Cir. 1991), ↥
12. 2009 U.S. District Lexis 67092 (D.N.J. July 31, 2009). ↥
13. 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. ↥
15. 1980-2 C.B. 294. ↥
16. FN Doc 2009-15305, 2009 TNT 129-19. For further discussion, *see* Wood, ''IRS Speaks Out on Employment Lawsuit Settlements,'' *Tax Notes*, Sept. 14, 2009, p. 1091. ↥
17. For further discussion, *see* Wood, "Should Employers Withhold on Attorney Fees?," Vol. 133, No. 6, *Tax Notes* (November 7, 2011), p. 751. ↥

18. 554 F3d 426 (3rd Cir. 2009). *See also* Wood, “Getting Additional Damages for Adverse Tax Consequences,” Vol. 123, No. 4, *Tax Notes* (April 27, 2009), p. 423. ↥