

# How IRS Taxes Employment Settlements

By Robert W. Wood

Legal claims about employment are common. Not surprisingly, every employment suit or settlement raises tax issues for employer and employee. Most plaintiffs use contingent fee lawyers, and many assume there are tax issues only for the net money they collect after legal fees. But in *Banks v. Commissioner*, 543 U.S. 423 (2005), the U.S. Supreme Court ruled that plaintiffs must include contingent legal fees in their gross income, even if they end up with a net check.

That means you have to know [how to write off legal fees](#). Fortunately, in employment cases, plaintiffs using contingent fee lawyers should not need to actually pay taxes on the legal fees their lawyer receives. There is a tax deduction if you know how to claim it. But you still must report the fees on your tax return as gross income, or the IRS will think you are shorting them.

Curiously, if you are using an hourly lawyer and the case spans multiple tax years, there is no tax deduction. That could mean you have to pay tax on the legal fees. Miscellaneous itemized deductions (the usual deduction for legal fees) were wiped out by Congress until 2026.

Most employment settlements involve some wages for back pay, front pay, or both. That means withholding and an IRS Form W-2. But some amounts usually represent a payment for emotional distress or other non-wage damages. The fact that the case arises out of employment does not necessarily mean that some of the settlement must represent wages. Sometimes the parties agree that all wages have been paid.

However, most of the time, treating a portion of the settlement as wages is wise for both parties, 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. Employment taxes are partially borne by the employee and partially by the employer. For the employee, the taxes at stake are 7.7% of the pay (for the entire year) up to the wage base of \$147,000, and 1.45% of amount over \$147,000.

Many plaintiffs want little or no wages. The reason some plaintiffs favor reduced wages, is to get a bigger net check at settlement time. But the plaintiff may end up worse off at tax time the following year if they have trouble paying their taxes. They also figure that a Form 1099 allows for more opportunities to claim an exclusion for physical injury or physical sickness damages.

Sometimes, the wage allocation issue comes down to the plaintiff trying to position what they claim is physical sickness money. Section 104 of the tax code shields damages for personal physical injuries and physical sickness. 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, there is still substantial confusion. Emotional

distress alone is taxable, even with physical consequences such as headaches, stomachaches, and insomnia. In contrast, if there are physical injuries or physical sickness which produce emotional distress damages, those emotional distress damages can be tax-free.

Many plaintiffs struggle with the chicken-or-egg issue of what comes first. Claims of post-traumatic stress disorder (PTSD) are increasing common in employment litigation, and PTSD arguably should be viewed as physical sickness, although there is no definitive tax case that says so.

Even in employment cases, some plaintiffs win on the tax front. For example, in *Domeny v. Commissioner*, T.C. Memo 2010-9 (2010), Ms. Domeny suffered 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.

If you receive a Form 1099, must you treat it as taxable? Not always. You must address the Form 1099 on your tax return, but on the right facts, you may be able to explain that the payment should not be taxable. In the employment context, many plaintiffs argue that their employer caused them physical injuries or physical sickness. Sometimes, there as 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 them PTSD. Ideally, the employer and employee should reach agree on the wording of the settlement agreement. But how about on the issuance of the form?

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. Even so, agreeing not to issue the form is not something some employers are willing to do. The employer might be willing to agree that a payment is for alleged physical injuries or physical sickness.

However, the employer may still say that they feel they must issue a Form 1099. The issuance of the form hurts the plaintiff's tax case, for it is always better if the plaintiff can convince the employer there should be no form. But as a technical matter, the issuance of the form does not foreclose the plaintiff's argument that it should not be taxed.

But what if you do *not* receive a Form 1099? Many people seem to think that if there is no Form 1099, there can be no income. However, that is 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 necessarily mean that you can avoid treating the payment as taxable.

Employment case settlements might seem to offer no flexibility. But is it worth fighting over employment case settlement agreement wording? You bet. The language of the settlement agreement does not bind the IRS or state taxing authorities. However, wording about these issues in the settlement agreement is important, in fact, you might say critical.

The IRS and the Tax Court both pay attention to what the settlement agreement says, and sometimes, they seem to act as if it is the most important thing of all. The “intent of the payor” is a phrase that features prominently in tax cases. There is no better statement of the payor’s intent in legal settlement than the wording of the settlement agreement. There are numerous tax cases where bad or neutral wording doomed a plaintiff’s tax claim.

Many employment disputes are emotional and difficult. Whenever possible, plan ahead for the tax issues, and consider being specific about taxes so there is no dispute later. You don’t want to have a fight later about how much is subject to withholding, about which tax forms are going to be issued, and so on.

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