

Wood Responds to Critique of His Article

To the Editor:

I appreciated Mr. Mobley's measured comments regarding my September 14 article (see Wood, "IRS Speaks Out on Employment Lawsuit Settlements," *Tax Notes*, Sept. 14, 2009, p. 1091, *Doc 2009-18678*, or *2009 TNT 175-4*; for Mobley's letter, see *Tax Notes*, Sept. 28, 2009, p. 1387, *Doc 2009-21097*, or *2009 TNT 185-19*). In fact, I agree with most of what he says. From a practical standpoint, however, I believe he suggests a somewhat rigid (and ultimately impracticable) approach to withholding on non-court ordered attorney fees in a wage dispute.

Although I credit Mobley for helping me to think more critically about this, I remain unconvinced that the authorities (or lack thereof) require 100 percent withholding. Mobley states that "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." I believe Mobley is suggesting that attorney fees paid pursuant to a fee-shifting statute would not represent the client's wages, so would not be subject to withholding. I agree.

However, he suggests that attorney fees paid in the absence of a fee-shifting statute — or in the presence of a fee-shifting statute, but where the fees are not actually ordered by the court — would (or should) constitute wages (to the client) subject to withholding when paid to the lawyer. Using the simple nomenclature from my article, Mobley suggests that choice 3 should apply. Under choice 3, the payor would withhold on the client's 60 percent share, but at a rate that takes into account the 40 percent being paid (with no withholding) to the lawyer. That means the (very angry) client will get very little.

To take a simple example, let's assume Plaintiff in a wage only case settles for \$500,000, and his contingent fee lawyer is entitled to 40 percent. Defendant insists on wage treatment for the full \$500,000, but his lawyer insists on his full \$200,000. So, Defendant withholds on the full \$500,000, but can only withhold it from the \$300,000 earmarked for Plaintiff. If Plaintiff is in California and is single with one withholding exemption, Plaintiff will receive take-home pay of about \$90,000 from his \$500,000 settlement.

The only way I know to truly ameliorate this is for (1) Plaintiff and his counsel to insist on choice 1; or (2) Plaintiff to submit a new Form W-4 claiming large numbers of exemptions (presumably based on the expectation that Plaintiff will qualify for an above-the-line attorney fee deduction for the \$200,000). The latter, of course, is only a partial fix, for employment taxes are still being paid on the attorney fees by both Plaintiff and Defendant. Besides, even if Plaintiff completes a new Form W-4, Mobley's client might not be willing to honor it.

Of course, the authorities are not perfect. Rev. Rul. 80-364, 1980-2 C.B. 294, contains no discussion of fee-shifting statutes. In Situation 3 of Rev. Rul. 80-364, a union filed claims on behalf of its members against a company for breach of a collective bargaining agreement. The union and the company entered into a court-approved settlement under which the company paid the union \$40x.

We do not know whether the settlement agreement in Situation 3 expressly provided for attorney fees, although the ruling indicates that the union paid \$6x in attorney fees, returning \$34x in back pay to the employees. The Service ruled that the \$6x in attorney fees did not constitute remuneration to the employees and was therefore not wages. The enforcement of the collective bargaining agreement (not a fee-shifting statute) evidently led the Service to rule that the attorney fees paid by the union were not wages.

TAM 200244004 (June 19, 2002), *Doc 2002-24564*, *2002 TNT 213-18*, concluded that a court award of attorney fees under a fee-shifting statute was not wages under the reasoning of Rev. Rul. 80-364. Nevertheless, TAM 200244004 does not foreclose the possibility that the attorney fees *may not be wages*, even if awarded in a lawsuit that seeks *only wages*, and even in the *absence* of a fee-shifting statute.

In LTR 200906010 (Oct. 24, 2008), *Doc 2009-2577*, *2009 TNT 24-17*, the Service considered an opt-out class action brought by employees for vacation pay. The court approved a settlement and awarded attorney fees to class counsel under the common fund doctrine. Relying on Situation 3 in Rev. Rul. 80-364, the Service ruled that the attorney fees were not wages to class members. Although LTR 200906010 involved court-awarded attorney fees, the Service did not concern itself with the presence of a fee-shifting statute.

In *Josifovich v. Secure Computing Corp.*, 2009 U.S. Dist. LEXIS 67092 (D.N.J. 2009), *Doc 2009-17641*, *2009 TNT 148-7*, a plaintiff suing her former employer for unpaid commissions settled. Agreeing that the attorney fees were not subject to withholding, the parties asked the court to determine whether any portion of the settlement proceeds were subject to withholding. Although the court limited its analysis to front and back pay, the court agreed (apparently based on the agreement of the parties) that the attorney fees were not subject to withholding.

In my article, I suggested that defendants will withhold only from the client's share of the recovery, and will pay the lawyer his gross 40 percent fee with no withholding. In fact, I have never seen it done otherwise. Mobley acknowledges that section 62(a)(20)'s above-the-line deduction should apply. I agree.

Regarding statutory fees, Mobley argues there will be situations where "no one really thinks a judge would award legal fees to the plaintiff." Perhaps he is right. Yet even in those situations, it seems possible for the parties to agree that attorney fees *should* be awarded under the statute (or otherwise).

After all, if the attorneys have manifested a claim for fees (and a statute suggests they have such a claim), an "allocation" (if that's the right word) to fees is precisely the kind of thing plaintiffs and defendants do with settlement allocations. An allocation in the settlement agreement coupled with a facially viable attorney fee claim may not be bulletproof, but it should help to sanitize the wage taint. True, some thought must be given to the underlying strength or weakness of the claims (including any claim for attorney fees), but one need not litigate (or relitigate) them for tax purposes.

Just look at the numbers in the above example and ask yourself if this case would settle. The plaintiff's lawyer is unlikely to be able to mollify the client that "don't worry, you'll get the money back at least for the income tax portion when you file your tax return next year." The plaintiff's lawyer is unlikely to even try. I truly don't think even the IRS wants wage character for the attorney fees. That was one reason I found the position taken on this issue in the Service's "Employment Tax Consequences" memo (*Doc 2009-15305, 2009 TNT 129-19*) so puzzling.

I still think choice 1 (withholding only from the client's 60 percent share of the recovery) is acceptable in the vast, vast majority of circumstances. I agree with Mobley that under some fact patterns, the defendant has potential (arguably theoretical) exposure for failure to withhold. Maybe we disagree primarily over the magnitude of the risk.

I too have been on the defense side at times. Mobley is right that it can be an uncomfortable role. Yet whatever (small, very small, limited, mostly theoretical, quite manageable) risk the tax lawyer conveys to his defendant/client on this point, I believe the client is always going to opt for door number one.

Very truly yours,

Robert W. Wood
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