



TAX TREATMENT OF RECOVERIES IN EMPLOYMENT DISPUTES

Committee on Labor & Employment Law

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The tax treatment of settlement payments and trial/arbitration awards in employment related disputes is a complex area with many uncertainties. This pamphlet is a brief overview of some of the general principles involved.¹ The pamphlet focuses on: (i) which payments are considered income to an employee and (ii) which payments constitute “wages” for payroll tax and withholding purposes.²

A. Recoveries in Employment Law Cases

Employees may receive settlement payments and/or an award of damages for a variety of causes of action including: breach of contract, violation of whistleblower statutes, violation of wage and hour laws, and violation of anti-discrimination/retaliation statutes.

If an employee is successful at trial or arbitration, he or she is entitled to different categories of damages depending on the claim he or she has won. Each type of damage is taxed differently.

Settlements can be characterized as compensation for a portion of the potential damages that an employee could have received if the case had gone forward. Settlements are therefore taxed according to the type of potential damages for which the employee is being compensated. A settlement agreement should allocate payment to taxable wages, subject to withholding and reported on Form W-2, and taxable, non-wage recoveries (e.g., amounts received on account of emotional distress or attorneys' fees), which are includable in income but not subject to employment tax or withholding. Allocations in a settlement agreement will generally be given deference provided the agreement was entered into by the parties in an adversarial context and negotiated at arms' length. However, an allocation in a settlement agreement is not binding on the IRS if other facts and circumstances indicate that the parties actually intended the payment to be made for a purpose other than its stated purpose.³ The settlement agreement should be explicit as to the reason for the characterization of a particular portion of the allocated settlement amount and whether a Form W-2 or Form 1099 will be issued. Finally, consistency in tax reporting among the parties is critical.

There are seven basic types of damages in employment law cases: 1) lost compensation, 2) emotional distress, 3) physical injuries, 4) compensation for medical expenses, 5) punitive damages, 6) interest on awards, and 7) attorneys' fees. Each of these types of damages is taxed differently. The manner in which each category of damages is taxed is discussed below.

¹ See Robert W. Wood, Taxation of Damage Awards and Settlement Payments (3d ed. 2005) for a more in-depth treatment of this subject matter.

² This pamphlet does not deal with deferred compensation payments that may require special treatment. Such payments are addressed in 26 U.S.C. § 409A (2008).

³ Robinson v. Comm'r, 102 T.C. 116 (1994).

1. Lost Compensation

Typically, the largest component of a settlement or award is payment for lost compensation. Lost compensation includes both payment for wages that have already been lost, *i.e.* back pay, and compensation for wages that may be lost in the future, *i.e.* front pay.

Both back and front pay are taxable as income unless they are received on account of personal physical injuries or physical sickness. Back and front pay constitute wages and are subject to payroll taxes such as FICA and FUTA, as well as income tax withholding.⁴ Back and front pay are generally subject to FICA and FUTA taxes in the year they are actually or constructively received by a plaintiff. Thus, for example, in United States v. Cleveland Indians Baseball Co., the United States Supreme Court held that a back pay award to baseball players in a settlement was subject to FICA and FUTA taxes in the year the settlement was paid and not the year that the wages should have been paid.⁵

When determining withholdings, the parties should be aware of the Internal Revenue Service ("IRS") regulation on "Supplemental Wage Payments," 26 C.F.R. § 31.3402(g)(2009), which states that wages are either "regular" or "supplemental." Severance, back, and front pay are all different forms of supplemental wages. An employer is permitted to make income tax withholdings at different percent rates for supplemental wages. Supplemental wages may also be "subject to specific withholding amounts set forth in the regulation."⁶ Similarly, there are specific New York State withholding rates applicable to supplemental wages.⁷

The Third Circuit's recent decision, Eschelmann v. Agere Sys., Inc., 554 F.3d 426, 441-42 (3rd Cir. 2009), may have an impact on the structure of awards and settlements in the future. In that decision, the Third Circuit held that a district court may, pursuant to broad equitable powers granted by the ADA, award a prevailing employee an additional sum of money to compensate him or her for the increased tax burden of a back pay award. It has yet to be seen whether this approach will be adopted by other circuits.

2. Emotional Distress

Damages for nonphysical injuries (*e.g.* emotional distress) are considered income to a plaintiff. Emotional distress damages are not, however, subject to payroll taxes. Emotional distress awards should be reported as "other income" (box 3) on Form 1099-MISC.⁸

⁴ Rev. Rul. 78-336, 1978-2 CB 255; Rev. Rul. 78-176, 1978-1 CB 303; Soc. Sec. Bd. v. Nierotko, 327 U.S. 358 (1946).

⁵ 532 U.S. 200, 219 (2001).

⁶ See Circular E, Employer's Tax Guide, I.R.S. Publication 15, at 14 (2009) accessed at <http://www.irs.gov/pub/irs-pdf/p15.pdf> (April 27, 2009).

⁷ See Withholding Tax Rate Changes for Supplemental Wages, TSD-M-88(8)I, N.Y. State Dep't of Taxation and Finance, Taxpayer Services Division, Technical Services Bureau, (Feb. 14, 1988) accessed at http://www.tax.state.ny.us/pdf/memos/income/m88_8i.pdf (April 27, 2009).

⁸ See Specific Instructions for Form 1099-MISC. There is a detailed analysis of IRS information returns and 1099 Forms in Johnson v. LPL Fin. Servs., 517 F. Supp. 2d 1231 (S.D. Cal. 2007).

3. Physical Injury

Section 104(a)(2) of the Internal Revenue Code of 1986, as amended (the “Code”) provides that the amount of any damages (other than punitive damages) received on account of personal physical injuries or physical sickness is excludable from income. For a recovery to be excludable under Section 104(a)(2), the underlying cause of action must be based upon tort or tort type rights and the resulting damages must be recovered on account of personal physical injuries or physical sickness.⁹ All damages that flow from a physical injury or physical sickness are excludable, even if the recipient of the damages is not the injured party (e.g. damages received by an individual on account of a claim for loss of consortium due to the physical injury of that individual’s spouse). Section 104 does not apply to nonphysical injuries such as loss of reputation or slander.

Emotional distress is not considered a physical sickness or physical injury even if physical symptoms such as insomnia, headaches, and stomach disorders, result from such emotional distress. Only emotional distress damages attributable to personal physical injury or physical sickness are excludable from income. Thus, for example, settlement payments for sexual harassment claims that are accompanied by a tort-like battery may be excludable under Section 104.

The term “physical” is not defined in the Code or Treasury Regulations. The IRS has stated that “direct unwanted or uninvited physical contacts resulting in observable bodily harms such as bruises, cuts, swelling and bleeding are personal physical injuries under Section 104(a) (2).”¹⁰ In Private Letter Ruling 200041022, the IRS ruled that damages attributable to physical contact that did not cause pain or result in any observable bodily harm were not personal physical damages and thus were not excludable under Section 104(a) (2).

4. Medical Expenses

Settlement payments or awards for medical expenses incurred to treat emotional distress are not considered income. This is true whether or not the expenses were incurred because of a physical injury.¹¹

5. Punitive Damages

Punitive damages are taxable income to the recipient but are not subject to payroll taxes. Punitive damages, including punitive damages received on account of physical injuries or physical sickness, are reported on Form 1099-MISC.

⁹ Comm'r v. Schleier, 515 U.S. 323, 337 (1995).

¹⁰ I.R.S. Priv. Ltr. Rul. 200041022 (Oct. 13, 2000).

¹¹ See 26 U.S.C. 104(a): “... For purposes of paragraph (2), emotional distress shall not be treated as a physical injury or physical sickness. The preceding sentence shall not apply to an amount of damages not in excess of the amount paid for medical care (described in subparagraph (A) or (B) of section 213(d)(1)) attributable to emotional distress.”

6. Interest on Award

Prejudgment interest is considered income to a plaintiff, but is not subject to payroll taxes.¹² Prejudgment interest is reported on Form 1099-MISC.

7. Attorneys' Fees

In the employment context, whether payments for attorneys' fees are includable in income depends on the nature of the related claim. If an award is not considered income, the related attorneys' fees and other legal costs will not be considered income to the employee. If the payments made to the employee are considered income, the related attorneys' fees will be considered income to the employee. These rules apply whether the attorneys are paid via a contingency arrangement¹³ or pursuant to a fee-shifting statute.

An employee is, however, allowed an above-the-line deduction for amounts attributable to attorneys' fees and costs received on account of certain discrimination/retaliation claims, whistleblower claims, civil rights claims, and claims against the United States. In those circumstances, an employee may be able to deduct legal expenses incurred in his or her suit as a business expense under Section 162 of the Code.

In other circumstances, legal expenses may also be deductible under Section 212 of the Code as expenses incurred for the production of income. Expenses paid or incurred for the production or collection of income are subject to a 2% floor, *i.e.*, the employee may only deduct that amount which exceeds 2% of his adjusted gross income. In addition, deductions under Section 212 are disallowed for purposes of calculating the alternative minimum tax.

Attorneys' fees payments are reported on Form 1099 with respect to the attorney and Form 1099-MISC with respect to the employee.

B. Penalties for Failure to Withhold

If an employer fails to deduct and withhold appropriate payroll taxes from its payments to an employee, the employer is liable for the amount of the tax that should have been deducted and withheld until the tax is paid.¹⁴ If an employer fails to withhold and/or pay FICA or FUTA and does not pay such tax within ten days after the IRS serves a notice and demand for payment, an addition to the tax equal to 0.5% of the amount of the tax for each month the tax remains unpaid, up to 25% will be assessed.¹⁵ An additional penalty of up to 10% may be imposed under Section 6656(a) for failure to deposit employment taxes, unless such failure is due to reasonable cause and not due to willful neglect. Interest will accrue on the amount owing and any penalties or additions to the tax assessed if any amount of tax is not paid when due.

¹² Greer v. Comm'r, TC Memo 2000-25 (Jan. 19, 2000).

¹³ Comm'r v. Banks, 543 U.S. 426 (2005).

¹⁴ 6 U.S.C. § 3403; Treas. Reg. § 31.3102-1(d); Treas. Reg. § 31.3403-1.

¹⁵ 26 U.S.C. § 6651(a)(2) and (3).