

Tax Considerations Before Settling Employment Matters

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Attorneys on either side of an employment law case need to consider the tax implications of settlement. Knowledge of the taxation and deductibility of settlement payments made to claimants and their attorneys, as well as the reporting requirements for such payments, will enable both sides to maximize the benefits and avoid unnecessary taxes and penalties for failure to comply with the Internal Revenue Code.



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Last year, the [IRS](#) issued a memorandum^[1] laying out what it considers the proper income tax treatment and reporting requirements for amounts — including attorneys' fees — paid to settle an employment claim. More important, the IRS memorandum makes clear that how the settlement agreement is drafted and how settlement payments are made can impact the tax liabilities on both sides.

All Payments — Including Amounts Allocated to Attorneys' Fees — Are Generally Included in the Claimant's Income

The tax treatment of a settlement depends on the origin and nature of the claims involved. For example, if the claimant is suing for wages, the settlement recovery will be treated as wages.

The IRS memorandum provides that all payments for employment claims — including those specifically allocated to attorneys' fees — will be included in the claimant's income, even if paid directly to the attorney. However, previous IRS rulings suggest that some payments for attorneys' fees in employment cases might not be included in the claimant's income.

For example, the IRS has ruled that payments for attorneys' fees in certain opt-out class action lawsuits are not included in class members' income where there is no contractual

agreement between the members and counsel.[2] Similarly, the IRS has ruled that amounts representing attorneys' fees paid in settlement of a lawsuit brought by a union against an employer to enforce a collective bargaining agreement are not included in the union members' income.[3]

Moreover, Internal Revenue Code Section 104 excludes from income amounts paid to compensate for physical illnesses, personal injuries and any emotional distress resulting from such illnesses or injuries. Although these types of claims are rarely present in employment cases, if a case involves such a claim, some portion of the settlement — including some portion of the attorneys' fees — may be excludable to the claimant.

Deductions for Attorneys' Fees

Even though the claimant will generally be taxed on the entire settlement — even including amounts paid directly to the attorney — the claimant will likely be entitled to deduct attorneys' fees. Internal Revenue Code Section 62(a)(20) provides above-the-line deductions for attorneys' fees incurred in claims for unlawful discrimination, as well as many other employment-related claims.

If the attorneys' fees are not deductible above the line, they may still be deductible as a miscellaneous itemized deduction on Schedule A. However, not only are such deductions allowable only to the extent they exceed 2 percent of adjusted gross income, but such deductions are also not allowable for Alternative Minimum Tax purposes.

Payments — Even Attorneys' Fees — May Constitute Taxable Wages

According to the IRS memorandum, all settlement payments regarding claims for severance pay, back pay and front pay are wages for employment tax purposes. The [U.S. Supreme Court](#) recently resolved a split among circuits in its March 25, 2014, *U.S. v. Quality Stores Inc.* decision, holding that severance payments are subject to Federal Insurance Contributions Act and Medicare taxes. However, the court's ruling does not impose employment taxes for severance payments made pursuant to supplemental unemployment benefit plans, suggesting that carefully worded severance agreements may still qualify for nonwage treatment.

In addition, while the Ninth Circuit treats awards for back pay and front pay as wages in all

instances, exceptions exist in other circuits: The Fifth Circuit does not treat front pay as wages, and the Eighth Circuit does not treat either back pay or front pay as wages in cases involving claims for illegal refusal to hire.[4]

Finally, the IRS asserts that attorneys' fees for wage claims are themselves wages subject to employment taxes, unless the settlement agreement expressly provides an allocation for attorneys' fees. For example, a settlement for \$50,000 — of which \$20,000 constitutes attorneys' fees — that fails to specifically allocate attorneys' fees can result in an additional \$3,060 in employment taxes. Such taxes are unnecessary and can add greatly to the costs for each side.

Reporting Requirements For Settlement Payments

Employers are generally required to file information returns for payments made for another person. Because the entire settlement — including attorneys' fees — will generally be income to the claimant, the full amount must be reported as paid to the claimant. This may be done with Forms W-2, 1099-MISC, or both, depending on the character of the payments (i.e., taxable wages or other income).

If the attorney is the named payee or a joint payee with the claimant, the employer must send the attorney a separate Form 1099-MISC for all amounts paid directly to the attorney. However, payments to attorneys need not be reported if they are only made to the attorney "in care of" the claimant.

Proper reporting may seem counterintuitive. Assume a settlement clearly allocates \$100,000 in wages and \$40,000 for attorneys' fees. The employer issues separate checks to the claimant and attorney. The employer must issue a Form W-2 to the claimant reporting \$100,000 of wages, as well as a Form 1099-MISC reporting \$40,000 of other income.

In addition, the employer must issue a Form 1099-MISC to the attorney reporting \$40,000 of other income. The employer has only paid \$140,000, but is required to report \$180,000. The offsetting deduction appears in the claimant's return.

Adding Insult to Injury

Failure to properly file a required information return or timely furnish the payee(s) with a

correct Form W-2 and/or 1099-MISC may result in a penalty equal to 10 percent of the settlement amount. Moreover, such penalties cannot be contested without paying the penalty first and then seeking a refund.

Look Before You Leap

Correctly evaluating both the income and employment tax aspects of settlements — as well as the correct reporting of settlement payments — is critical to obtaining the best result possible.

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[1] IRS Office of Chief Counsel, “Reporting Requirements for Attorney’s Fees Paid Pursuant to Settlement Agreements,” 2013 IRS NSAR 3501F (Aug. 30, 2013).

[2] See Private Letter Ruling, PLR 200625031 (2006).

[3] See Rev. Rul. 80-364, 1980-2 C.B. 294 (1980).

[4] *Doston v. U.S.*, 87 F.3d 682 (5th Cir. 1996); *Newhouse v. McCormick & Co. Inc.*, 157 F.3d 582 (8th Cir. 1998).