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Those who have experience settling employment disputes know that one of the thorniest issues to arise after agreeing to the principal terms of a settlement involves how to describe the payment in the settlement agreement. The all-important corollary to that issue is how the payment should be taxed, if at all.

Recent anecdotal information suggests that the Internal Revenue Service (IRS) is scrutinizing settlement payments in employment and wage-based cases. This should come as no surprise given the agency issued a memorandum a year ago on the proper tax treatment of employment settlements with current or former employees. The memorandum, released by the Office of Chief Counsel on Aug. 30, 2013, goes through a variety of scenarios and fact patterns in describing the reporting requirements and tax treatment of employment-related claims.

Fortunately for the readers of this column, I do not endeavor to discuss or even comment on the myriad of possible scenarios. More importantly, readers should recognize that I am not an accountant, nor a tax professional, nor remotely qualified to offer any advice on issues relating to taxes. The prudent thing is to consult a qualified professional and to review the agency's Chief Counsel Memorandum 20133501F, which can be found at http://www.irs.gov/pub/irs-lafa/20133501f.pdf.

As a general rule, Internal Revenue Code (IRC) Section 61 states all income from whatever source derived is taxable, unless specifically excluded by another code section. IRC Section 104, however, contains an exclusion from taxable income for lawsuits, settlements and awards. Since 1996, Section 104(a)(2) of the code has required that the settlement be "on account of personal physical injuries or physical sickness" in order for damages to be excludable from income.

Which brings us to employment disputes. If a claimant receives a settlement payment that is not on account of physical injuries, then it is includable in income. Further, as articulated by the memorandum, any amounts allocated as part of the settlement or judgment to attorney fees are also includable in the claimant's income, even if the amount is paid directly to the attorney. (See *Commissioner v. Banks*, 543 U.S. 426 (2005), holding that when a litigant's recovery constitutes income, the litigant's income includes any portion paid to the attorney as a contingent fee under the anticipatory assignment of income doctrine.)

As explained in the memorandum, the traditional American rule is that a prevailing litigant may not ordinarily recover his or her attorney fees and costs unless authorized by statute, as in *Alyeska Pipeline Service v. Wilderness Society*, 421 U.S. 240, 247 (1975). The U.S. Supreme Court has long held that a claim for attorney fees under a fee-shifting statute belongs to the client, not to the attorney. (See *Evans v. Jeff D.*, 475 U.S. 717, 730-732 (1986); and *Astrue v. Ratliff*, 560 U.S 586 (2010).) Thus, a prevailing plaintiff must include in his or her gross income attorney fees recovered under a fee-shifting statute if the underlying recovery is taxable. That

is often the case in claims brought pursuant to Title VII, the Americans with Disabilities Act, the Age Discrimination in Employment Act, the Family and Medical Leave Act and other similar civil rights statutes.

Since we have clear instructions on when employment settlements are taxable, the next step is to determine when the attorney fee portion is subject to employment withholdings, if ever. The memorandum starts with listing three issues, compiled in response to a request for advice from agents of the IRS.

The issues are as follows: "(1) When are attorney fees paid by an employer as part of a settlement agreement with a former employee subject to employment taxes?

(2) What are the information reporting requirements for attorney fees paid by an employer pursuant to a settlement agreement with a former employee?

(3) What penalties can be asserted if an employer fails to comply with reporting requirements for attorney fees paid as part of a settlement agreement with a former employee?"

According to the memorandum, determining the correct treatment of employment-related settlement payments is a four-step process. First, the parties should determine the character of the payment and the nature of the claim that gave rise to the payment. Second, they should determine whether the payment constitutes an item of gross income. Third, the parties should determine whether the payment is wages for employment tax purposes. Fourth, they must then determine the appropriate information reporting for the payment and any attorney fees (Form 1099-MISC and/or Form W-2).

Once the foregoing determinations have been made, the agency will then scrutinize the settlement based on several other factors, including how the payment is allocated, if at all.

To that end, the memorandum instructs the following: "(1) In the absence of a specific allocation for attorney fees in these settlement agreements, attorney fees paid by an employer as part of a settlement agreement with a former employee, which are includable in income, are subject to employment taxes to the extent they are wages attributable to an employment-related claim. The service's position is that payments constituting severance pay, back pay, and front pay are wages for employment tax purposes.

(2) The appropriate information reporting requirements depend on the facts and circumstances of each case. Unless the attorney fees are specifically allocated in a settlement agreement, the payments made in settlement of wage-based claims are generally considered wages that are required to be filed and furnished to the employee on Form W-2, Wage and Tax Statement. If the attorney fees are specifically allocated, they are generally required to be filed and furnished to the employee on Form 1099-MISC, Miscellaneous Income. The reportable amounts are always filed and furnished to the attorney on Form 1099-MISC.

(3) An employer that fails to file and furnish correct information returns that report attorney fees paid as part of a settlement agreement may be subject to penalties under Sections 6721(a) and 6722(a) of the Internal Revenue Code. If the employer intentionally disregarded the reporting requirements, the penalties increase under Sections 6721(e) and 6722(e)."

In discussing the agency's memorandum and directives with more qualified professionals, the following advice has emerged for practitioners. First, it is always a good idea to recite the amount, or absence, of lost wages in the settlement agreement. Second, while most confidential settlement agreements will allow for disclosure of the terms when compelled by law, it makes sense to also allow for sharing the agreement with the IRS. Third, the settlement agreement should be specifically drafted with an explicit allocation of fees, wage and non-wage

damages. Given the potential danger in attorney fees being treated as wages and subject to employment withholdings, it just makes sense to be as specific as possible. Fourth, it is not enough to just allocate, but it is a good practice to smartly and accurately allocate the portions for non-wages. Being aggressive in over-estimating the amount for compensatory damages is never advisable, but more importantly can subject the non-wage portion of the payment to even more scrutiny by the IRS.

And, of course, the best advice when in doubt is to consult with a qualified tax professional—which, admittedly, I am not. There are a number of traps for the unwary and there is no substitute for speaking to someone who is familiar with the code, the regulations and the revenue rulings.

Jeffrey Campolongo *is the founder of the Law Office of Jeffrey Campolongo, which, for over a decade, has been devoted to counseling employees, working professionals and small businesses in employment discrimination and human resource matters. The law office also counsels aspiring and established artists and entertainers regarding various legal issues arising in the entertainment and media industries.* •

Companies, agencies mentioned: Form W-2 | Wilderness Society | Office of Chief | Internal Revenue Service | Alyeska Pipeline Service Company | Supreme Court of the United States

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