Employment Litigation and Claim Settlements: Tax Withholding and Reporting Implications for Employers

Maximizing Tax Benefits and Avoiding Penalties When Allocating Settlement Proceeds, Drafting Settlement Agreements and Reporting Payments

WEDNESDAY, SEPTEMBER 28, 2016

1pm Eastern  |  12pm Central  |  11am Mountain  |  10am Pacific

Today’s faculty features:

Elizabeth Erickson, Partner, McDermott Will & Emery, Washington, D.C.

Meghan Bowen Frazer, Esq., Ogden Murphy Wallace, Seattle

The audio portion of the conference may be accessed via the telephone or by using your computer’s speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact Customer Service at 1-800-926-7926 ext. 10.

NOTE: If you are seeking CPE credit, you must listen via your computer — phone listening is no longer permitted.
Tips for Optimal Quality

**Sound Quality**
If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial 1-866-370-2805 and enter your PIN when prompted. Otherwise, please send us a chat or e-mail sound@straffordpub.com immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

**NOTE:** If you are seeking CPE credit, you must listen via your computer — phone listening is no longer permitted.

**Viewing Quality**
To maximize your screen, press the F11 key on your keyboard. To exit full screen, press the F11 key again.
Continuing Education Credits

In order for us to process your continuing education credit, you must confirm your participation in this webinar by completing and submitting the Attendance Affirmation/Evaluation after the webinar.

A link to the Attendance Affirmation/Evaluation will be in the thank you email that you will receive immediately following the program.

For CPE credits, attendees must participate until the end of the Q&A session and respond to five prompts during the program plus a single verification code. In addition, you must confirm your participation by completing and submitting an Attendance Affirmation/Evaluation after the webinar and include the final verification code on the Affirmation of Attendance portion of the form.

For additional information about continuing education, call us at 1-800-926-7926 ext. 35.
Employment Litigation and Claim Settlements: Tax Withholding and Reporting Implications for Employers

Elizabeth Erickson

Meghan Frazer

September 2016
In an increasing number of cases, the IRS is reviewing and challenging the allocation and tax reporting of settlement amounts.

On audit, taxpayers must:
- Be able to defend their settlement allocation.
- Demonstrate that they have accurately reported for all amounts paid to claimants.
Your Best Defense

- Establish best practices for allocating settlement amounts.
- Understand and follow the tax reporting requirements for all settlement amounts.
Employment Claims

- Breach of contract.
- Discrimination and harassment (Title VII, ADEA, ADA, EPA).
- Violations of Family Medical Leave Act and comparable leave statutes.
- Tort like damages for injuries (often precluded by industrial insurance).
- State law based claims.
Employment Damages

- Depends on the nature of claim and statute involved.
- Back pay – pay that would have been received but for employer’s conduct prior to settlement.
- Front pay – pay that would have been received but for employer’s conduct after settlement.
- Compensatory damages – compensation for physical and non-physical injuries (humiliation, defamation, emotional distress, pain and suffering).
- Punitive/liquidated damages – amount agreed to in contract to pay for breach, OR amount prescribed by statute as penalties (such as double damages).
- Attorneys fees – agreed to by contract or allowed by statute.
Tax Reporting Requirements: Basic Rule for Claimants

- Almost all settlement payments are taxable as income to the claimant, including:
  - Wages and Benefits.
  - Punitive, liquidated, emotional distress, and compensatory damages.
  - Attorney fees.
Tax Reporting Requirements: Exception – Physical Injury

- Limited exception to taxability for personal physical injury in IRC § 104(a)(2).
- If action has its origin in physical injury or physical sickness then all damages (other than punitive damages) that flow from the injury or sickness are excepted.
- Damages for emotional distress not arising from a physical injury do not qualify (even if accompanied by physical symptoms such as insomnia, headaches, and stomach disorders).
- However, reimbursements for actual expenses of medical treatment for emotional distress can be deducted.
- Most workplace injury lawsuits are barred by workers compensation laws.
Tax Reporting Requirements: Basic Rule for Employers

- Employers have a duty to withhold taxes from anything qualifying as “wages,” meaning any remuneration for employment.
- Wages include front pay, back pay, “severance/separation” pay based on hourly wage, salary, commissions, bonuses, etc.
  - Even if claimant was never an employee (refusal to hire claim) or if award represents payments for periods during which former employee was not performing services.
- Wages do not include liquidated damages, such as awarded under the FLSA or ADEA or damages for emotional distress (although such amounts are taxable income to the claimant).
Tax Reporting Requirements: Basic Rule for Employers

- Key inquiry: look at nature of item for which damage recovery is a substitute (including remedies allowed for underlying cause of action).
- IRS will look beyond characterization in settlement agreement to determine whether something qualifies as wages.
- Employer that fails to withhold is liable for amount that should have been withheld and potentially penalties and interest.
Understanding Motivations

- Because damages for physical injury are nontaxable, employees may want to characterize settlement allocation to physical injury (proceed with caution).

- Because employers pay taxes based on employee wages (such as social security at 6.2%) employers may look for ways to characterize settlement payments as non-wage related (such as compensatory damages for emotional distress).
Allocating Settlement Amounts
-- Best Practices

- Every settlement agreement should explicitly state the purpose for all payments.
- For example, where appropriate, specific settlement amounts should be allocated either to “wages” and/or to “remuneration for damages separate and distinct from wages.”
- In addition, all payments pursuant to a settlement agreement should (as a general matter) settle all claims enumerated in the lawsuit whether or not you are admitting wrongdoing and whether or not amounts are actually allocated to all claims. The settlement agreement should state that all claims are being settled.
Allocating Settlement Amounts
- Best Practices

- Taxpayers should document in a memorandum to the case file the potential exposure of all claims.
- If the settlement agreement and allocation is approved by an independent third party (judge or arbitrator), documentation to this effect should also be placed in the case file.
- A settlement allocation in the settlement agreement should be a reflection of the analysis that is documented in the case file memorandum.

Counsel should be consulted prior to producing any case file materials to the IRS or opposing counsel.
Allocating Settlement Amounts
- Best Practices

- Ensure your client understands the tax implications of any settlement or settlement proposals.
- Before mediation, consider checking with opposing counsel ahead of time to see if you both agree on what the tax code requires.
- If there is a claim regarding physical injury, ensure there is medical documentation supporting the claim.
- Include indemnity and defense provision in settlement agreement if needed.
- Check state law – for example, at least one Washington State court awarded a plaintiff a supplemental award for adverse tax consequences in a state discrimination claim.
Allocating Settlement Amounts to Non-Wage Claims

- Most common IRS allegation? More of the settlement amount should be allocated to wages.

- Thus, companies need to be able to defend any non-wage allocation as:
  - Reasonable; and
  - Reflective of potential exposure.
Allocating Settlement Amounts to Non-Wage Claims

- Think about developing guidelines for the maximum recommended settlement amount attributable to non-wage claims in the most common types of lawsuits.
  - Wage and hour.
  - Harassment.
  - Discrimination and wrongful termination.

- To justify any allocation to non-wage claims, you must believe that you have potential exposure on these claims should the case proceed to trial.

- Plaintiffs’ lawyers help things by throwing in the kitchen sink -- including punitive damages.
Allocating Settlement Amounts to Non-Wage Claims -- Wage and Hour Lawsuits

- If you are allocating settlement amounts to non-wage claims, make sure there are non-wage claims in the complaint!
- Examples: emotional distress, loss of enjoyment of life or self-esteem, shame and/or humiliation, false imprisonment, injury to reputation, mental anguish, anxiety/worry, intimidation/threats, penalties, or punitive damages.
Contact Counsel If….

- Your company is not settling all claims brought in the lawsuit.
  - Counsel may want to add language clarifying the allocation of payments in this circumstance.

- You do not have significant exposure on the non-wage claims in the lawsuit should the case proceed to trial.
  - Counsel will want to review any settlement to ensure that your company can justify an allocation to non-wage claims in this circumstance.

- The settlement allocation does not reflect your company’s analysis of its exposure.
  - Counsel will want to review any settlement to ensure that your company can justify its allocation in this circumstance.

- The settlement agreement provides for the payment of fines or penalties to a governmental entity.
  - Fines and penalties paid to a governmental entity may be treated differently for tax purposes and special language may be needed.

- A particular lawsuit does not seem to be following the pattern set out in the guidelines.
Tax Reporting Requirements: Forms

- All payments that are taxable to the claimant must be reported on Form W-2 and/or Form 1099 issued to the claimant.
  - Wages = W-2.
  - Attorney fees and other items = Form 1099.
Highlight: Attorney Fees

- As a general rule, settlement payments for attorney fees are taxable to claimants.
  - Fee structure does not matter.
  - Even if the claimant owes these amounts to another.
  - Even if the claimant never gets the amounts.
- “Assignment of Income” doctrine - attorney fees are the obligation of the claimants, who receive a benefit when they are paid.
- Comm’r v. Banks - 2005 Supreme Court case.
Attorney Fees: Exceptions to General Rule

- Physical injury cases - I.R.C. § 104.
  - Very narrow, must be physical injury or medical expenses.
  - If a non-taxable recovery, attorney fees are also excluded.

- Cases where a claimant is not liable for attorney fees.
  - Again, very narrow.
  - Fees must actually be the expenses of another person or entity. (Not an attorney!)
  - Based on IRS Revenue Ruling 80-364, example 3.
  - In the class action context, this translates to: Opt-out class actions, with no fee agreement.
Attorneys Fees: Deduction

- There is an “above-the-line” tax deduction for attorneys fees available in most discrimination or civil rights actions. I.R.C. § 62(a)(20) and (e).

- This applies to actions involving most claims of discrimination under federal, state, local, or common law.

- The deduction cannot exceed the amount includible in income on account of the settlement.
Form 1099 to Attorney

- Companies should also issue a Form 1099 to the attorney whenever the check is written in a manner that gives the attorney the right to endorse the check.
- This may result in the issuance of Forms 1099 to the claimant and the attorney for more than the total settlement amount.
- Treas. Reg. § 1.6041-1(a), -1(f), -2; 1.6045-5(f).
Example 1

- Company settles lawsuit for $25,000 in back wages and $75,000 damages.
- Company writes check payable to claimant for $100,000.
- Company issues W-2 to claimant for $25,000.
- Company issues Form 1099 to claimant for $75,000.
- Company does not issue Form 1099 to attorney.
- Same result if claimant took $100,000 check from Company and paid her attorney $30,000.
Example 2

- Company settles lawsuit for $25,000 in back wages, $50,000 damages, and $30,000 attorney fees.
- Company writes check payable to **claimant** for $105,000.
- Company issues W-2 to claimant for $25,000.
- Company issues Form 1099 to claimant for $80,000 ($50,000 + $30,000).
- Company does not issue Form 1099 to attorney.
Example 3

- Company settles lawsuit for $25,000 in back wages and $75,000 damages.
- Company writes check payable to attorney for $100,000.
- Company issues W-2 to claimant for $25,000.
- Company issues Form 1099 to claimant for $75,000.
- Company issues Form 1099 to attorney for $100,000.
- Same result if Company writes check payable to attorney and client jointly.
Example 4

- Company settles lawsuit for $25,000 in back wages, $50,000 damages, and $30,000 attorney fees.
- Company writes check payable to claimant for $75,000 and writes check payable to attorney for $30,000.
- Company issues W-2 to claimant for $25,000.
- Company issues Form 1099 to claimant for $80,000 ($50,000 + $30,000).
- Company issues Form 1099 to attorney for $30,000.
Example 5

- Company settles lawsuit for $100,000 for physical injury and medical expenses (non-taxable).
- Company writes check payable to claimant for $100,000.
- No Form 1099/W-2 is required.
Example 6

- Company settles lawsuit for $100,000 for physical injury and medical expenses (non-taxable).
- Company writes check payable to attorney for $100,000.
- No Form 1099 for claimant is required.
- Company issues Form 1099 to attorney for $100,000.
- Same result if check is payable to attorney and claimant jointly.
Example 7

- Company settles with Union for $100,000 on behalf of member/employees.
- Union then pays $25,000 of settlement in attorney fees and divides the remaining settlement among employees.
- Company issues Form 1099 to Union for $100,000.
- Union issues W-2 to employees for $75,000.
- Union issues Form 1099 to attorney for $25,000.
Final thoughts...

- Real-life examples are complicated.
- Open Questions:
  - Fee-shifting statutes.
  - Injunctive relief.
  - Non-certified classes.
- Rules can lead to unfortunate results.
Elizabeth Erickson is a partner in the law firm of McDermott Will & Emery LLP and is based in the Firm’s Washington, D.C., office. She focuses her practice on tax controversies, including tax litigation. Elizabeth represents clients in disputes before the U.S. Tax Court, U.S. district courts, the Internal Revenue Service Appeals and Examination Divisions, and the Internal Revenue Service National Office. Substantive issues in dispute in these matters have included captive insurance, capitalization and change in method of accounting issues, accounting for redemption of premium coupons, section 1341 claims, the tax treatment of settlement payments and legal fees, including tax reporting requirements, and tax advantaged transactions.

Elizabeth also has substantial experience assisting clients with the resolution of transfer pricing issues, including competent authority matters and advance pricing agreements.

**Education**
Georgetown University Law Center, J.D. *cum laude*
The Florida State University, M.Acc.
The Florida State University, B.S. *magna cum laude*
Meghan Frazer is an associate in Ogden, Murphy Wallace, PPLC’s municipal practice and is based in the Firm’s Seattle, Washington office. She has hands-on experience in a wide variety of municipal matters, including labor and employment, land use, public records requests, open public meetings, and public works. Prior to joining Ogden Murphy Wallace, she was a human resources manager at a large municipality where she oversaw ADA accommodations, investigated charges of discrimination, appeared before the Equal Employment Opportunity Commission, interpreted and negotiated Collective Bargaining Agreements, and handled labor grievances. She has also worked as an associate attorney primarily representing municipal clients at another Seattle-area law firm.

**Education**
University of Washington School of Law, J.D.
Whitman College, B.A.