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IRS Reaffirms Advice on the Proper Employment Tax Treatment of Settlements

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On August 30, 2013, the IRS reiterated its longstanding positions on the proper tax treatment of litigation settlements with current or former employees. In its [Chief Counsel Advice \(CCA\) Memorandum 20133501F](#), the IRS presented and answered three questions:

1. When are attorney's 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's 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's fees paid as part of a settlement agreement with a former employee?

Background Facts

An employer enters into several typical settlement agreements with former employees wherein the employees waive rights to bring further claims under various statutes such as the Age Discrimination in Employment Act (ADEA), the Americans with Disabilities Act (ADA), and Title VII of the Civil Rights Act (Title VII) in exchange for lump sum payments. The lump sum payments are characterized as including wages, tort damages, reimbursements of medical costs, and attorney's fees. The attorney's fees are, variously, paid directly to the employee, only to the employee's attorney, or jointly to the attorney and the employee.

The Memorandum addresses three examples of settlement payments that include attorney's fees. In the first example, all sums but attorney's fees are reported on a 1099 issued to both the employee and counsel. In the second example, the employer reports the lump sum payment as wages on a W-2 to the employee and attorney's fees on a 1099 to counsel, but does not report any portion of the attorney's fees on a 1099 to the employee. The third example includes a lump sum to settle all claims paid to the employee's attorney without any allocation between types of claims or claims and attorney's fees.

Analysis

The IRS began its analysis by laying out a four-step process:

- First, determine the character of the payment and the nature of the claim that gave rise to the payment.
- Second, determine whether the payment constitutes an item of gross income.
- Third, determine whether the payment is wages for employment tax purposes.
- Fourth, determine the appropriate information reporting for the payment, including payments of attorney's fees.

The CCA does not analyze the first step in the process, explaining that this determination simply requires (1) an examination of the claims made and (2) the intent of the parties in making the payment.

With respect to the second step, inclusion in income, the IRS explained that generally gross income includes income from settlements, including amounts paid directly to attorneys, relying upon the Supreme Court's opinion in *Commissioner v Banks*.¹ Attorney's fees are income even when the fees are paid under fee shifting statutes.² The CCA does note the potential "above-the-line" deduction for attorney's fees paid in employment related litigation under Internal Revenue Code (Code) section 62(a)(20).

Turning to the third step, whether the payment constitutes wages for employment tax purposes, the CCA explains that whether an amount received in settlement of a dispute is remuneration for employment subject to employment tax depends on the nature of the item for which the settlement amount is a substitute.³ It does not matter whether an employment relationship exists at the time of payment.⁴

Relying heavily upon Revenue Ruling 80-364, the CCA concludes that when an employment-related claim brought under a fee-shifting statute is settled outside of court and the settlement agreement clearly allocates a reasonable amount of the settlement proceeds as attorney's fees, the amount allocated to attorney's fees, while includable in income, is not wages for employment tax purposes. On the other hand, if the settlement agreement does not clearly allocate an amount for attorney's fees, and/or the claim is brought under a statute that does not provide for fee-shifting, the entire amount paid to the claimant-employee is wages for employment tax purposes.

Addressing the fourth step, the proper reporting requirements, the CCA cites to both the general reporting requirements under Code section 6041 and its regulations to conclude that when the entire amount of the settlement is includable in income and includes attorney's fees, such fees must be reported as income to the plaintiff. With respect to the reporting of the attorney's fees to counsel, the CCA cites to Code section 6045 and its regulations, concluding that Code and regulations make clear that separate reporting of such fees to both the plaintiff and plaintiff's counsel is required. This is commonly referred to as "dual reporting." The CCA also notes that failure to perform proper tax reporting can result in penalties of between \$100 and \$250 per failure.⁵

CCA's Conclusions

The CCA reached three summary conclusions:

1. In the absence of a specific allocation for attorney's fees in these settlement agreements, attorney's 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.⁶

1 *Commissioner v Banks* 543 U.S. 426 (2005).

2 Citing *Sinyard v. Commissioner* (9th Cir. 2001) 268 F.3d 756 and *Vincent v. Commissioner*, T.C. Memo 2005-95.

3 Citing *Alexander v. Internal Revenue Service* (1st Cir. 1995) 72 F.3d 938, 942 (the test for purposes of determining the character of a settlement payment for tax purposes "is not whether the action was one in tort or contract but rather the question to be asked is 'in lieu of what were the damages awarded?'""); *Hort v. Commissioner* (1941) 313 U.S. 28 (holding that an amount received upon cancellation of a lease was a substitute for the rent that would have been paid under the lease and, thus, was taxable as ordinary income); Rev. Rul. 96-65, 1996-2 C.B. 6, (holding that payments received by an individual in satisfaction of a discrimination claim under Title VII are both income and wages).

4 Treas. Reg. §§ 31.3121(a)-1(h)(i), 31.3306(b)-1(i), 31.3401(a)-1(a)(5); *Social Security Board v. Nierotko* (1946) 327 U.S. 358, 365-66.

5 IRC §§ 6721, 6722; Treas. Reg. § 301.6721-1(f)(3), 301.6722-1(c)(1).

6 In footnotes, the IRS notes that there are some splits among the courts regarding the character of severance pay, back pay in illegal refusal to hire cases, and front pay cases.

2. The appropriate information reporting requirements depend on the facts and circumstances of each case. Unless the attorney's 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's 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's fees paid as part of a settlement agreement may be subject to penalties under §§ 6721(a) and 6722(a) of the Internal Revenue Code. If the employer intentionally disregarded the reporting requirements, the penalties increase under §§ 6721(e) and 6722(e).

Takeaways

The CCA does not provide any new analysis or law, nor does it signal any change in the IRS' longstanding positions. However, it is helpful in that it explains the dual reporting obligation which is often resisted by all parties. Notably, the recent Memorandum does not address the related question of when a payment need not be included in gross income, as, for example, a payment issued to compensate for a personal physical injury.

The IRS has been aggressively auditing settlement agreements between employers and current or former employees and forcing employers to defend any non-wage treatment of payments. Employers should recognize that it is not acceptable to "agree" with an employee that the entire amount of a settlement is not wages, pay the lump sum amount to counsel's trust account, and defer responsibility (and/or liability) for an IRS challenge to the employee. Rather, employers should:

- Understand the nature of the claims being asserted, their character and the basis for settlement;
- Carefully craft settlement agreements that specify the nature of each amount being paid in the agreement with clear allocations between the kinds of payments (wages, attorney's fees, etc.);
- Ensure that amounts are properly reported on IRS forms W-2 and 1099 as required, with separate forms to plaintiff's counsel as well as plaintiff.

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