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## Tax Pitfalls To Avoid In Employment Litigation Settlements

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By all measures, 2021 was a banner year for hiring, but 2022 and 2023 have been the opposite.

According to one media source, more than 121,000 jobs in the technology sector alone – think Google LLC, Amazon.com Inc., Microsoft Corp., Meta Platforms Inc., Salesforce.com Inc., Yahoo Inc. and others – have been lost in 2023, thanks to the economy, inflation, higher interest rates and over hiring. Aside from a few bright spots, such as the hospitality and retail sectors, the outlook is increasingly ominous given the likelihood of future interest rate hikes by the Federal Reserve Bank.[1]

With employers looking to trim the size of their workforce comes the risk that unhappy employees will raise legal claims, either on their way out the door without waiving the claims in a severance agreement or after termination.

Rather than engaging in a protracted litigation, which puts pressure on an already strained bottom line, an employer may choose to get closure by settling claims matter and moving on.

Once a settlement is reached, the next hurdle is determining tax reporting: Does the amount go on a Form W-2 or a Form 1099? If on a Form 1099, which version of the form is correct? What, if anything, should the settlement agreement say on tax reporting? What happens if it's done wrong?

Here is a short list of things to keep in mind to ensure it's done right the first time.

### What are the income tax reporting requirements for employee settlements?

How a settlement should be reported to the Internal Revenue Service depends upon the nature of the employee's claim. The origin of the claim rule provides that the tax treatment of the damages a plaintiff receives is based on the type of claim being settled.[2]

Generally this determination is made on the basis of all the facts and circumstances of the litigation, but in the context of an employee settlement it is relatively straightforward – the damages will represent either wages or something else.[3]

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## Wages on Form W-2

If the settlement represents wages, then it must be reported on an Internal Revenue Service Form W-2 wage and tax statement. "Wages" is actually a technical term under the Internal Revenue Code that means all remuneration for services performed by an employee for their employer, including the cash value of all remuneration, including benefits paid in any medium other than cash, unless specifically excepted by law.[4]

Vacation pay, payments made on account of involuntary separation, bonuses, commissions, taxable fringe benefits, payment by an employer of an employee's tax and compensation paid to a former employee for services performed while still employed are all considered to be wages.[5]

Thus, payments by an employer to an employee under a settlement agreement for back pay or front pay will be considered wages for income tax purposes. This means that employers are responsible for withholding and remitting federal income tax, as well as applicable state and local income taxes, from the settlement amount. The employer is also responsible for both the employee's and employer's portion of federal payroll taxes i.e., Social Security and Medicare tax, together referred to as FICA.

If the employee's wages exceed a certain threshold, the employer is also responsible for remitting the employee's additional Medicare tax.[6] For 2023, only the first \$160,200 of an employee's wages are subject to the Social Security tax. Employees who earn more than \$200,000 are subject to additional Medicare tax of 0.9% on the portion of wages that exceed that threshold however, this is an employee-only tax.

Because the employer is responsible for withholding these taxes at the source i.e., from the employee's pay the employer is liable in the first instance if the amounts are not withheld and remitted to the U.S. Department of the Treasury and the employee does not pay them by date they are due.[7] In addition to the tax, the employer is liable for penalties and interest on any unpaid amounts.

The Social Security tax rate for both employers and employees is 6.2%, for a total of 12.4%. The Medicare tax rate is 1.45% for both employers and employees, for a total of 2.9%.

Any amount representing wage income should be reported on a W-2 even if the employee has separated from the employer and is working for someone else, or not working at all, when the settlement amount is paid.[8] Moreover, the amount should be reported on a W-2 even if it causes overwithholding of the employee's FICA for the calendar year.

This would occur if the employee exceeded the Social Security wage base before separating, but took a new job before the year ends. In the event this happens, the employee can file a Form 843 claim for refund and request for abatement with the IRS.

In contrast, amounts paid as compensation to nonemployees are reported on IRS Form 1099-NEC. So if an employer settles a claim with an individual whom it treated as an independent contractor and the settlement represents compensation for services as opposed to wages paid to an employee the amount should be reported on a 1099-NEC.

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## Nonwages on Form 1099-MISC

If the settlement amount represents payment for something other than wages, the amount should not be reported on a Form W-2. Instead, it generally should be reported in box 3 of IRS Form 1099-MISC, which is used for payments of "Other Income."

As the name of the form suggests, it is used to report payments that don't have their own special form, such as a W-2 in the case of wages or a Form 1099-INT in the case of interest earned on a bank deposit.[9] Except in certain unusual circumstances, the payor of an amount reported on a Form 1099-MISC does not withhold income tax.[10]

In the context of employee settlements, amounts reported on a Form 1099-MISC will usually relate to claims of emotional distress.[11] Damages received by an individual on account of physical injuries are not taxable, so they do not trigger a tax reporting obligation.[12]

## What's the harm in reporting the entire settlement as miscellaneous income?

An employee may want the settlement amount to be reported on a 1099-MISC rather than a W-2, because the former avoids tax withholding and maximizes the amount the employee takes home. However, this can create problems for both the employee and the employer:

### For the Employee

If the settlement amount is significant compared to other sources of income for the year in which the settlement is paid, the employee could be subject to an underpayment penalty at tax time for not paying enough tax to the IRS during the course of the year.[13]

This penalty arises because the IRC imposes a pay-as-you-go regime, which applies to both employees via employer withholding and self-employed individuals via payments of estimated taxes. Unlike some tax penalties that are limited to a set percentage of the tax owed, the underpayment penalty is not capped.

### For the Employer

If the settlement does in fact represent wages and the employee does not pay at tax time, the employer will be on the hook for unwithheld income tax, as well as the employee and the employer's portion of FICA. In addition, if the employer is a large employer that is audited by the IRS as a matter of course, this irregularity which could lead an examiner to make further inquiries.

## When does an employer need to issue a 1099-Misc to the employee's attorney?

There are circumstances in which the employer must issue a 1099-MISC to the employee's attorney.[14] Generally, this obligation is triggered when the employer pays the employee's legal fees directly to the attorney, or when a check for the full settlement amount is paid to the attorney typically for deposit into the attorney's trust account followed by remittance to the employee.

In the context of employee settlements, the former situation is the most common.

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Frequently, the parties will agree that the employer will cut two checks: one to the plaintiff for the net settlement amount and another to the plaintiff's attorney in satisfaction of the attorney's fee.

For income tax purposes, the employee is actually taxable on both amounts, regardless of who receives the check, because the employee is treated as having received the full amount of the settlement from the employer and then having paid the attorney their fee using a portion of that amount.[15]

For instance, consider a taxable settlement involving an employment discrimination. The employee, EE, is represented by attorney A. EE settles the claim with the employer, ER, for \$300,000, which the parties further agree constitutes back pay.

EE and A have a contingent fee arrangement for 30% of EE's award. The parties agree that ER will write two checks, one payable to A in the amount of \$100,000 representing A's contingent fee, and another payable to EE in the amount of \$150,000 representing the remaining \$200,000 less applicable tax withholding.

ER must issue: (1) a 1099-MISC to A, with \$100,000 reported as "Other Income" in box 3; and (2) a W-2 to EE, reflecting \$300,000 in back pay.[16] The crucial point is that the amount reported to the plaintiff on the W-2 is not reduced by the legal fee.

### What needs to be included in the settlement agreement?

The parties may disagree on how specific the settlement agreement should be in setting out the tax reporting of the various payments. Generally, the approaches to this fall in one of two categories.

#### First Approach

The settlement agreement may provide that the employer is obligated to report the payments made to any party pursuant to the agreement in accordance with applicable law and IRS instructions. The benefit of this approach is that it allows the parties to ink the settlement with some assurance that the tax reporting will be completed properly at the appropriate time.

#### Second Approach

Alternatively, the settlement agreement may list out each payment to be made to each party and the IRS form on which the payments will be reported. This approach often leads to contention between the parties and can delay the signing of the agreement. It can also have consequences for all three parties the employer, the employee and the attorney later down the line if the IRS disputes how the amounts were reported.

To minimize legal fallout when right-sizing your workforce, proper tax reporting following any employee settlement, often an afterthought, carries equal importance.

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[1] Natasha Mascarenhas and Alyssa Stringer, "A Comprehensive List of 2023 Tech Layoffs," Tech Crunch, Mar. 13, 2023, available at <https://techcrunch.com/2023/03/13/tech-industry-layoffs/> (last accessed Mar. 13, 2023).

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[2] See *Tribune Pub. Co. v. U.S.*, 836 F.2d 1176, 1178-79 (9th Cir. 1988) (holding that the tax character of the proceeds received in a recovery on a legal claim depends upon "the original and character of the claim which gave rise" to the dispute); *Raytheon Prod. Corp. v. C.I.R.*, 144 F.2d 110, 113 (1st Cir. 1944) ("the question to be asked is, 'In lieu of what were the damages awarded?'").

[3] *Melcher v. C.I.R.*, T.C. Memo. 2009-210 (the "ascertainment of a claim's origin and character must be made on the basis of the facts and circumstances of the litigation" and is "not a mechanical search for the first in the chain of events that led to the litigation but rather requires an examination of all the facts.").

[4] Internal Revenue Code ("IRC") 3401(a); Treas. Regs. 31.3401(a)-1(a)(2).

[5] Treas. Regs. 31.3401-1(b)(3) and (b)(4); IRS Publication 15 (Circular E), Employer's Tax Guide (2022).

[6] See IRC 3402, 3403 (regarding income tax withholding); IRC 3101, 3102, 3121 (regarding Federal Insurance Contribution Act withholding, which covers Social Security and Medicare).

[7] IRC 3403.

[8] Treas. Regs. 31.3401-1(a)(5).

[9] See IRC 6041(a) (establishing reporting requirements for amounts that aren't reportable under another provision of the IRC).

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[10] A payor who reports an amount on a Form 1099-MISC must withhold income tax where the recipient does not provide the payor with a federal tax identification number (and for certain payments to Native American tribes).

[11] See IRC 104(a)(6) (emotional distress damages are not excludible as damages received on account of personal physical injury or sickness under IRC 104(a)(2)). Other amounts which may be reportable on a 1099-MISC could be damages for defamation or other similar commercial torts.

[12] See Treas. Regs. 1.6045-5, ex. 2 (defendant does not file an information return with respect to tax-free damages paid to the plaintiff). Plaintiffs will sometimes try to shoehorn a settlement payment into the excludible physical injury category, but courts generally have rejected these efforts. See, e.g., *Oyelola v. C.I.R.*, T.C. Summ. Op. 2004-28 (ex-employee who brought an employment discrimination lawsuit based on race claimed that a \$30,000 settlement for his emotional distress claim was intended to compensate him for a physical injury he sustained when he collapsed to the floor at cut his lips, allegedly due to the distress; the court held that the amount was intended to compensate him for the more pervasive emotional distress he endured from the race discrimination in his workplace, not the single incident).

[13] See generally IRC 6654. The underpayment penalty is determined by applying the underpayment rate of Section 6221 of the Code, the amount of the underpayment, and the period of the underpayment. Interest is assessed on penalties. To avoid the penalty, an individual must pay during the course of the year either (i) 90% of the tax shown on the return for that year, or (ii) 100% of the tax shown on the return of the individual for the preceding taxable year. IRC 6654(d)(1)(B).

[14] See generally Treas. Regs. 1.6045-5 (Information reporting on payments to attorneys).

[15] See *Banks v. C.I.R.*, 543 U.S. 426 (2005). Outside the employment discrimination context, this rule creates what is known as the "contingent fee trap," which can result in the plaintiff netting less than 20% of his or her the gross award. For example, consider a plaintiff in a defamation lawsuit who is awarded \$10,000,000. The plaintiff resides in Los Angeles County, California. Assuming an effective federal income tax rate of 36.59%, effective state and local income tax rate of 13.03%, and a 35% contingent fee, the plaintiff is left with \$1,538,000a mere 15.38% of the total award. However, this trap does not come into play in cases involving "unlawful discrimination," because attorneys' fees in those cases are deductible "above the line" under Section 62(a)(20) of the IRC.

[16] See Treas. Regs. 1.6045-5(f), example 3.

#### **ATTORNEYS MENTIONED**

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