The IRS - The Silent Party in the Employment Claim Settlement Agreement

By: Shauna N. Correia and Alden J. Parker

Many of our employer clients and their in-house counsel recognize that most of the claims paid in an employment settlement are taxable income for the employee, and wisely require that at least some of the settlement payment to the employee be made in the form of a payroll check, with applicable withholding deducted. Employees, however, often want to minimize the portion of their settlement proceeds that is subject to withholding.

In-house counsel handling these claims may believe that taxation is "between the employee and the IRS" and simply agree to whatever allocation the employee wants or go ahead and 1099 the whole settlement payment. It is true that the burden is on the taxpayer with respect to properly reporting income as "wages" on a W-2 or other income on a 1099-MISC. However, IRC section 6672(a) imposes a penalty equal to the 100% of the amount of the employee's portion of unremitted taxes on every "responsible person" who "willfully" fails to see that the taxes are paid. The IRS may assess the penalty against the employee, the employer, or both.

From the IRS or state taxing authority's perspective, the primary concern with respect to settlement of employment claims is whether a reasonable amount was allocated to wages, and thereafter the correct amount of taxes was withheld and paid by the employer. An employer may find itself the subject of an IRS audit and an accusation that it under-withheld and underpaid the employer's contribution of FICA, FUTA, or income taxes with respect to settlements of employment claims. The larger the employer, the more likely an audit will be conducted. Employers, especially large employers, who settle significant numbers of claims may be required to report all settlements each year to the IRS for review.

Employers can take a stronger stance with regard to allocation because of this risk when the plaintiff cavalierly states "I'll take my chances" when negotiating allocation of settlement payments. The allocation should be rationally related to the claims in the complaint with respect to what proportion of the payment will be allocated as wages and paid via payroll check after withholding all appropriate deductions, and what will be deemed non-wage reportable income.

It bears reminding that the IRS treats almost all employment-related settlements as taxable – even emotional distress, unless it relates to a "physical injury" (such as bruising, cuts, or swelling) or "physical sickness" or does not exceed the amount of medical expenses actually incurred. (See IRC section 104(a)(2).

While we cannot give tax advice in this blog, and this is not meant to be a comprehensive treatise that replaces tax or legal advice, we offer the following pointers to reduce the risk that your settlement will break down or that the company will find itself the subject of unwanted IRS attention:

- Do not "spring" the issue of allocation to the tail end of a settlement negotiation or mediation. Like any other material provision, it should be one of the deal points that is brought up reasonably early.
- Do not collude with the employee with respect to allocation – while the IRS is not bound by the settlement agreement's characterization, in order for the allocation in a settlement agreement to pass muster, it must be entered into in an adversarial relationship, at arm's length and in good faith.
- Do not unilaterally make the allocation determination – the burden is on the taxpayer and the employer should be sure that the employee cannot claim that it relied on the employer to allocate.
- Include a tax indemnification provision in all settlement agreements and insert a provision acknowledging that the employee has had the opportunity to consult a tax advisor.
- Clearly document the allocation of settlement sums that will be paid as "wages" for wage based claims such as back pay, front pay and severance pay (W-2), the sums attributable to tort-based claims such as for emotional distress (1099) or physical injuries (not reported), liquidated damages and interest (1099), and the portion of the settlement that is being paid in lieu of statutory attorneys' fees (1099 but able to be deducted "above the line" by the employee).

For additional information, the Internal Revenue Service (IRS) Office of Chief Counsel has outlined four main factors necessary to determine the correct tax treatment of employment-related settlement payments. See Office of Chief Counsel Internal Revenue Service Memorandum, dated October 22, 2008, UILC: 61.00-00, 3101.00-00, 3111.00-00, 3402.00-00, Income and Employment Tax Consequences and Proper Reporting of Employment-Related Judgments and Settlements (the "IRS Counsel Memorandum"). The IRS Counsel Memorandum outlines both the income and employment tax consequences, as well as the appropriate reporting, of settlement payments and contains useful information for companies settling employment-related lawsuits.

For more information, please contact your Weintraub Tobin employment and tax attorneys.