

Employers Who Fail to Properly Withhold Taxes from Settlement of Wage Claims Will Have to Contend with the Internal Revenue Service

Payments made to settle employment-related disputes generally fail to qualify for an exclusion from taxation under IRC 104(a)(2). This is because the payments almost always represent wages and seldom compensate for tort-like *physical* injuries. Misallocation of settlement payments places employers at risk of being penalized by the Internal Revenue Service ("IRS").

In July 2009,¹ the IRS issued the Program Manager's Technical Advice 2009-035 Memorandum² ("the PMTA"), to clarify the tax treatment of settlements of employment-related claims.³ The PMTA is clear – *under an employment-related settlement agreement, settlement funds generally are treated as wages or taxable, non-wage compensatory damages for non-physical harm, with very little, if any, can properly be characterized as tax-exempt compensatory damages for physical injuries.*

Amounts paid to settle wage claims are subject to income and employment taxation and withholding and must be reported on the IRS Form W-2. Amounts paid as

compensatory damages for emotional distress or other non-physical injury or sickness is subject to income tax, but not withholding or employment taxes, and must be reported on the IRS Form MISC-1099. Only sums paid in compensation for *physical* injury or sickness or for medical costs for non-physical injuries is tax-exempt and should *not* be reported on either Form W-2 or 1099.

Under the PMTA's four-step approach to determining how damages should be treated for tax purposes, an employer must determine whether a compensatory damage⁴ claim exists, and if so, whether there is sufficient supporting evidence for such a claim.⁵

For example, a settlement payment could be made for lost wages and non-physical injury (emotional distress) on a claim under Title VII of the Civil Rights Act of 1964. However, before any of the settlement funds may be allocated to emotional distress damages, the employer must have evidence that the employee actually suffered emotional distress injuries. This is generally demonstrated by medical records.

By contrast, emotional distress damages are not recoverable on a claim under the Age Discrimination in Employment Act. Hence, all sums paid to settle an ADEA

¹ Although the Memorandum is dated October 22, 2008, it was not released until July 2009.

² See The Office of Chief Counsel Internal Revenue Service Memorandum dated October 22, 2008, designated as the Program Manager's Technical Advice 2009-035.

³ While the PMTA cannot be cited as precedent, it does provide employers with some necessary guidance when having to settle employment related lawsuits and claims.

⁴ Compensatory damages include compensation for physical injury and non-physical injury, *i.e.* humiliation and defamation, and for the intangible elements of personal injury such as emotional distress and pain and suffering.

⁵ The PMTA also addresses the correct tax treatment of types of damages, including but not limited to punitive and liquidated damages.

claim – with the possible exception of attorneys' fees - must be allocated to wages and reported on the IRS Form W-2.

Absent Clear Supporting Evidence, Little, If Any, of a Settlement May Be Allocated to Non-Taxable Compensatory Damages for Physical Injuries or Physical Sickness.

The PMTA states that employment-related cases *seldom* raise claims for physical injury. The IRS views personal physical injury as observable or documented bodily harm such as bruising, cuts, swelling or bleeding and emotional distress arising from physical injury or physical sickness.

In an employment case, most compensatory damages are limited to emotional distress or similar injuries. These damages typically do not arise from physical injuries or physical sickness and are taxable, except for the portion reimbursing medical expenses that have not previously been deducted by the employee.

Compensatory damages for physical injuries and physical sickness as well as reimbursement for medical expenses for emotional distress are not subject to income tax or employment tax and do not have to be reported.⁶ However, compensatory damages not tied to a showing of physical injury or physical sickness, are subject to income taxation, but are neither subject to employment tax nor to income tax withholding. These funds are reported on the IRS Form MISC-1099.

Some parties try to avoid these tax requirements by treating all settlement funds as non-wages and reporting the full amount on the IRS Form MISC-1099. However, employers must understand *the IRS is not*

bound to the allocations of the settlement proceeds stipulated in a settlement agreement between an employer and employee/former employee. If an employer is audited, the IRS will look to the true nature and substance of the claims and all of the facts surrounding the settlement agreement to determine which claims and potential damages are represented by the agreement. This means the IRS will look outside the four corners of the settlement agreement to claims alleged in any complaint, to assertions in claim letters and to evidence supporting those claims. If the IRS determines a portion of the settlement was mistreated as non-wages, it may impose additional income and employment tax and penalties against the employer.

Proper tax treatment of settlement payments is far from simple. While the PMTA provides a good resource for employers, it is an incomplete analysis. We strongly suggest employers speak to counsel to address these issues as early as possible when resolving employment related disputes. Also, there are additional tax consequences surrounding employment related settlements which must also be considered, such as attorneys' fees.

If you have any questions about the PMTA and the proper allocation of settlement funds, please direct them to Rhonda L. Nelson 415-677-5502, rln@severson.com or Danielle M. Ellis at 415-677-5504, dme@severson.com.

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⁶ Damages for emotional distress arising from physical injury and physical sickness are treated as damages from physical injury and physical sickness.