

TAX IMPLICATIONS OF EMPLOYMENT SETTLEMENTS AND DAMAGE AWARDS

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I. Overview

A. *No distinction between settlements and judgments.* It makes no difference from a tax standpoint whether litigation is concluded through a court adjudication or through an agreement of the parties. It is sometimes suggested that a taxpayer may strengthen his or her tax position by taking the matter to judgment and ensuring that the court order allocates the payments to the claims in the manner the taxpayer desires. However, an allocation made by a court is not necessarily conclusive.

B. *Origin of the claim.* The origin of the claim controls the tax treatment of any resulting recovery, whether received pursuant to a settlement or a judgment. *See U.S. v. Gilmore*, 372 U.S. 39 (1963). The recovery should be taxed in the same manner as the item for which it is a substitute.

C. *Example.* In a recent private letter ruling (TAM 200244004), the IRS stated its positions on a number of tax issues relating to the settlement of employment discrimination claims.

(1) *Facts.* Employee A filed charges of discrimination with the EEOC alleging violations of the Family and Medical Leave Act and alleging disparate treatment based on her race and sex. The employer and Employee A entered into a settlement agreement in which one-half of the payment was allocated to damages for emotional distress and the remaining one-half was allocated to damages for lost wages.

Employee B filed charges with the EEOC alleging age discrimination. The employer and Employee B entered into a settlement agreement in which two-thirds of the payment was allocated to damages for emotional distress and the remaining one-third was allocated to back pay. Further, an additional amount was paid directly to Employee B's attorney.

(2) *Analysis.* The IRS reached the following conclusions:

(a) *Inclusion in gross income of back pay and damages for emotional distress.* The employees were taxable on both the back pay and the damages for emotional distress. Although damages for personal physical injuries (other than punitive damages) are generally not taxable, emotional distress is not treated as a physical injury for this purpose. *See* IRC § 104(a).

(b) *Inclusion in gross income of payment to attorney.* The IRS' position is that a taxpayer is taxable on amounts paid directly to the taxpayer's attorney pursuant to a contingent fee arrangement. The courts, however, are split on the issue, and the Fourth Circuit has affirmed the IRS' position. The Supreme Court has decided to hear two cases in which it will resolve the issue. Consistent with its general position, in the ruling the IRS held that Employee B was taxable on the amount paid directly to his attorney.

(c) *Withholding of employment taxes from back pay.* The employer was required to withhold income, FICA, and FUTA taxes from the back pay and to include such amounts on Forms W-2.

(d) *Inapplicability of withholding taxes to damages for emotional distress.* The damages paid to Employee A for emotional distress did not constitute wages and were not subject to FICA, FUTA and employment tax withholding. Instead, the employer properly reported such damages on a Form 1099 issued to the employee.

The IRS held that the allocation of a portion of the amount received by Employee B to damages for emotional distress was not reasonable. The IRS determined that the employee did not initially seek damages for emotional distress and that such claim was added only to achieve a desirable tax result. Thus, the IRS ruled that the amount the parties attempted to allocate to Employee B's emotional distress was in fact wages subject to employment tax withholding.

(e) *Inapplicability of withholding taxes to payment to attorney.* A court award of attorney's fees under a fee-shifting statute is not wages subject to withholding. Thus, the IRS ruled that the amount paid to Employee B's attorney was not wages subject to withholding. Instead, such amount was properly reported on Forms 1099 issued both to Employee B and the attorney.

II. Taxability of Settlements and Damage Awards

A. *Personal Injury.* Section 104 excludes from taxable income damages received for personal injury or sickness. Damages arising from many traditional torts, such as wrongful death, loss of consortium, intentional or negligent infliction of emotional distress, and defamation, have been held to be excludable from income. Prior to the 1996 change in the law, wrongful termination and various discrimination claims were held to result in excludable recoveries.

B. *Requirement of physical injury.* After the 1996 Tax Act, the Section 104 exclusion only applies to damages on account of a personal physical injury or physical

sickness. If an action has its origin in a physical injury or physical sickness, all damages (other than punitive damages) deriving from the injury are treated as received on account of a physical injury regardless of whether the recipient of the damages is the injured party. For example, damages received by an individual for a claim for loss of consortium due to the physical injury of such person's spouse are excludable from gross income. Similarly, damages received on account of a wrongful death claim are excludable.

C. *Emotional distress.* Under current law emotional distress is not considered a physical injury or physical sickness. Even if the emotional distress includes physical symptoms such as insomnia, headaches, and stomach disorders, damages resulting from a claim of emotional distress are not excludable unless the claim has an origin in a physical injury. On the other hand, if a battery produces both physical harm and emotional distress, the entire recovery (other than punitive damages) is excludable.

D. *Examples.*

(1) *Damages resulting from kick by Dennis Rodman.* In *Amos v. Commissioner*, TC Memo 2003-329, a television cameraman settled a claim against Dennis Rodman based on Rodman's well-publicized kick of Amos. Amos took the position that the \$200,000 he collected from Rodman was excluded under Section 104 because it resulted from a physical injury. The court noted that the nature of the claim that was the actual basis for the settlement controls whether the damages are excludable under Section 104. The court stated that the character of the settlement payment hinges on the dominant reason of the payor in making the payment. The court held that \$120,000 of the total settlement was paid on the account of physical injuries and was therefore excludable. The remaining \$80,000 was paid for other reasons, such as Amos' agreeing not to press criminal assault charges, and was therefore includable in income.

(2) *Physical injury not caused by employer.* In *Johnson v. U.S.*, No. 02-1330 (10th Cir. 2003), Johnson was injured while restraining an inmate in a prison where Johnson was employed as a guard. Because Johnson could no longer perform the duties of a guard, he was terminated. Johnson sued his employer under the Americans with Disabilities Act, alleging discrimination for the employer's failure to accommodate him with another job that he could perform. A jury awarded Johnson back pay, front pay, damages for emotional distress, pain, and suffering, prejudgment interest, and attorneys' fees. The court held that the full recovery was taxable because the actual cause of the loss of income and injury was Johnson's unlawful termination not his personal physical injury.

(3) *Sexual assault.* In PLR 200041022, an employer physically and sexually assaulted a female employee on several occasions. The employer cut and bit the employee, causing skin discoloration and swelling accompanied by extreme pain for which the employee received medical treatment. The employee filed a suit charging sexual discrimination, battery, and intentional infliction of emotional distress. The parties settled the case but did not allocate the proceeds among the claims. The IRS ruled that the damages the plaintiff received for the employer's unwanted physical contacts that did not produce any observable bodily harm were not received on account of personal physical injuries and,

therefore, were taxable. In contrast, the damages received for pain, suffering, and emotional distress after the first assault were excludable under Section 104 because they were attributable to physical injuries.

E. *Punitive damages.* After the 1996 Tax Act, the Section 104 exclusion does not apply to any punitive damages received on account of physical injury or sickness.

F. *Medical expenses.* The taxability of emotional distress damages does not apply to the extent the damages do not exceed the amount paid for medical care that is attributable to the emotional distress. Thus, the Section 104 exclusion still applies to medical expenses that the plaintiff receives on account of emotional distress even if there are no physical injuries.

G. *Prejudgment interest.* Prejudgment interest is not excludable from income under Section 104. When a settlement in a personal injury case entered into following a judgment contains no allocation of damages to prejudgment interest, the IRS may allocate a portion of the settlement to interest. *See Rozpad v. Commissioner*, 154 F.3d 1(1st Cir. 1998).

H. *Periodic Payments.* If a recovery is excludable under Section 104(a)(2), it is immaterial whether the taxpayer receives the payment in one lump sum or in installments over many years. The plaintiff's receipt of installments over a number of years in a structured settlement permits the plaintiff, in effect, to receive investment earnings tax-free. The payor may assign its obligation to make periodic payments under a personal injury judgment or settlement to a third party such as an insurance or annuity company. *See IRC* § 130.

III. Contingent Attorney Fees: Excludable v. Deductible

A. *Background.* When a plaintiff's attorney has a right to receive a percentage of a settlement or award, it is unclear whether the plaintiff (a) can exclude the attorney fees from income or (b) must include the attorney fees in income and then deduct the fees as a miscellaneous itemized deduction. Where state law gives the attorney a property right in the contingent fees, some courts, including those in the Fifth, Sixth, Ninth, and Eleventh Circuits, have held that a plaintiff can exclude contingent fees paid to his or her attorney. *See e.g., Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959). A majority of the circuits, including the Fourth Circuit, have held that a plaintiff must include contingent attorney fees in income and then deduct them as a miscellaneous itemized deduction. *See, e.g., Young v. Commissioner*, 240 F.3d 369 (4th Cir. 2001).

B. *Consequences.* The two approaches can yield vastly different results for the plaintiff. Excluding the fees from gross income obviously involves no tax cost to the plaintiff. In contrast, a plaintiff's having to include the entire settlement (including attorney fees) in gross income and deduct the fees as miscellaneous itemized deductions can result in a large portion of the attorney fees, in substance, not being deductible. In most cases a significant portion of the fees will not be deductible because of the 2% floor on miscellaneous itemized deductions under Section 67, the overall limitation on itemized

deductions in Section 68, and the disallowance of miscellaneous itemized deductions for alternative minimum tax (“AMT”) purposes pursuant to Section 56(b). The disallowance of the deduction for AMT purposes is especially costly to plaintiffs.

C. *Supreme Court will resolve the issue.* The Supreme Court has agreed to settle the conflict among the circuit courts of appeal by reviewing two pro-taxpayer decisions: *Banks v. Commissioner*, 92 AFTR2d 2003-6298 (6th Cir.); *Banaitis v. Commissioner*, 92 AFTR2d 2003-5834 (9th Cir.). From a policy standpoint plaintiffs should certainly be able to deduct attorney fees fully. However, a majority of courts have held that applicable law does not permit that result notwithstanding its reasonableness and that the proper remedy is for Congress to change the law rather than for the courts to misapply the law to reach a fair result.

D. *Employer’s perspective.* Because employers are liable for all or a portion of taxes not withheld, employers may be reluctant to permit employment taxes to be avoided by not treating attorney fees as paid to the employee unless a fee-shifting statute covers the situation.

E. *Reporting of payments to attorneys.* When a payment is made directly to a plaintiff’s attorney, the payment should be reported on Forms 1099 filed for both the plaintiff and the attorney. See TAM 20024404; IRC § 6045(f); Prop. Reg. § 1.6045-5; Notice 2001-7.

F. *Deduction of legal fees.* Legal fees follow the same character as the recovery or the payment. For example, if a payment is required to be capitalized, legal fees incurred by the defendant in the litigation also have to be capitalized. The origin and nature of the claim determines whether legal fees are deductible. Even if the lawsuit is unsuccessful and there is no recovery, legal fees may be deductible depending upon the origin of the claim. If a recovery is required to be allocated to more than one claim, legal fees must also be apportioned among the various claims ratably.

Legal fees that are incurred in recovering an amount that is excludable from gross income (such as damages arising from a personal physical injury) are not deductible. An apportionment of legal fees and expenses is required when the plaintiff recovers both taxable and nontaxable amounts. The deductible portion of the legal fees and expenses is equal to the amount of the fees and expenses multiplied by (the non-exempt income divided by the total recovery).

IV. Wages for Withholding Tax Purposes

A. *Importance.* Under current law it is unusual for an employment recovery to be nontaxable because rarely will the claim be the result of a personal physical injury. In most cases, therefore, the primary tax issue is to what extent is the recovery wages subject to withholding.

B. *Wage withholding.* Employers generally must report and pay federal employment taxes on wages paid to employees. Employment taxes include those imposed

under the Federal Insurance Contribution Act (FICA), the Federal Unemployment Tax Act (FUTA), and statutes requiring federal and state income taxes to be withheld. FICA taxes are imposed on employers and employees equally. FUTA taxes are borne entirely by the employer. Federal and state income taxes are, of course, borne only the employee.

(1) *Employee v. independent contractor.* Employment tax withholding applies only to employees. Whether an individual is an employee or independent contractor for tax purposes is generally based on the same common law principals that apply in other areas. *See* Rev. Rul. 87-41. In many cases it is unclear whether an individual is an employee or an independent contractor.

(2) *Time for deposit of taxes.* The frequency with which employment taxes must be deposited generally depends on the amount of taxes accumulated by the employer. Tax deposits are required monthly if taxes during the look-back period (i.e., the four quarters ended June 30 of the immediately preceding calendar year) total \$50,000 or less. Deposits are required every three to five banking days if look-back taxes exceed \$50,000. An employer that accumulates \$100,000 or more of taxes at any time must deposit them on the next banking day.

(3) *Methods of deposit.* A taxpayer that deposits more than \$200,000 of depository taxes during the calendar year must deposit them by electronic funds transfer via the electronic federal tax payment system rather than filing a paper form (i.e., Form 8109).

(4) *Liability and penalties.* Subject to certain limitations, an employer is generally responsible for all or a portion of withholding taxes that it is required to collect and pay. *See* IRC §§ 6672, 3509, 3402. In addition, an employer may be subject to several penalties. First, Section 6651(a)(2) imposes a penalty on a failure, due to willful neglect and without reasonable cause, to pay the full tax stated on the return. The penalty is generally .5% of the unpaid amount per month (which is increased to 1% per month in certain circumstances), not exceeding 25%. Second, Section 6651(a)(3) imposes a penalty on a failure to pay, due to willful neglect and without reasonable cause, a tax that was required to be reported but was not. The amount of the penalty is generally calculated in the same manner as for the penalty described above. Third, Section 6672 provides that when a responsible person (i.e., a person charged with collecting, accounting for and paying over withholding taxes) willfully fails to collect and pay such taxes, the person is liable for a penalty equal to the amount of the unpaid taxes (which is sometimes referred to as the 100% penalty).

C. *Meaning of wages.*

(1) *Back and front pay.* Back and front pay are wages because they reflect compensation resulting from the employer-employee relationship regardless of whether the employee actually worked during the period in question. *See Gerbec v. Commissioner*, 164 F.3d 1015 (6th Cir. 1999); Rev. Rul. 74-252; Rev. Rul. 57-55. The IRS' position is that compensation for lost wages is subject to withholding even if the plaintiff never worked for the employer. For example, if a company makes payments to class members who were

refused employment on the basis of racial discrimination, the payments are subject to withholding because they represent compensation for loss of prospective services. *See* Rev. Rul. 78-176. If an order of the National Labor Relations Board makes both the employer and a labor organization jointly and severally liable, the back pay award is subject to withholding even if the labor organization makes the full payment. However, a back pay award is not subject to withholding when made by labor organization if the individual's employer is not a party to the NLRB's back pay award order. *See* Rev. Rul. 57-55; PLR 9347028.

(2) *Severance pay.* Amounts paid by an employer as dismissal or severance pay constitute wages. Although such amounts are perhaps not paid for specific work actually done, they are nevertheless wages because they are compensation paid within the broader employment relationship. *See* Rev. Rul. 74-252; *McCorkill v. U.S.*, 32 F. Supp. 2d 46 (D. Conn. 1999).

(3) *Liquidated damages.* Liquidated damages paid in addition to back pay awards are not subject to withholding because they are required as a penalty for failure to comply with the law. *See* Rev. Rul. 72-268.

(4) *Emotional distress damages.* Damages for emotional distress or similar torts should not be classified as wages. In Rev. Rul. 96-55, the IRS stated that the back pay portion of the award was wages but did not so classify the emotional distress damages.

(5) *Interest.* Where a court awards interest as well as back pay, the interest is not wages because it is not remuneration for employment. *See* Rev. Rul. 80-364; PLR 9603015.

(6) *Attorney's fees.* Plaintiffs' attorney's fees paid pursuant to court order and the administrative expenses incurred in connection with the litigation are not wages. *See* Rev. Rul. 80-364; PLR 200009046.

(7) *Signing bonuses.* In Rev. Rul. 58-145, the IRS held that signing bonuses paid to new baseball players solely for signing their first contracts without any requirement of subsequent service are not remuneration for services and therefore are not wages. In contrast, bonuses predicated on continued employment are wages. *See also* Rev. Rul. 74-108; GCM 35396. In Rev. Rul. 69-424, the IRS concluded that amounts paid to a college by a baseball club on behalf of a player who was under contract with one of the club's minor league teams for three months in the summer were wages. *See also* Rev. Rul. 71-532.

(8) *Contract cancellation payments.* In Rev. Rul. 55-520 and Rev. Rul. 58-301, the IRS concluded that amounts received on cancellation or relinquishment of an employment contract were not wages. In each ruling the employment contract was for a fixed term and provided a fixed rate of pay.

In contrast, in Rev. Rul. 75-44 the IRS concluded that a payment for the relinquishment of seniority rights earned through the performance of services under a general contract of employment that could be terminated by either party at any time was compensation for past services and therefore was wages. In Rev. Rul. 74-252, an employment contract provided for

payments equal to six-months' salary if the contract was terminated before the end of its three-year term. The IRS concluded that such payments were dismissal payments (i.e., wages) rather than payments made for the cancellation of a contract. However, the only difference between the facts in Rev. Rul. 74-252 and the facts in earlier rulings (Rev. Rul. 55-520 and Rev. Rul. 580-301) was that the amount required to be paid on cancellation was negotiated ahead of time.

In *North Dakota State University v. Commissioner*, 255 F.3d 599 (8th Cir. 2001), the court rejected the government's argument that the relinquishment of professors' tenure rights was distinguishable from the relinquishment of contract rights in Rev. Rul. 58-301. Thus, the court held that the amounts received on relinquishment of tenure rights in connection with an early retirement program were not wages.

D. *Reporting of payments not constituting wages.* Even if settlement or judgment payments do not represent wages, they are subject to reporting on a Form 1099 if they constitute "fixed or determinable gains, profits, and income" under Section 6041. A Form 1099 will generally be required if the payments are required to be included in the income of the recipient. A payor should normally report a payment if it is of a type that is ordinarily taxable. Although this general rule does not apply if the payor receives information that because of special circumstances the payments are not taxable, a payor has no affirmative duty of inquiry. See Rev. Rul. 80-22.

V. Deduction of Payments

A. *General.* Section 162(a) provides that a business taxpayer may deduct all ordinary and reasonable expenses paid or incurred while carrying on a business. For a legal expense to be deductible under Section 162, it must be either directly connected with or proximately result from the taxpayer's business.

B. *Exception for capital expenditures.* Legal expenses incurred in connection with the acquisition or protection of capital assets are generally added to the basis of such assets rather than deducted in the year incurred. When legal expenses are capitalized, they are either recovered as depreciation or amortization or, if depreciation and amortization is not available (such as in the case of land), recovered upon the disposition of the asset. Whether litigation expenses are immediately deductible or must be capitalized depends on the origin of the claim relating to the legal costs.

C. *Settlement of employment claims coupled with the redemption of stock.* In *Chief Industries v. Commissioner*, TC Memo 2004-45, a corporation sought to deduct payments made to an executive to settle employment and litigation claims even though the settlement payments were made at the same time the corporation paid substantial amounts to the executive to redeem his stock. Although Section 162(k) bars a corporation from deducting amounts paid to acquire its stock, the court held that the payments made to settle the executive's employment claims were deductible notwithstanding they were made at the same time other amounts were paid to the executive to redeem his stock because the

settlement payments were in fact related to the employment claims rather than the redemption.

D. *Nondeductibility of certain fines and penalties.* It is generally not relevant that the payor's conduct that gave rise to the payment violated a law or was reprehensible. However, Section 162(f) provides that no deduction is allowed for any fine or similar penalty paid to a governmental unit for the violation of any law. A payment that is punitive in nature rather than compensatory will generally constitute a nondeductible fine or penalty.

E. *Nondeductibility of golden parachute payments.* Section 280G denies a deduction for excess parachute payments. Parachute payments generally include payments that are contingent on a change in the ownership or control of a corporation or in the ownership of a substantial portion of the assets of the corporation. Exceptions are provided for payments by certain small business corporations.

F. *Nondeductibility of certain employee compensation in excess of \$1 million.* Section 162(m) denies a deduction to a publicly held corporation for certain compensation to any covered employee (generally the chief executive officer and the other four highest compensated officers) to the extent the compensation for the year with respect to such employee exceeds \$1 million. Exceptions are provided for certain performance-based compensation.

G. *Timing of payor's deduction.* A cash basis taxpayer may generally deduct payments in the year in which they are made. Taxpayers using the accrual method of accounting can deduct allocable expenses in the year in which all events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. If the liability of a taxpayer requires a payment to another person and arises out of any tort, economic performance occurs as the payments to such person are made. *See* IRC § 461(h)(2). Economic performance also occurs when payments are made that arise out of any breach of contract or violation of law.

H. *Designated settlement funds.* Payments to a trust fund for the benefit of a plaintiff are generally not deductible because they do not satisfy the economic performance test. However, Section 468B provides an exception for irrevocable payments made to a court ordered settlement fund. Thus, payments to a designated settlement fund are generally deductible in the year in which made. A designated settlement fund is a fund (1) that is established pursuant to a court order and that extinguishes completely the taxpayer's tort liability for claims arising out of personal injury, death, or property damage, (2) with respect to which no amounts may be transferred other than in the form of qualified payments, (3) that is administered by persons a majority of whom are independent of the taxpayer, (4) that is established for the principal purpose of resolving and satisfying present and future claims against the taxpayer, (5) under the terms of which the taxpayer may not hold any beneficial interest in the income or corpus of the fund, and (6) with respect to which an election is made by the taxpayer.

I. *Qualified settlement funds.* Regulations issued under Section 468B have extended the treatment accorded designated settlement funds to qualified settlement funds. A qualified settlement fund is an account or trust that (1) is established pursuant to an order of or approved by a governmental authority and is subject to the continuing jurisdiction of that authority, (2) is a trust under state law or its assets are otherwise segregated from the other assets of the transferor, and (3) is established to resolve or satisfy certain specified claims, including those arising out of a tort, breach of contract, or violation of law or under CERCLA.

VI. Allocation of Recovery among Different Claims

A. *Importance.* Where a portion of recovery is not taxable (such as an award due to personal physical injuries) but a portion is taxable (such as punitive damages and prejudgment interest), it is important to maximize the allocation to the nontaxable portion. In employment litigation the entire recovery will generally be taxable. However, how the damages are allocated among different claims will affect the amount that is subject to employment taxes.

B. *Allocations not necessarily respected.* When a settlement agreement allocates the settlement proceeds among various claims and the allocation is arrived at in an adversarial context at arm's-length and in good faith, the allocation is generally binding for tax purposes. For example, in *McKay v. Commissioner*, 102 TC 465 (1994), the court upheld the parties' allocations because the record established that the parties were hostile adversaries with respect to the allocation since the defendant did not want any amount allocated to RICO or punitive damages because of the negative impact on its reputation in the oil industry. On the other hand, an express allocation set forth in a settlement agreement is not necessarily determinative if the facts indicate that the allocation was uncontested, nonadversarial, and tax-motivated. See *Robinson v. Commissioner*, 102 TC 116 (1994); *Bagley v. Commissioner*, 105 TC 396 (1995).

Allocations made in a settlement supervised by a trial judge or incorporated into a final judgment will not necessarily be respected. For example, in PLR 8437084 the IRS ruled that written findings of a judge supervising the settlement of a lawsuit are a relevant factor but not conclusive in determining the tax treatment of the payments. Similarly, in *Robinson v. Commissioner*, 102 TC 116 (1994), the court held that the IRS is not bound by an allocation of damages in a state court's final judgment reflecting a settlement between the parties where the trial judge does not conduct an independent review of the settlement.

C. *Characterization of the recovery where there is no express agreement.* If an agreement does not provide any allocation, the issue is what claims are intended to be settled. The ultimate question is why did the payor make the payment. See *Agar v. Commissioner*, 290 F.2d 283 (2d Cir. 1961). In *Stocks v. Commissioner*, 98 TC 1 (1992), the court stated that if the settlement agreement does not make an allocation, the most important factor in determining the tax treatment of the payments is the intent of the payor as to the purpose in making the payment. Factors to be considered include the details surrounding the litigation, the allegations contained in the payee's complaint, the arguments made in the underlying

proceedings by the parties, and court orders and judgments. *See Robinson v. Commissioner*, 102 TC 116 (1994).

In Rev. Rul. 95-98, the IRS stated that it looks to the complaint as the most persuasive evidence of how to characterize the recovery. In that case the taxpayer brought a suit for libel and requested \$150,000 in compensatory damages and \$450,000 in punitive damages. The parties settled the case for \$240,000. The IRS allocated the settlement using the ratio of the amount of compensatory and punitive damages requested to the total damages requested. Thus, one-fourth of the \$240,000 (\$60,000) was allocated to compensatory damages and the balance (\$180,000) was allocated to punitive damages.

VII. Tax Planning

A. *Plaintiff's perspective.* To the extent feasible, the plaintiff will want to allocate the settlement to damages resulting from personal physical injury and away from back pay, front pay, and punitive damages. Where it is not feasible to describe damages as attributable to physical injury, the plaintiff will attempt to maximize the allocation to items that do not constitute wages for employment tax withholding purposes, such as damages arising from tort claims and attorney fees under fee-shifting statutes.

B. *Employer's perspective.* Because the employer is responsible for all or a portion of any employment taxes not withheld, the employer will want to ensure that the allocation of the settlement or damage award makes a reasonable allocation to wages. On the other hand, minimizing the allocation to wages will reduce the employer's share of FICA taxes.

C. *Description of claim and allocation in settlement agreement.* When the plaintiff first presents or files his or her claim, the allegations should, if reasonable, emphasize physical injury or illness; and pain, suffering, emotional distress, and the like should be described as a consequence of that physical injury or illness. Similarly, in the settlement agreement the parties should make an allocation of the damages among the different claims taking into account the tax consequences of each claim. Although such an allocation will increase the parties' chance of success if challenged, the IRS or the courts may, of course, determine that the parties' allocation is not reasonable.

D. *Indemnification by employee.* In most cases the employer will want the employee to indemnify the employer against any taxes, interest, and penalties for which the employer is liable (other than the employer's share of FICA taxes) for failing to withhold employment taxes, especially if the employee has insisted on an aggressive allocation to non-wage claims. However, in many cases the indemnification may have little practical value because the employee does not have significant assets or is likely to be difficult to locate. Also, if the allocation to which the parties agree is clearly unreasonable, a court might find the employer's right to indemnification to be unenforceable because it would violate public policy for the employer knowingly to violate its wage withholding requirements and then seek indemnification.

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