



Publications

PUBLICATIONS

Taxation of Terminations, Settlements and Judgments

June 28, 2010

by David M. Repp

Unless specifically exempted, every employer making payment of wages to an employee is required to withhold Federal income taxes and to pay such withheld taxes to the United States Treasury. IRC § 3402(a)(1). The term “wages” is defined as all remuneration for services performed by an employee including the value of remuneration paid in a medium other than cash unless specifically excluded. IRC § 3401(a). A similar (but not identical) set of rules apply to FICA withholding. IRC §§ 3101; 3121(a). This article discusses some of the more common forms of compensation paid to a terminating employee and whether such payments are subject to income tax and FICA withholding.

Severance Pay. The most common type of payment to a terminated employee is severance pay, which is taxable compensation income. IRC § 61; *Ramella v. Comr.* 1979 TCM 177. Severance pay is taxable even if, as part of their separation agreements, departing employees sign waivers releasing their former employers from potential future claims, including claims of unlawful discrimination. *Webb v. Comr.*, 1996 TCM 50; *Sodoma v. Comr.*, 1996 TCM 275; *Foster v. Comr.*, 1996 TCM 276. Amounts paid to a terminated employee are compensatory and taxable as severance pay, even where the employer had no legal obligation to make the payments. *Schwartz v. Comr.*, 1989 TCM 97. Severance or dismissal pay is treated as supplemental wages and fully subject to federal income tax withholding. The IRS allows two alternative withholding methods on severance pay: the flat rate method and the aggregate method. IRS Information Letter 2010-0042.

Optional flat rate withholding method. This method allows an employer to withhold from the severance payment at a flat rate of 25% without regard to the employee's filing status or allowances claimed on Form W-4. An employer may only use this method if it has also withheld income tax from regular wages paid to the employee during the same calendar year as the severance payment, or in the preceding calendar year if the supplemental wages are separately stated on the employer's payroll records.

Aggregate method. Under the aggregate method, the employer adds the supplemental and regular wages (if any) for the most recent payroll period in the current year together, and then figures the income tax withholding as if the total were a single payment. This calculation takes into consideration the employee's filing status and withholding allowances. Employers may use this method in any situation where they are paying an employee supplemental wages that do not exceed \$1 million in a calendar year.

However, whether severance pay is subject to FICA tax withholding is less than clear. Treas. Reg. §§ 31.3401(a)-1(b)(4), 31.3402(g)-1(a); Rev. Rul. 74-252. In 2002, the Court of Federal Claims held that severance pay was not subject to FICA (*CSX Corp. v. U.S.*, Ct of Fed Cl 4/1/02). However, in 2008, the Court of Appeals for the Federal Circuit reversed and held that the severance pay involved in the taxpayer's various downsizing programs was subject to FICA (*CSX Corp. v. U.S.*, (CA FC 3/6/2008) 101 AFTR 2d ¶2008-553. Most recently, a Federal District Court has held that severance is not subject to FICA withholding. *U.S. v. Quality Stores, Inc.*, 105 AFTR 2d 2010 ¶1533 (DC MI, 2/23/2010).

Back Pay. Back pay is compensation paid to an individual to compensate him or her for pay he or she would have received up to the time of settlement or court award but for the employer's wrongful conduct. For example, back pay is awarded to an employee if he or she is illegally terminated by an employer, or to an applicant for employment who is not hired for illegal reasons. In most cases, back pay is taxable, subject to FICA and income tax withholding, and must be reported on Form W-2 in the year payment is received (rather than the year payment should have been received). *Cleveland Indians Baseball Co. v. U.S.* 532 U.S. 200 (2001). Back pay for lost wages received on account of personal physical sickness or physical injury is not subject to FICA and income tax withholding. *Anderson v. United States*, 929 F.2d 648, 654 (Fed. Cir. 1991) (payments which are excluded from IRC § 61's definition of “gross income” are not

subject to income tax or FICA withholding).

In the Eighth Circuit, back pay (and front pay) awarded for an illegal refusal to hire is not subject to FICA and income tax withholding. *Newhouse v. McCormick & Co.*, 157 F.3d 582; 82 AFTR 2d ¶198-6576 (8th Cir. 1998) (explaining that no employment relationship existed so character of the payment could not be “wages”). However, the back pay is taxable to the recipient and reportable by the payer on Form 1099-MISC, Box 3 Other Income. In every other Circuit, such back pay is subject to FICA and income tax withholding and reportable on Form W-2. Rev. Rul. 78-176; see also IRS Publication 957.

Front Pay. Front pay is paid to an individual to compensate him or her for pay he or she would have received after the settlement date or court award but for the employer's wrongful conduct and the circumstances—e.g., extreme animosity between the employer and employee—which make it impracticable to place the employee in the position. Front pay in all Federal Circuit courts except the Fifth Circuit is considered wages subject to FICA and income tax withholding and must be reported on Form W-2. *Gerbec v. United States*, 164 F.3d 1015, 1026 (6th Cir. 1999); *Mayberry v. United States*, 151 F.3d 855, 860 (8th Cir. 1998); and *Hemelt v. United States*, 122 F.3d 204, 209 (4th Cir. 1997). The Fifth Circuit holds that only back pay is subject to FICA and income tax withholding. *Dotson v. U.S.*, (CA 5 1996) 78 AFTR 2d ¶196-5436 (“wages” is compensation for services already performed, not for services that will not be performed). However, front pay in the Eighth Circuit is exempt from FICA and income tax withholding when no employment relationship existed. *Newhouse v. McCormick & Co.*, 157 F.3d 582; 82 AFTR 2d ¶198-6576 (8th Cir. 1998).

Employment Contracts. An amount paid to an employee as consideration for cancellation of an employment contract and relinquishment of contract rights is ordinary income, and wages for purposes of FICA, FUTA, and Federal income tax withholding. Rev. Rul. 2004-110. Prior to the issuance of Revenue Ruling 2004-110, severance payments made to an employee in consideration for early termination of an employment contract was not considered “wages” or compensation, but ordinary income and not subject to FICA, FUTA or income tax withholding. Rev. Rul. 74-252; Rev. Rul. 58-301; Rev. Rul. 55-520.

Amounts Paid in Settlement of Personal Injury Suits. Damages and other amounts received on account of certain personal injuries or sickness are excludable from the recipient's income. Code Sec. 104(a)(2). This rule applies to amounts received as a result of a lawsuit or the settlement of a lawsuit or under workers' compensation acts. In the past, the rule was liberally applied and permitted the exclusion of amounts received on account of nonphysical, tort or tortlike injuries such as emotional distress. However, as a result of a law change, for amounts received after August 20, 1996, and in tax years ending after that date, Code Sec. 104(a)(2) has been amended to provide that the exclusion applies to damages other than punitive damages that are received on account of personal, physical injuries or physical sickness. Code Sec. 104(a)(2), as amended by the Small Business Job Protection Act of 1996 (P.L. 104-188). In addition, if an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness whether or not the recipient of the damages is the injured party. For example, damages (other than punitive) received by an individual on account of a claim for loss of consortium due to the physical injury or physical sickness of such individual's spouse are excludable from gross income. Conf. Rept. to the Small Business Job Protection Act of 1996 (P.L. 104-188); PLR 2001121031 (taxpayer's loss of consortium claim excludable resulting from spouse's asbestos-related disease). In addition, damages (other than punitive) received on account of a claim for wrongful death continue to be excludable from taxable income as under prior law.

Damages Received on Account of a Nonphysical Injury or Sickness, Such As Age Discrimination or Injury to Reputation, Are Not Excludable From Gross Income. The 1996 amendment to Code Sec. 104(a)(2), in effect, prospectively overturns court decisions which held that damages attributable to nonphysical personal injuries or sickness may be excludable under that section. As under the former rule, the IRS clearly views back pay received in satisfaction of a claim for denial of a promotion due to employment discrimination under Title VII as taxable income because it is not attributable to a personal injury or sickness. Rev. Rul. 96-65.

Damages for emotional distress and the physical symptoms of emotional distress may not be treated as damages on account of a personal, physical injury or sickness, except for amounts paid for medical care that is attributable to emotional distress. Code Sec. 104(a), as amended by P.L. 104-188; Rev. Rul. 96-65; *Wells v. Commissioner*, TC 2010-5. However, damages for emotional distress and similar nonphysical injuries or sickness remain excludable from a recipient's taxable income to the extent that they *are attributable* to a physical injury or sickness House Committee Report to P.L. 104-188.

Payroll Withholding on Amounts in Settlement of Personal Injury Suits and Nonphysical Injury Suits. Personal injury damages are not “wages” for purposes of FICA, FUTA and income tax withholding. *Anderson v. United*

States, 929 F.2d 648, 654 (Fed. Cir. 1991) (payments which are excluded from IRC § 61's definition of "gross income" are not subject to income tax or FICA withholding); I.R.C. §§ 3121(a), 3306(b) and 3401(a) (defining wages subject to withholding as "remuneration for employment"). Any other portion of a settlement payment which does not represent wages, such as attorney fees and interest, and even emotional distress, is not subject to payroll taxes, provided the settlement or judgment makes a specific allocation indicating the amount of nonwage payments. Rev. Rul. 80-364; TAM 200244004 (emotional distress payment not subject to employment tax; provides nice summary of FICA and tax withholding rules). If no allocation is made, the Internal Revenue Service will treat the entire payment as wages subject to payroll taxes. Rev. Rul. 80-364. In addition, the emotional distress must be documented and the allocation reasonable. TAM 200244004. **Therefore, if unnecessary payroll taxes are to be avoided, it is crucial that the settlement agreement or judgment clearly indicate how much of the total amount received by the plaintiff constitutes wages subject to withholding and how much represents other types of payments. If the other type of payment is for emotional distress, the emotional distress must be real and not simply fabricated at the time of settlement.** TAM 200244004.

The Eighth Circuit recently overruled a long standing IRS rule that an employer has an obligation to withhold income and FICA taxes for employment discrimination even if an employer/employee relationship never existed. *Newhouse v. McCormick & Co.* 82 AFTR2d ¶ 98-5388 (10/2/98, CA8). The taxpayer, Newhouse, worked for McCormick for 23 years before being terminated as a result of outsourcing. He worked for an unrelated employer for five years before applying for a new position at McCormick & Co. but was denied employment due to age discrimination. A district court granted Newhouse a large settlement for lost back pay and front pay. McCormick & Co. withheld income tax and FICA tax on the settlement payments but Newhouse complained and filed suit demanding that McCormick & Co. pay the entire amount. The Eighth Circuit agreed with Newhouse saying that if no employment relationship ever existed, the settlement payments cannot be subject to employment taxes (such as FICA) and income tax withholding. This is contrary to the IRS position set forth in Rev. Rul. 78-176 and in other Circuits, but it is now the law in the Eighth Circuit. Even though the court held that no wage withholding or FICA tax was applicable, settlement payments are still subject to income tax to the recipient.

Attorney Fees Paid Out of Judgment or Settlement Award. Until two recent events, plaintiffs receiving taxable judgment or settlement awards would direct the defendant to pay the plaintiff's attorney fees directly to the attorney from the judgment or settlement proceeds. The Second, Fifth, Sixth, Ninth and Eleventh Circuits held that attorney fees paid directly to plaintiff's attorney by the defendant was not gross income to the plaintiff. *Raymond v. U.S.* 91 AFTR 2d 2003-535 (D.C. VT 12/17/2002); *Srivastava, Sudhir P. v. Comr.*, 220 F.3d 353 (5th Cir. 2000); *Clarks, Arthur L Estate v. U.S.*, 202 F.3d 854 (6th Cir. 2000); *Banaitis v. Comr.* 340 F.3d 1074 (9th Cir. 2003), cert. granted, No. 03-907 (S.Ct. Mar. 29, 2004); *Foster, Mattie v. U.S.* 106 F. Supp 2d 1234 (DC Ala. 2000). All the other circuit courts and the IRS held that the plaintiff was taxable on the entire judgment or settlement award with an offsetting deduction for the attorney fees. The deduction, however, was limited and in some cases completely unavailable due to the Alternative Minimum Tax.

The first event that changed the legal landscape regarding the taxation of judgment or settlement awards was the enactment of the American Jobs Creation Act of 2004. The American Jobs Creation Act of 2004 provides that in cases of "unlawful discrimination" a plaintiff's attorney fees and costs may now be deducted by the plaintiff in calculating adjusted gross income (an above-the-line deduction). *Codified at IRC §§ 62(a)(20) & (e)*. The deductions may not exceed the amount includible in income by the plaintiff. Thus, the deduction will apply only in cases of unlawful discrimination in which the plaintiff received an award or a settlement of damages that are taxable to the plaintiff. The deduction would not apply if the damage award or settlement were nontaxable (such as awards on account of a personal injury) and would not apply if the plaintiff were not successful in receiving a damage award or settlement.

The second event was a decision issued by the United States Supreme Court on January 25, 2005. In *Commissioner v. Banks and Banaitis*, 543 U.S. 426 (2005), the Court held that attorney fees paid to a plaintiff's attorney is taxable to the plaintiff regardless of whether the plaintiff is or is not entitled to a deduction for the attorney fees. The Court reasoned that the law of agency applies to such cases where the attorney is the agent and the plaintiff is the principal. The attorney, in his capacity as agent, is "duty bound to act only in the interests of the principal and so it is appropriate to treat the full amount of the recovery as income to the principal."

In summary, in all situations in which a judgment or settlement award is taxable, the plaintiff is required to include in taxable income the full amount of the judgment or settlement award. The plaintiff will then be entitled to an above-the-line deduction for attorney fees if the judgment or settlement award arose due to unlawful discrimination. In all other cases, the plaintiff will be entitled to a below-the-line deduction for attorney fees which may be limited by the alternative minimum tax or otherwise. If the settlement agreement between the plaintiff and defendant requires the defendant to pay the plaintiff's attorney fees directly to the plaintiff's attorney, two Form 1099-MISCs must be

generated. The first will report the amount of attorney fees in Box 3, Other Income, and be issued to the plaintiff. The second will report the amount of attorney fees in Box 14 and be issued to the plaintiff's attorney. Treas. Reg. §§ 1.6041-1(f); 1.6045-5.

Copyright 2010. Dickinson Mackaman Tyler & Hagen PC. All rights reserved.