

## Handling Employment Settlement Tax Issues

By Robert W. Wood

Legal claims about employment are one of the most common kinds of legal disputes. Just about every employment suit or settlement raises tax issues for employer and employee, and there are some common misconceptions. Most plaintiffs use contingent fee lawyers, and many assume that they are only responsible for the *net* money they collect after legal fees. But in *Banks v. Commissioner*, 543 U.S. 423 (2005), the U.S. Supreme Court ruled that plaintiffs must include contingent legal fees in their gross income, even if they end up with a net check.

Fortunately, in employment cases, plaintiffs should not need to actually pay taxes on the legal fees their lawyer receives. There is a reliable tax deduction if you know how to claim it. But you still must report the fees on your tax return as gross income, or the IRS will think you are shorting them. Notably, though, if you are using an hourly lawyer and the case spans multiple tax years, there's no easy answer to avoid paying tax on the legal fees. Miscellaneous itemized deductions (the usual deduction for legal fees) were suspended by Congress starting in 2018 and continuing through the end of 2025.

Are the settlement wages subject to withholding? Usually, a portion of the claim is for lost wages, back pay, front pay, or both. But some amount usually represents a payment for emotional distress or other non-wage damages. The fact that the case arises out of employment does not necessarily mean that some of the settlement *must* represent wages. The parties may agree that all wages have been paid.

However, 99% of the time, treating a portion of the settlement as wages is wise, and an agreed allocation is best. Plaintiff and defendant should arrive at a wage figure that is large enough to make the employer comfortable that it is complying with its withholding obligations. Many plaintiffs want little or no wages. Employment taxes are partially borne by the employee and partially by the employer.

For the employee, the taxes at stake are 7.7% of the pay (for the entire year) up to the wage base of \$147,000, and 1.45% of amount over \$147,000. Some plaintiffs favor reduced wages is to get a bigger net check at settlement time. But the plaintiff may end up worse off at tax return time the following year if they have trouble paying their taxes.

Finally, getting a Form 1099 may allow for more opportunities to claim an exclusion for physical injury or physical sickness damages. It is easier to claim it with a Form 1099 than with a Form W-2.

Sometimes the wage allocation issue comes down to the plaintiff trying to position what they claim is physical sickness money. Section 104 of the tax code shields damages for personal physical injuries and physical sickness. Before 1996 "personal" injury damages were tax free, so emotional distress, defamation, and many other legal injuries *also* produced tax-free recoveries. That changed in 1996, and since then, an injury or sickness must be physical to give rise to tax-free money.

Unfortunately, in the more than 25 years since section 104 was amended, there is still substantial confusion, and taxpayers. Emotional distress alone is taxable, even with physical consequences such as headaches, stomachaches, and insomnia.

In contrast, if there are physical injuries or physical sickness first which produce related emotional distress damages, those emotional distress damages can be tax-free. Many plaintiffs struggle with the chicken-or-egg issue of what comes first. Claims of post-traumatic stress disorder (PTSD) are increasing common in employment litigation, and PTSD arguably should be viewed as physical sickness, though there is no definitive tax case.

If you receive a Form 1099, must you treat it as taxable? Not always. You must address the Form 1099 on your tax return, but on the right facts, you can explain that the payment was non-taxable. In the employment context, many plaintiffs argue that their employer caused them physical injuries or physical sickness. Sometimes, there as a physical or sexual assault, severe or minor in the workplace.

Sometimes the employee claims that the employer caused physical sickness or exacerbated an existing physical sickness. Sometimes the employee claims that the workplace gave them PTSD. The employer and employee may reach a compromise on the wording of the settlement agreement. But how about on the issuance of the form? The Form 1099 regulations and form instructions say that a payment of compensatory damages for physical injuries or physical sickness should not be reported on a Form 1099.

Even so, that may a bridge too far for the employer. The employer might agree that a payment is for alleged physical injuries or physical sickness, but still say they feel that they must issue a Form 1099. The issuance of the form hurts the plaintiff's tax case—it's always better if the plaintiff can convince the employer there should be no form. Even so, the issuance of the form does not foreclose the plaintiff's argument that it should not be taxed.

But what if you do *not* receive a Form 1099? Is it like a tree falling in the forest with no one there to hear it? Hardly. Many people seem to think that if there is no Form 1099, there can be no income, but that's not true. Numerous kinds of payments are not required to be reported on a Form 1099. And even if the payment is clearly required to be the subject of a Form 1099, the fact that the defendant fails to issue one does not mean that it is not income.

In this context, of course, not getting a Form 1099 is something the plaintiff would like. But it does not guarantee that the payment is not taxable. The plaintiff still should get tax advice, in nearly any kind of case, employment or otherwise. As just one example, PG&E and Edison are not issuing Forms 1099 to plaintiffs in fire cases, but there are enormous tax issues for those plaintiffs, and key decisions to make on their tax returns. The fact that they do not get a Form 1099 does not mean they don't have big time tax issues and tax elections they need to make.

Is it worth fighting over employment case settlement agreement wording? You bet. The language of the settlement agreement does not bind the IRS or state taxing authorities. However, wording about these issues in the settlement agreement is important, in fact, you might say critical. The IRS and the Tax Court both pay enormous attention to what the settlement agreement says, and sometimes, they seem to act as if it is the most important thing of all. The intent of the payor is

a phrase that features prominently in tax cases, and there is no better statement of the payor's intent in legal settlement than the wording of the settlement agreement. There are numerous tax cases where bad or neutral wording doomed a plaintiff's tax claim.

#### Conclusion

Many employment disputes are emotional and difficult, perhaps even more so than with many other kinds of legal disputes. Whenever possible, plan ahead for the tax issues, especially if you are a plaintiff or plaintiff's lawyer. And whichever side you are on, consider being specific about taxes so there is no dispute later. You don't want to have a fight later about how much is subject to withholding, about exactly what tax forms are going to be issued, and so on. I've seen big disputes about these issues post-settlement, and even some lawsuits when the parties probably thought they were done with litigation when they settled. For this and other reasons, try to get some tax advice before the settlement agreement is signed whenever you can.

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