

**Employment Dispute Settlements And
Awards Are Taxable; IRS Withholding Provisions Apply
By Karen Sutherland**

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Many employment attorneys have become accustomed to liberal federal income tax treatment afforded personal injury cases to exclude most, if not, all settlement awards arising out of employment disputes. Historically, damages received on account of a personal injury or sickness are not taxable. IRC § 104. This section has long been applied to injuries from events such as car accidents and product liability suits arising from workplace injuries. Attorneys used to apply this same concept to settlements and awards arising from employment disputes, on the theory that the emotional distress and physical manifestations thereof (loss of sleep, loss of consortium, depression, irritability, stomach disorders, etc.) were personal injuries, and thus not subject to taxation.

In recent years, though, the rules have changed. First, there was *U.S. v. Burke*, 504 U.S. 299, 199 L. Ed. 2d 34, 112 S. Ct. 1867 (1992). *Burke* involved the taxability of a settlement of Title VII sex discrimination claims. The settlement included back pay, from which their employer withheld federal income taxes. The employees sued the IRS for a refund, claiming that the award was excluded from taxable income under IRC § 104(a)(2) (which governs the nontaxability of personal injury awards). The U. S. Supreme Court found that, although employment discrimination causes harm to individuals, it does not automatically imply that there is a tort-like injury (a requirement under IRC § 104), and that nothing in Title VII's remedial scheme purported to compensate a plaintiff for any traditional harms associated with a personal injury. Thus, the Supreme Court held that the settlement award was subject to federal taxation and denied the refund.

More recently, in *Commissioner v. Schleier*, 515 U.S. 323, 132 L. Ed. 2d 294, 115 S. Ct. 2159 (1995), the Supreme Court held that an ADEA (Age Discrimination in Employment Act) settlement was taxable. The settlement agreement allocated the proceedings one-half to back pay and one-half to liquidated damages. In response to an IRS assessment, the taxpayer claimed that the amount allocated to the liquidated damages portion of the settlement award was excluded from taxable income under IRC § 104(a)(2). The Supreme Court held that although age discrimination causes both personal injury and loss of wages, *no* part of the settlement award was excluded from taxable income under the plain meaning of IRC § 104(a)(2), finding that

liquidated damages were intended by Congress to be classified as punitive damages, which are taxable.

Despite (or, in another way of thinking, because of) these two Supreme Court cases, attorneys in employment disputes attempted to allocate awards between back wages (which would be taxable) and tort damages such as emotional distress (which arguably would not be). Congress responded by amending IRC § 104 to provide that, effective August 20, 1996, amounts received on account of personal injuries or sickness are excluded from gross income *only* if the damages are received on account of a personal *physical injury or physical sickness*. *Inserting the requirement that damages be received on account of physical injuries or sickness* was a major departure from the previous law.

In the committee report to Section 1605 of HR 3448, Congress expressed its frustration with attempts by taxpayers to exclude amounts received on account of nonphysical personal injuries and sickness by stating:

[The] confutation as to the tax treatment of damages received in cases not involving physical injury or physical sickness has led to substantial litigation, including two Supreme Court cases within the last four years. The taxation of damages received in cases not involving a physical injury or sickness should not depend on the type of claim made.

Additionally, Congress provided that emotional distress is not considered a physical injury or physical sickness even if such physical symptoms as insomnia, headaches, and stomach disorders result from such emotional distress.

This amendment to IRC § 104 makes it highly unlikely that an employment discrimination settlement or award can be allocated in a manner so as to avoid taxation. Roughly put, if the employer did not cause some sort of actual physical harm to the employee's body, the entire award or settlement will be taxable. Also, attorneys should keep in mind that most physical harm they could inflict on an employee is subject to workers compensation, and thus will not be an element of the employee's claim, unless the injury was beyond the scope and course of employment or was the result of an intentional act, or fit within some other exception to the Industry Insurance Act, RCW Title 51.

A settlement or damages award in an employment dispute is not only taxable, but is also subject to withholding *even if the employee is no longer employed by the employer*. IRC § 3402(a)(1) provides, generally, that every employer making payment of wages shall deduct and withhold federal income tax. Wages means *all* enumeration for services performed, unless such enumeration is specifically excepted by statute, even though at the time the money is paid the relationship of employer and employee no longer exists. Reg. § 31.3401(a)-1. Additionally, any payment made by an employer to an employee on account of *dismissal*, that is, involuntary separation from the service of the employer, constitutes wages regardless of whether the employer is legally bound by contract, statute or otherwise to make payments. Reg. § 31.3401(a)-1(b)(4). A broad exception to the requirement that an employer withhold federal income tax from amounts paid by an employee (or former employee) are amounts that are

excluded from the employee's gross income. However, as discussed above, settlement proceeds are not excluded from the employee's gross income.

There are also FICA withholding requirements. Generally, the FICA withholding rules and regulations are parallel to the federal income tax withholding rules and regulations. The employee's portion of FICA taxes is required to be deducted and withheld by the employer from the employee's wages pursuant to IRC Section 3102. Wages for the purposes of FICA withholding requirements means all enumeration for employment even if the employee/employer relationship no longer exists. Reg. § 31.3121(a)-1(i). Although the FICA regulations do not contain a parallel provision to Reg. § 31.3401(a)-1(b)(4), the law has been that FICA withholding applies to dismissal payments since the Social Security Act Amendments of 1950, which eliminated provisions that excluded dismissal payments from wages if the employer was not legally required to make them. *See* Private Letter Ruling 9331007 (May 5, 1993), holding that amounts received as part of a severance package that were made pursuant to a "termination agreement and waiver and release of age discriminations" were subject to federal income tax and FICA withholding requirements.

In light of these changes to the tax laws, attorneys who handle employment cases, particularly plaintiffs' attorneys, should educate their clients so that they understand that amount they settle for or receive in court is not the amount that they will actually take home. Rather, Uncle Sam intends to share in the award as well. Additionally, attorneys whose clients settle their own employment disputes without legal assistance should be aware of these provisions so that they do not run afoul of the withholding requirements.

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