



Allocation Considerations in Employment Discrimination Settlements: The Taxing Details



By Debra L. Weiss and Andrew J. Erler

When negotiating the settlement of an employment discrimination or harassment action, there are many aspects to consider. One issue that is often given little consideration, if any, until the very end of the negotiation is how the settlement proceeds will be allocated and how they will be reported to the federal and state taxing authorities. Overlooking this critical determination, however, could be costly to your clients, whether you represent employees or employers, plaintiffs or defendants. This article provides a broad overview of how taxing authorities treat various types of employment damages for purposes of taxation, outlines some of the issues that employment practitioners face when settling an employment matter, and offers some practical guidance on how to approach these issues.

Taxation of Employment Discrimination Settlements

The Internal Revenue Service¹ (IRS) treats various employment-related settlement damages differently depending on the nature of the damages for which the payment was meant to compensate. The IRS, therefore, must determine the nature of the claim that gives rise to the payment, whether that payment constitutes gross income, and whether the payment, while constituting income, also counts as wages, thereby subjecting it to payroll taxes. In the following section, we address how the IRS treats some of the most common types of employment damages.

1. Lost Wages (Back and Front Pay)

Lost wages, including back pay and front pay, are routinely recognized as gross income,

pursuant to 26 U.S.C. § 61 of the IRS Code (“the Code”). Back pay has been defined as “an amount equal to the wages the employee would have earned from the date of discharge to the date of reinstatement, along with lost fringe benefits such as vacation pay and pension benefits.”² Front pay has been defined as “money awarded for lost compensation during the period between judgment and reinstatement or in lieu of reinstatement.”³

In addition to constituting income that subjects the lost wages to income tax withholding, the IRS takes the position that back pay and front pay constitute wages under 26 U.S.C. § 3401(a) and are, therefore, subject to payroll taxes, or Federal Insurance Contributions Act (FICA).⁴ So, what does this all mean to the employer or employee, and their practitioner? First, because these payments constitute income under 26 U.S.C. § 61 of the Code, they are, therefore,

taxable. Additionally, employers are obligated to withhold the appropriate income and FICA taxes.⁵ This classification may create obligations for the employer pursuant to sections 26 U.S.C. §§ 3102(a) and 3402(a)(1) of the Code, which mandate that payroll and income taxes are to be collected (or withheld) “by the employer . . . as and when paid.” In fact, an employer who willfully fails to withhold payroll or income taxes may be held personally liable for a penalty equal to the amount owed under 26 U.S.C. § 6672(a). Accordingly, treating the payment appropriately is critical.

2. Compensatory Damages (Physical Injury and Emotional Distress)

Plaintiffs in employment lawsuits regularly seek compensatory damages in the form of compensation for physical injury and/or emotional distress. Because the Code allows

the exclusion of certain types of compensatory damages from gross income, parties must clearly designate the nature of the damages in order to determine potential tax liability. Not surprisingly, the IRS broadly construes the definition of gross income under § 61 while it narrowly construes exceptions.⁶ Gross income includes most aspects of damages except it does not include “the amount of any damages (other than punitive damages) received . . . on account of personal physical injuries or physical sickness.”⁷ Because compensation for personal physical injury is meant to make the employee whole, the IRS does not tax those proceeds as income.

Physical Injuries

In *Commissioner v. Schleier*, the U.S. Supreme Court set forth a two-prong test to determine whether damages are excludable from gross income as physical injuries, requiring that: “1) the underlying cause of action giving rise to the recovery is based on tort or tort-type rights, and 2) the damages were received on account of personal injuries or sickness.”⁸ Since *Schleier*, however, the IRS commissioner has removed the reference to “tort-type rights” from the regulatory language, recognizing that damages recovered under no-fault statutory schemes should also be excluded from income.⁹ In short, amounts allocated to compensation for a personal physical injury or sickness is not considered gross income and, therefore, not subject to income taxes. In attempting to determine whether an item constitutes a personal physical injury or sickness, the IRS looks for “observable or documented bodily harm, such as bruising, cuts, swelling, or bleeding” as evidence of physical injury.¹⁰

Practitioners should pay particular attention to claims that result in a recovery to an employee who has asserted a claim for assault and battery or false imprisonment, as those types of intentional torts will often fall into the category of personal physical injuries that are not subject to income taxes. Workplace-related violent acts, such as a fistfight, rape, or other traumatic event, are examples of such conduct.

Emotional Distress

Damages for emotional distress constitute a traditional tort-like cause of action. Because the underlying cause of action constitutes a tort or tort-like claim, it passes the first prong of the *Schleier* test. The more difficult analysis, however, focuses upon whether the damages were received “on account of ‘personal injuries or sickness.’” The 1996 amendments to 26 U.S.C. 104(a)(2) attempted to provide greater clarification on the meaning of “personal” injuries, requiring that excludable damages be incurred “on account of personal physical injury

or physical sickness.”¹¹ Emotional distress caused by a physical injury or physical sickness will be excludable whereas a physical injury or physical sickness caused by emotional distress generally will not be excluded. Treas. Reg. § 1.104-1(c)(1).

Recent decisions from the tax court provide some insight into how tax courts have determined when emotional distress constitutes a personal physical injury or sickness that is not subject to income taxes. For example, in *Domeny v. Commissioner*, T.C. Memo 2010-9, the plaintiff alleged she suffered severe emotional distress as a result of the actions of her supervisor, leading to a flare-up of her pre-existing multiple sclerosis condition that left her medically unable to work for a year. The tax court agreed with plaintiff that the portion of the settlement allocated as compensation for physical injuries was properly excluded from income under § 104(a)(2).

But in *Blackwood v. Commissioner*, T.C. Memo 2012-190, the tax court did not characterize the plaintiff’s distress as excludable from income where she alleged relapsing into depression and suffering symptoms such as insomnia, migraines, nausea, weight gain, and vomiting. The tax court concluded that the plaintiff “did not provide evidence that [her] physical symptoms of depression were severe enough to rise to the level of physical injury” . . . or that she had been determined “too ill to work.”¹²

Judging by these decisions, the underlying factors relating to a claim for emotional distress must be sufficiently severe to garner the exclusion from income. The vast majority of claims for emotional distress damages in employment-related disputes will be considered income and will be subject to income taxes. Accordingly, the analysis typically focuses on, not whether the payment is subject to income tax, but rather whether the payment is subject to payroll taxes. It is also important to understand that the decision of a district court judge to approve a settlement is not dispositive of the issue of income or what portion is subject to taxation. Instead, the IRS has the discretion to conduct a *de novo* review to determine whether the damages constitute income or not.¹³

3. Punitive and Liquidated Damages

Generally, punitive damages are considered income and, therefore, subject to income taxes (26 U.S.C. § 104(a)(2)).¹⁴ Punitive damages are, however, generally not subject to payroll or FICA taxes. IRS guidance specifically calls for reporting punitive damages as “other income” on Form 1040, line 21, and not as wages subject to FICA on a W-2.¹⁵

What if, however, some of the punitive damages are based upon an award of back pay? For

example, the Minnesota Human Rights Act allows for trebling of compensatory damages when an unfair discriminatory practice underlies the cause of action.¹⁶ In particular, in Minnesota, back pay is included within the larger umbrella of compensatory damages that can be trebled.¹⁷ But the basis for the statutory damages (lost wages) does not change the overall characterization of them as punitive in nature. Accordingly, punitive damages arising from a trebling of back pay will be subject to income tax, but not FICA, like other wage-based damages.¹⁸

4. Attorney’s Fees and Other Costs

Attorney’s fees are another common item of damages that employees are usually able to recover in an employment litigation matter. The IRS treats attorney’s fees as income to the employee. Under the Code, a taxpayer cannot exclude an economic gain from gross income by assigning that gain in advance to another party.¹⁹ The rationale behind this “anticipatory assignment of income” doctrine is that the principal who earns the compensation should be taxed for the compensation.²⁰ Because the attorney-client relationship is akin to a standard principal-agent relationship (insofar as the attorney has a duty to act only in the interests of the client), it is appropriate to include as gross income to the employee all attorneys fees.²¹ It is important to note that 26 U.S.C. § 62(a)(19) allows deduction of “attorney fees and court costs . . . in connection with any action involving a claim of unlawful discrimination.” This remains true for fees recovered under fee-shifting provisions found in statutes. The IRS takes this position because the statutory language commonly found in fee-shifting statutes allows courts to award attorney’s fees to “the prevailing party.”²²

What this means to employees is that they must include the entire portion of the settlement funds going to their attorneys as income on their tax returns, although attorney’s fees are not considered wages subject to FICA. This includes any fees awarded under a fee-shifting statute, as well as any standard contingency fee. Section § 62(a)(19) does, however, allow employees to deduct (above the line) the total amount of attorney’s fees. And as long as the employer is properly reporting and withholding the settlement award, this section does not impact them.

Impact of Employment Discrimination Settlements on the Parties

While employees understand that the vast majority of their settlement proceeds will be subject to some taxation, whether income taxes alone or income and payroll taxes, many,

however, are concerned about the impact the settlement will have on their state and federal benefits, such as unemployment compensation and Social Security benefits.

Unemployment Compensation

Payments meant to compensate an employee in Minnesota for lost wages are deductible from otherwise available unemployment compensation. This tracks the plain language of Minnesota's unemployment compensation statute, Minn. Stat. § 268.085, subd.6. The underlying purpose is to "prevent[] an employee's double recovery due to the receipt of both [back pay] and unemployment benefits."²³ Because lost wage pay will reduce, on a dollar-for-dollar basis, unemployment benefits the employee would otherwise be entitled to recover, many employees try to apportion as much of the settlement allocation as possible to emotional distress-related damages to avoid that reduction.²⁴ The parties should, however, be cautious in attempting to allocate settlement amounts away from wages, as the IRS may intervene to challenge the allocation. In Schleier,²⁵ for example, the IRS filed a deficiency action against a plaintiff who failed to disclose a portion of his settlement attributed to liquidated damages.

Social Security

There is a limit on how much of one's income is subject to Social Security taxes.²⁶ For 2017, the maximum amount of income subject to Social Security tax liability is \$127,000. Because back pay is apportioned to the calendar period in which the money would have been earned, Social Security can have two different impacts on a settlement.²⁷ To the extent the settlement agreement allocates money to back pay for a calendar year in excess of that year's maximum income limit, Social Security taxes are not imposed.

For the employee who is below the maximum income limit, a settlement that creates Social Security tax liability can increase future Social Security benefits. Therefore, increasing one's net income for a prior calendar year (without exceeding that year's max) has the effect of increasing the gross amount of earnings used to calculate benefits.

Medicare

Unlike Social Security taxes, Medicare taxes are not subject to a maximum annual income limit. Instead, Medicare imposes a tax of 1.45 percent on all wages earned per year. For high wage earners, Medicare imposes an additional 0.9 percent Medicare tax, which is triggered for married couples who earn \$250,000 or more,

and for single taxpayers who earn \$200,000 or more.²⁸

Concerns of the Parties

The employee's primary concern is to minimize tax liability and maximize the net payment. Because lost wage proceeds are subject to both income and FICA taxes, it is usually the least attractive option for the tax-adverse employee. On the other hand, the primary concern for employers is to avoid future tax liability, particularly because employers can be held personally liable to the IRS for failing to properly withhold taxes.²⁹

Final Thoughts and Practical Tips

While the taxation of employment discrimination settlements can be confusing, the employment law practitioner should be mindful of a few simple, but key, guidelines. First, damages classified as lost wages will always be subject to both income and payroll taxes, and should be treated appropriately. Second, punitive damages (including wage damages that are trebled) are subject to income taxes, but not FICA. Third, it is rare that any portion of an employment settlement is not subject to income taxes at all. Instead, only those damages that are considered to be a personal physical injury or illness will be categorically excluded from income. Garden-variety emotional distress damages will not generally be excluded from income taxes. Fourth, practitioners should carefully consider proposed settlement allocations with an eye toward reasonableness to avoid IRS scrutiny. Finally, parties that are really struggling with taxation issues can seek a detailed answer in the form of a private letter ruling from the IRS. The private letter ruling is binding upon the IRS with respect to that taxpayer's specific factual scenario. And while the IRS periodically publishes its private letter rulings to the public, those rulings are neither precedential nor binding, though they can be helpful in providing additional explanation and insight to the weary practitioner.

¹ Because Minnesota largely follows the Federal Tax Code for purposes of taxation, we have not included a separate discussion about how Minnesota treats these issues. See M.S.A. §§ 290.01 subd. 19–29; M.S.A. § 290.92.

² *United States v. Burke*, 504 U.S. 229, 239 (1992) (superseded by statute on other grounds).

³ *Pollard v. E.I. du Pont de Nemours & Co.*, 532 U.S. 843, 846 (2001).

⁴ *But see Newhouse v. McCormick & Co.*, 157 F.3d 582, 585 (8th Cir. 1998) (requiring the existence of an employer-employee relationship to characterize front and back pay as wages).

⁵ See Noel v. New York State Office of Mental Health Central New York Psychiatric Center, 697 F.3d 209, 213 (2nd Cir. 2012).

⁶ See Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 429–430 (1955); Commissioner v. Jacobson, 336 U.S. 28, 38 (1949).

⁷ 26 U.S.C. § 104(a)(2).

⁸ 515 U.S. 323, 336–37 (1995).

⁹ See *Perez v. Commissioner*, 144 T.C. 51, 62–3 (2015).

¹⁰ I.R.S. Tech. Adv. Mem. 2009-035, at 5 (Oct. 22, 2008).

¹¹ *Murphy v. I.R.S.*, 362 F.Supp.2d 206, 214 (D. D.C.) *aff'd* *Murphy v. I.R.S.*, 493 F.3d 170 (D.C. Cir. 2009).

¹² Additionally, the tax court in *Blackwood* made note that five of the eight symptoms plaintiff testified to at trial (insomnia, sleeping too much, migraines, nausea, and vomiting) are identical or very similar to the nonexclusive list of emotional distress symptoms in the legislative history of § 104(a). See H.R. Conf. Rept. No. 104-737, at 301 n. 56 (1996). *Blackwood*, T.C. Memo. 2012-190, at 4 (superseded on other grounds).

¹³ See I.R.S. Priv. Ltr. Rul. 8437084 (June 13, 1984); I.R.S. Priv. Ltr. Rul. 8405018 (Oct. 28, 1983).

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¹⁵ See I.R.S. Priv. Ltr. Rul. 8437084 (June 13, 1984); I.R.S. Priv. Ltr. Rul. 8405018 (Oct. 28, 1983).

¹⁶ See also O'Gilve v. United States, 519 U.S. 79 (1996).

¹⁷ See I.R.S. Publication 4345, Rev. 12-2016, <https://www.irs.gov/pub/irs-pdf/p4345.pdf>.

¹⁸ Minn. Stat. § 363.071, subd. 2.

¹⁹ *Phelps v. Commonwealth Land Title Ins. Co.*, 537 N.W.2d 271, 278 (Minn. 1995).

²⁰ See *Glenshaw Glass Co.*, 348 U.S. 426, 431–32 (ruling that the 2/3rds treble damages are subject to income, but not payroll taxes).

²¹ *Lucas v. Earl*, 281 U.S. 111 (1930); *Helvering v. Horst*, 311 U.S. 112, 116–17 (1940). These early cases get into the concept of assignment of income and the general disfavor the IRS has in allowing a taxpayer to shift otherwise taxable income to third parties.

²² *Lucas v. Earl*, 281 U.S. 111, 114 (1930).

²³ *C.I.R. v. Banks*, 543 U.S. 426 (2005).

²⁴ See, e.g., *Evans v. Jeff D.*, 475 U.S. 717, *reh'g denied*, 476 U.S. 1179 (1986).

²⁵ *Robertson v. Special Sch. Dist. No. 1*, 347 N.W.2d 265, 267 (Minn. 1984).

²⁶ See *Peterson v. Northeast Bank—Minneapolis*, 805 N.W.2d 878, 883 (Minn. Ct. App. 2011) (Hudson, J.).

²⁷ 515 U.S. 323, 327.

²⁸ See *Your Retirement Benefit: How It's Figured*, SOCIAL SECURITY ADMINISTRATION (2017) (two-page pdf that includes every year's index factor and maximum allowed earnings going back to 1956) <https://www.ssa.gov/pubs/EN-05-10070.pdf>.

²⁹ See Social Sec. Bd. v. Nierotko, 327 U.S. 358, 370 (1946).

³⁰ 26 U.S.C.A. § 3101(b)(2).

³¹ 26 U.S.C.A. § 6672.



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