I. Overview

It is easy to put-off thinking about the potential tax consequences of a settlement or judgment until it is imminent or already in hand. However, by that time, the parties (and claimants in particular) may find that certain planning opportunities have already been foreclosed—as even the initial demand letter or complaint could have significant consequence for how the settlement payment or judgment will be characterized and taxed.

The Internal Revenue Service (the “Service”) employs a four (4)-step process to determine the correct treatment of payments made in connection with an employment related claim—whether as part of negotiated settlement or pursuant to a court judgment.¹

Step 1: Determine the character of the payment and the nature of the claim that gave rise to such payment

Step 2: Determine whether the payment constitutes an item of “gross income”

Step 3: Determine whether the payment constitutes “wages” for employment tax purposes

Step 4: Determine the appropriate reporting for the payment and any attorneys’ fees

II. Character of the Payment and Nature of the Claim

A. Character of the Payment

In the context of employment law claims, the most common types of payments are:

1. Severance Pay. Severance pay is best understood as a voluntary payment made by an employer to an employee upon the occurrence of a separation event—usually a qualifying “retirement” or an involuntary termination by the employer. Typically, the terms and amount of severance pay is a matter of contract and/or employer policy, and is often based on the length of the employee's service. Even in the absence of a contractual right to severance pay, a

¹ See Office of Chief Counsel Internal Revenue Service Memorandum, dated October 22, 2008, UILC: 61.00-00, 3101.00-00, 3111.00-00, 3402.00-00, “Income and Employment Tax Consequences and Proper Reporting of Employment-Related Judgments and Settlements.”
voluntary payment made as consideration for a release of claims by a former employee (whether a general release or specific release) is often referred to colloquially as “severance” (e.g. a “Severance and Release Agreement”).

2. **Back Pay.** Back pay is compensation paid to an individual to make them whole for amounts that he or she would have received up to the time of the settlement/judgment, but for the employer's wrongful conduct.

3. **Front Pay.** Front pay is paid to an individual to make them whole for amounts that he or she would have received after the settlement/judgment, assuming that reinstatement were infeasible.

4. **Compensatory Damages.** Compensatory damages are amounts paid to make an individual whole for a variety of non-economic damages—e.g., for physical injury, emotional distress, pain and suffering, etc.

5. **Consequential Damages.** Consequential damages are compensation for damages, losses, or injuries that do not flow directly and immediately from a wrongful act, but are the consequences or results of such wrongful act—e.g., loss of consortium.

6. **Punitive/Liquidated Damages.** Liquidated damages are amounts that parties agree to pay in the event of a breach of an agreement as a substitute for compensatory damages. Liquidated damages may also be imposed by statute—e.g., the Fair Labor Standards Act of 1938 and the Equal Pay Act of 1963. By contrast, punitive damages are intended to punish the payee for some wrongful conduct.

**B. Nature of the Claim**

Some of the most common employment claims are:

1. **Title VII of the Civil Rights Act of 1964, as amended by the Civil Rights Act of 1991.** Title VII of the Civil Rights Act of 1964, as amended by the Civil Rights Act of 1991, prohibits discrimination in employment based on race, color, religion, sex, or national origin, and provides for the award of back pay and attendant benefits, compensatory damages, compensation for emotional distress, and punitive damages.

   (a) There are limits on the amount of compensatory and punitive damages a person can recover in a Title VII action. These limits vary depending on the size of the employer:

   - For employers with 15-100 employees, the limit is $50,000.
   - For employers with 101-200 employees, the limit is $100,000.
   - For employers with 201-500 employees, the limit is $200,000.
   - For employers with 501+ employees, the limit is $300,000.

---

2. **Age Discrimination in Employment Act (ADEA) of 1967.** The ADEA provides for an award of back pay and other equitable relief, but does *not* provide for the recovery of compensatory damages of a tort-like nature (e.g., emotional distress) or liquidated damages.

3. **Americans with Disabilities Act of 1990 (ADA).** Employing the remedial scheme of Title VII and the Civil Rights Act of 1991, the ADA authorizes the recovery of back pay, compensation for noneconomic damages such as emotional distress, and punitive damages.

4. **Fair Labor Standards Act of 1938 (FLSA).** The FLSA requires the payment of minimum wages and overtime pay. The FLSA provides for recovery of unpaid wages, unpaid overtime compensation, and non-punitive liquidated damages, but *not* compensatory damages of a tort-like nature (e.g., for emotional distress).

5. **Equal Pay Act of 1963 (EPA).** The EPA is an amendment to the FLSA, prohibiting discrimination on account of gender in the payment of wages by employers. The EPA provides for recovery of unpaid wages, unpaid overtime compensation, and liquidated damages.

6. **State Statutes.** State law often has corollary provisions to Federal employment laws, but may have differing remedies. In Wisconsin, the most significant corollary is the Wisconsin Fair Employment Act (“WFEA”). The WFEA provides broader coverage in a number of respects, inasmuch as (i) it explicitly covers all employers having at least one (1) employee (as opposed to most federal employment discrimination laws, which have at least a fifteen (15) employee threshold); and (ii) it includes more express bases of prohibited discrimination (notably, arrest and conviction record, use or nonuse of lawful products off the employer's premises during nonworking hours, and declining to attend a meeting or to participate in any communication about religious matters or political matters). However, since 2012, WFEA no longer provides for compensatory or punitive damages.

7. **Common Law Claims.** State common law may provide for a number of ancillary claims that could be brought in lieu of, or in conjunction with, federal and state statutory employment claims. Typical common law claims that might attend an employment action are wrongful discharge, invasion of privacy, defamation and a variety of negligence claims (e.g. negligent hiring and retention). The remedies available for such claims can be quite broad, and typically include compensatory damages. However, in the specific context of employment, certain claims may be barred by the exclusive remedy provision of workers compensation laws—depending on whether the action complained of occurred within the scope of the employment, as a part of the termination of employment, or after the employment.

---

3 29 U.S.C. § 621
4 42 U.S.C. § 12101
5 29 U.S.C. § 201
6 29 U.S.C. § 206(d)
7 Wis. Stat. § 111.31 et. seq.
III. Gross Income, Exclusions, and Attorneys’ Fees

A. Definition of “Gross Income”

Section 61(a) of the Internal Revenue Code of 1986, as amended (the “Code”) defines the term “gross income” to mean “all income from whatever source derived.” The Supreme Court has long recognized that the definition of gross income is broad in scope and reflects Congress’ intent to bring within its purview all accessions to wealth, unless excluded by another section of the Code.8 Exclusions from income must be narrowly construed.9

B. Section 104(a)(2)

1. Background. Section 104(a)(2) of the Code, as amended by Section 1605 of the Small Business Job Protection Act of 1996 (“the 1996 Act”), provides that “gross income does not include . . . the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness.” (Emphasis added.) However, the “flush” language to I.R.C. § 104(a) goes on to provide that “for purposes of paragraph (2), emotional distress shall not be treated as a physical injury or physical sickness.” (Emphasis added.) The legislative history behind the 1996 Act indicates that “[i]t is intended that the term emotional distress includes symptoms (e.g., insomnia, headaches, stomach disorders) which may result from such emotional distress.”10 However, the exclusion would still apply “to an amount of damages not in excess of the amount paid for medical care (described in subparagraph (A) or (B) of section 213(d)(1)) attributable to emotional distress.”11

2. Application. In order for an amount to be excludable from income under Section 104(a)(2), a taxpayer must satisfy the two prong test established in Commissioner v. Schleier, 515 U.S. 323, 336-37 (1995) (interpreting former § 104(a)(2)). The first prong requires a taxpayer to establish that damages were received through a “tort or tort-like” action. The second prong requires a taxpayer to establish that the damages received were “on account of” a personal injury or sickness. Again, however, the 1996 Act’s revision to I.R.C. § 104(a)(2) adds the further requirement that such injuries or sickness also be “physical” in nature.

3. PLR 200041022 (July 17, 2000). The first real guidance as to how Section 104(a)(2), as amended by the 1996 Act, would be applied in practice came in Private Letter Ruling 200041022.12

---

11 See I.R.C. § 104(a).
12 A private letter ruling (PLR) is a written response to a taxpayer by the IRS National Office. A private letter ruling interprets and applies the tax laws to a taxpayer’s specific set of facts. PLRs constitute a historical record of interpreting the IRS position. While explicitly devoid of precedential authority, they have high credibility since the IRS is unlikely to reverse itself once it has established a position on a certain tax issue.
The Facts

- C and C’s corporation employed A in various capacities from Date 1 through Date 4.

- From Date 2 through Date 3, A was C's full-time driver and accompanied C on many trips. Early in this period, C acted in a friendly manner toward A. After a while, however, C began a slow progression of attempts to make sexual contact with A and made several suggestive or lewd remarks in A's presence. Also, early in this period, C physically touched A but these contacts did not result in any observable bodily harm (e.g., cuts, bruises, etc.) to A's body or cause extreme pain to A.

- Later, while on a road trip, C assaulted A causing what A represents was extreme pain (the “First Pain Incident”). After the First Pain Incident, A began to have headache and digestive problems, but two doctors could not find anything physically wrong. The ruling request does not assert that these problems were due to the First Pain Incident or prior events.

- On a subsequent road trip, C also assaulted A, cutting her and biting her (the “First Physical Injury”).

- Around Date 3, A became executive director of C’s household. During this period, C physically and sexually assaulted A. In one assault, C cut A. As a result of another series of C's assaults, A suffered skin discoloration and swelling accompanied by extreme pain for which A received medical treatment from a doctor.

- On Date 4, A terminated her employment with C.

- A subsequently retained the services of a law firm, which presented C with a complaint. The complaint alleged that C inflicted emotional and physical harm on A. A's complaint asserted causes of action, including sex discrimination and reprisal under Statute, battery, and intentional infliction of emotional distress. The complaint also specifically requested leave to amend the complaint to add a claim for punitive damages for A's common law claims.

- On Date 5, C executed a Settlement Agreement with A and B under which C agreed to pay $z to settle all claims of A and B. The Settlement Agreement did not allocate the proceeds to any of the claims.
The Ruling

- The Service noted that the term “personal physical injuries” is not defined in either I.R.C. § 104(a)(2) or the legislative history of the 1996 Act. Nevertheless, citing Black's Law Dictionary 1304 (Rev. 4th ed. 1968)—which defines the term “physical injury” as “bodily harm or hurt, excluding mental distress, fright, or emotional disturbance”—the Service was comfortable with the conclusion that “direct unwanted or uninvited physical contacts resulting in observable bodily harms such as bruises, cuts, swelling, and bleeding are personal physical injuries under Section 104(a)(2).” (Emphasis added.)

- C's uninvited and unwanted physical contacts with A prior to the First Pain Incident did not result in any observable harms (e.g., bruises, cuts, etc.) to A's body, or cause Taxpayer pain. Further, it was not represented that the medical treatment that A received after the First Pain Incident for headaches and digestive problems were related to events that occurred with or prior to that incident. Thus, any damages Taxpayer received for events occurring prior the First Pain Incident are not received on account of personal physical injuries or physical sickness under I.R.C. § 104(a)(2).

- Taxpayer suffered several physical injuries within a relatively short period of time, commencing with the First Physical Injury. Under the facts of this case, damages that Taxpayer and her husband received under the Settlement Agreement for pain, suffering, emotional distress and reimbursement of medical expenses that are properly allocable to the period beginning with the First Physical Injury are attributable to and linked to the physical injuries Taxpayer suffered, and were received on account of personal physical injuries or physical sickness under I.R.C. § 104(a)(2).

- Damages that Taxpayer and her husband received under the Settlement Agreement that are properly allocable to punitive damages are includible in their gross income. A portion of damages received may be properly allocable to punitive damages notwithstanding that a settlement agreement is entered into prior to a jury's award of punitive damages. See Burditt v. Commissioner, T.C.M. 1999-117 and Rev. Rul. 85-98, 1985-2 C.B. 51.

- No opinion was expressed concerning the percentage of the damages received that is excludable from income under I.R.C. § 104(a)(2)—as the Service will not ordinarily issue a ruling on whether a settlement agreement’s allocation between back pay, compensatory damages, and punitive damages is a proper for federal income tax purposes.
4. **CCA 200809001 (November 27, 2007).** On February 29, 2009, the IRS released a legal memorandum from its Office of Chief Counsel, providing internal guidance on how to address a taxpayer’s settlement payment. While the memorandum is vague in the extreme—describing the tortfeasor only as “Entity” and the taxpayer’s claim only as “Tort”—both the lack of detail and conciliatory approach are much more understandable when one considers that, of the ten (10) largest sexual abuse settlements by Roman Catholic institutions in the U.S., seven (7) of these settlements occurred between 2003 and mid-2007 (the period of time for which the guidance sought would likely be most relevant).13

**The Facts**

- Taxpayer alleged that Entity's agent(s) caused physical injury through “Tort” while he was a minor under the care of Entity's agent(s). A substantial amount of time has elapsed since the alleged Tort occurred.

- Taxpayer alleges that he continues to struggle with the trauma resulting from the alleged Tort. Because of the passage of time, and because Taxpayer was a minor when the Tort allegedly occurred, Taxpayer may have difficulty establishing the extent of his physical injuries.

**The Ruling**

- Under these circumstances, it is reasonable for the Service to presume that the settlement compensated Taxpayer for personal physical injuries, and that all damages for emotional distress were attributable to the physical injuries.

- The Service should concede that compensatory damages paid to settle the claim are excludable from gross income for federal income tax purposes. In addition, the Service should not assert that information reporting is required for such payments under I.R.C. § 6041.

- Any portion of a damage award that is allocable to punitive damages or interest, however, is includible in the gross income of C under I.R.C. § 61. A payor that pays punitive damages or interest must issue a Form 1099 and furnish a copy of that form to C, if the payor’s aggregate payments to C of interest and punitive damages from the settlement and other payments described in Treas. Reg. § 1.6041-1(a)(1)(i)(B) of the Income Tax Regulations during the calendar year equal $600 or more.

Even if the Service is not prepared to come right out and say that sexual assault should always be regarded as a “personal physical injury,” this CCA suggests that the Service is pretty reluctant (and appropriately so) to put sexual abuse victims to their proof where the facts and circumstances (to say nothing of common sense) suggest that a physical injury was likely.

---

C. Treatment of Attorney’s Fees

1. Recovery of Fees Generally Includible in Income

As a general rule, if a claimant’s recovery constitutes income, any amounts allocated to attorney’s fees are also includable in the claimant’s income—even if the amount is paid directly to the attorney, and even the amount is payable pursuant to a contingent fee agreement. See Commissioner v. Banks, 543 U.S. 426 (2005). The Supreme Court’s decision in Banks on this point resolved a then long-standing split among the circuits. It also (for a time) created a tax “whipsaw” for claimants.

At the time Banks was decided, a plaintiff who was required to include a recovery of attorney’s fees in income was still allowed a “miscellaneous itemized deduction” for such fees. However, miscellaneous itemized deductions were subject to the two percent (2%) floor of I.R.C. § 67 —meaning they could only claim that amount of their total expenses which exceeded 2% of their adjusted gross income (which would typically be artificially high if the claimant received a large settlement or judgment that year). Miscellaneous itemized deductions were then further reduced by 3% of the amount by which the taxpayer’s adjusted gross income exceeded a threshold amount (referred to as the “Pease” limitation). What is worse, however, if a taxpayer were subject to the Alternative Minimum Tax (“AMT”)—which would be more likely where gross income were artificially high due to the taxpayer’s receipt of a settlement or judgment—no miscellaneous itemized deductions were permitted in computing alternative minimum taxable income. See I.R.C. § 56(b)(1)(A).

Note: The use of the past-tense in the preceding paragraph is purposeful, as the “Tax Cuts and Jobs Act of 2017,” signed into law on December 22, 2017, suspends miscellaneous itemized deductions for tax years 2018-2025.14 For 2018 through 2025, individual claimants will have no miscellaneous itemized deduction available to them. However, this is unlikely to be an issue for the vast majority of employment law claimants on account of I.R.C. § 62(a)(20) – the “above the line” deduction.

2. Above-the-Line Deduction for Claims of “Unlawful Discrimination”

Surprisingly, Congress acted quickly to address the tax “whipsaw” created by many tax cases (and culminating in Banks). The American Jobs Creation Act of 2004 created new Section 62(a)(20), which provides an “above the line” deduction for attorney’s fees and court costs paid by, or on behalf of, a taxpayer in connection with any action involving a claim of “unlawful discrimination.” By taking the deduction “above the line”—i.e. before the computation of adjusted gross income—claimants could effectively obtain a complete exclusion of such fees.

For purposes of I.R.C. § 62(a)(20), the term “unlawful discrimination” is defined by 62(e), and is something of a misnomer—because it covers a wide array of employment matters wholly unrelated to what one usually thinks of as “discrimination” claims. Specifically, the following:

---

14 P.L. 115-97 at sec. 11045.
(2) Section 201, 202, 203, 204, 205, 206, or 207 of the Congressional Accountability Act of 1995 (2 U.S.C. 1311, 1312, 1313, 1314, 1315, 1316, or 1317).
(3) The National Labor Relations Act (29 U.S.C. 151 et seq.).
(8) Title IX of the Education Amendments of 1972 (20 U.S.C. 1681 et seq.).
(10) The Worker Adjustment and Retraining Notification Act (29 U.S.C. 2102 et seq.).
(12) Chapter 43 of title 38, United States Code (relating to employment and reemployment rights of members of the uniformed services).
(15) Section 804, 805, 806, 808, or 818 of the Fair Housing Act (42 U.S.C. 3604, 3605, 3606, 3608, or 3617).
(16) Section 102, 202, 302, or 503 of the Americans with Disabilities Act of 1990 (42 U.S.C. 12112, 12132, 12182, or 12203).
(17) Any provision of Federal law (popularly known as whistleblower protection provisions) prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted under Federal law.
(18) Any provision of Federal, State, or local law, or common law claims permitted under Federal, State, or local law—
   (i) providing for the enforcement of civil rights, or
   (ii) regulating any aspect of the employment relationship, including claims for wages, compensation, or benefits, or prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.
   (Emphasis added).

The disjunctive construction of subsection (18)’s “catch-all” provision seems to pick up virtually any claim arising out of, or related to, the employment relationship (e.g. basic wage/compensation claims)—even in the absence of what might ordinarily be considered “discrimination.”
IV. Wages & Employment Taxes

A. General Rules

Assuming that any amounts payable to a claimant under a settlement or judgment are taxable as “income,” the next question is whether any portion of such income constitutes “wages.” This is significant because “wages” are subject to certain employment taxes and withholding requirements which are not applicable to “non-wage” income. These include:

1. **FICA.** FICA taxes consist of the Old-Age, Survivors, and Disability Insurance portion (OASDI or social security) and the Hospital Insurance portion (HI or Medicare). The OASDI portion is applied to wages paid up to a dollar amount which is set annually (e.g., $128,400 for 2018). The Medicare portion is not capped. The OASDI and Medicare portions of FICA tax are imposed separately against the employee and employer at the rate of 6.2 percent and 1.45 percent, respectively (totaling 12.4% and 2.9%, respectively). See I.R.C. §§ 3101; 3102; 3111.

2. **Income Tax Withholding.** An employer is required to withhold federal income tax on remuneration for employment (wages) paid to its employees. See I.R.C. § 3402(a). States have their own corollary rules on income tax withholding. See, e.g. Wis. Stat. 71.64

3. **Unemployment Taxes.** The Federal Unemployment Tax Act (FUTA) and corresponding state unemployment systems provide for payments of unemployment compensation to workers who have lost their jobs. Most employers pay both a Federal and a state unemployment tax.

B. The Service Takes a Broad View of Wages

1. **Severance.** Generally, any payments made by an employer to an employee on account of dismissal constitute wages for income tax withholding purposes—regardless of whether the employer is legally bound by contract, statute, or otherwise, to make such payments. See Treas. Reg. § 31.3401(a)-1(b)(4).

2. **Back pay.** The Service and most courts agree that “back pay” should be treated as wages for FICA and income tax withholding purposes, except where received on account of a personal physical injury or physical sickness. However, there is some divergence of opinion in the case of back pay awarded for an improper refusal to hire. The Service's position (unsurprisingly) is that back pay is wages even where no employment relationship had been created. See, e.g., Rev. Rul. 78-176, 1978-1 C.B. 303. However, in Newhouse v. McCormick & Co., 157 F.3d 582 (8th Cir. 1998), the Eighth Circuit rejected the Service's position in Rev. Rul. 78-176, holding that FICA tax and income tax withholding do not apply unless an actual employer-employee relationship existed.

3. **Front Pay.** The Service's position is that front pay constitutes wages for FICA and income tax withholding purposes. Most appellate courts addressing the issue have
agreed. However, in *Dotson v. United States*, 87 F.3d 682, 689 (5th Cir. 1996), the 5th Circuit held that only the back pay portion of a settlement was wages for FICA tax purposes.

**4. Compensatory Damages.** Amounts paid as compensatory damages for non-wage claims, should not be treated as wages. However, the Service gives very little comfort on this score.

**5. Attorneys’ Fees.** In Rev. Rul. 80-364, 1980-2 C.B. 294, the Service provides guidance on the tax treatment of amounts paid by an employer as a result of litigation and partially used for attorney's fees. The ruling supports the proposition that when attorney’s fees are clearly allocated as such by a court in a judgment awarding back pay, such attorney’s fees—while includable in income—are not wages for employment tax purposes. However, if a court order does not make a distinct allocation for attorney’s fees and the claimant pays the attorney’s fees out of their recovery, then the entire recovery, including the amount paid to the attorney, is wages for employment tax purposes.

In 2013, the Service issued a Chief Counsel Memorandum clarifying that, although Rev. Rul. 80-364 addresses court awards and not settlements, the reasoning in the ruling can be extended to settlement payments. Thus, if an employment-related claim brought under a fee-shifting statute is settled outside of court, and the settlement agreement clearly allocates a reasonable amount of the settlement proceeds as attorney’s fees, then the amount so allocated to attorney’s fees—while includable in income—is not wages for employment tax purposes. However, if the settlement agreement does not clearly allocate an amount for attorney’s fees, or the claim is brought under a statute that does not provide for fee-shifting, then entire amount paid to the claimant-employee is wages for employment tax purposes.

**V. Allocations and Reporting**

**A. Allocating Damages and the “Origin of the Claim” Doctrine**

The determination of whether the proceeds of a settlement or judgment constitute income under I.R.C. § 61 depends on the nature of the claim and the actual basis for recovery. However, a settlement or judgment may comprise multiple elements, each of which may or may not be income and/or wages.

A judgment awarded by the court may break down the amount of the award into its constituent elements (such as back pay, emotional distress damages, and attorney’s fees), making it much easier to determine which portions constitute income and/or wages. In the case of a settlement payment, the nature of the claim and the actual basis for recovery will be determined with reference to all the facts and circumstances, including the remedies available for the particular claims. The claims must be bona fide claims, but do not necessarily have to be valid.

---

15 See Office of Chief Counsel Internal Revenue Service Memorandum, dated August 30, 2013, Release Number 20133501F, “Reporting Requirements for Attorney’s Fees Paid Pursuant to Settlement Agreements.”
Rather, the critical inquiry is this: “[I]n lieu of what was the settlement amount paid?”

In ascertaining the true substance or nature of the claims that were settled, all of the facts and circumstances must be considered. Where there is a settlement agreement that is entered into in an adversarial context, at arm’s length and in good faith, determining the nature of the claims settled is usually made by reference to such agreement. However, if a settlement agreement lacks express language allocating the payment between claims, courts look to the intent of the payor in making such a determination.

Although the belief of the payee is relevant to that inquiry, the character of the settlement payment hinges ultimately on “the dominant reason of the payor in making the payment.” It is on this point where pleading and practice become significant considerations, as the payment and release terms must be consistent with the true substance of the underlying claims.

Claims that are made at the outset may frame the basis for any ultimate settlement. For example, compensatory damages in the nature of tort-like remedies (e.g., emotional distress) are not available for ADEA claims. Thus, if the written record show only a demand letter and/or complaint for an ADEA claim, it would be hard to justify allocating a portion of the recovery to emotional distress or some other non-wage income on audit.

Jurisdiction and other civil procedure concepts may also have a significant influence. For example, take two hypothetical plaintiffs in Wisconsin: Employee A who works for a large company having over 500 employees, and Employee B who works at a very small company having just 10 employees. Both Employee A and Employee B believe that they experienced an adverse employment action of their race or national origin.

- Employee A can make a claim for discrimination under both Title VII and the WFEA. By contrast, Employee B can only make a claim for discrimination under the WFEA, because the employer in question has fewer than 15 employees.

- Assuming that a discrimination claim under Title VII and/or the WFEA is the only claim on the table, Employee A would have a strong basis on which to allocate at least a portion of any settlement proceeds to non-wage compensatory damages (as Title VII would permit up to $300,000 of compensatory damages). However, Employee B would not have a good

---

17 See Bagley v. Comm’r, 105 T.C. 396, 406 (1995), aff’d, 121 F.3d 393 (8th Cir. 1997); Church v. Comm’r, 80 T.C. 1104, 1109 (1983).
19 See D’Amico v. Comm’r, T.C. Memo. 1999-374 [CCH ¶ 53,621(M)].
21 See D’Amico, T.C. Memo. 1999-374 (citing Fono, 79 T.C. at 694).
basis to do so, as the WFEA no longer permits recovery of compensatory damages.

Recall that the tax treatment of settlement proceeds does not turn on the validity of the underlying claims, but simply whether they are credibly on the table. This could make pre-trial motion practice and the timing of settlement significant. For instance, if Employee B made other, non-frivolous ancillary common law claims—e.g. infliction of emotional distress, wrongful termination, defamation, etc.—there may be a mixed question of law and fact as to whether such claims might be barred by the exclusivity provision of the Worker’s Compensation Act. If these ancillary claims were disposed of on summary judgment prior to settlement, it may be harder to justify an allocation a portion of the settlement payment to such claims than it would be if the settlement occurred before they were disposed of as a matter of law.

Allocations between wage and non-wage recoveries can greatly affect the tax treatment and economics of a payment. While the most conservative approach would be to treat all amounts paid in the settlement of an employment related claim as “wages” subject to employment taxes and withholding, this is likely to be overbroad. That said, because there is no real tax adversity between the parties when it comes to allocating a settlement between wage and non-wage claims—i.e., both sides would be disposed to do so—a stipulated allocation is unlikely to be given much deference on audit. Accordingly, where a claimant seeks an allocation to non-wage income, an employer would be prudent to require a “tax indemnity” whereby the employee will make the employer whole for any failure to have treated the amounts as “wages.”

To the extent that there is any credible basis to claim a personal, physical injury, this should be put front and center in the demand or complaint and, if possible, should be incorporated as factual predicate of each claim.

B. Amos v. Commissioner: 22 A Cautionary Tale

On January 15, 1997, the Chicago Bulls played the Minnesota Timberwolves in Minnesota. The Bulls won by 10 (112 to 102), led by Scottie Pippen, who had 29 points for the night and was shot 55% from the field. More relevant for purposes of federal income tax law, Chicago’s Dennis Rodman kicked a courtside cameraman – Mr. Eugene Amos – squarely in the groin in an apparent fit of pique, after crashing into a group of photographers and twisting his ankle.

Mr. Amos was treated at the hospital shortly after the incident. While there was no sign of visible trauma, Mr. Amos complained of pain and was limping. Apparently, Mr. Amos also contacted a personal injury attorney while seeking treatment. Shortly after his discharge from the hospital, he filed a police report regarding the incident.

On January 21, 1997, less than a week after the incident, Mr. Rodman and Mr. Amos executed a “Confidential Settlement and Release.” This settlement agreement provided for a payment of $200,000.00 in exchange for a release of all claims and a covenant that Mr. Amos would not (1) defame Dennis Rodman, (2) disclose the existence or the terms of the settlement agreement, (3) publicize facts relating to the incident, or (4) assist in any criminal prosecution against the defendant with respect to the incident. No allocation of the $200,000.00 was made among the various claims released or covenants given. Notably, though, the agreement purported to impose liquidated damages of $200,000.00 on Mr. Amos if he were to materially breach his obligations thereunder.

In filing his tax return for 1997, Mr. Amos excluded the entire settlement payment from his income under I.R.C. § 104(a)(2) – on the grounds of personal physical injury. However, the IRS challenged this position, stating that some of it should be included in Mr. Amos’ income as consideration for the various covenants, rather than for excluded personal physical injuries. The Tax Court agreed, holding:

Nonetheless, based upon our review of the entire record before us, and bearing in mind that petitioner has the burden of proving the amount of the settlement amount at issue that Mr. Rodman paid him on account of physical injuries, we find that Mr. Rodman paid petitioner $120,000 of the settlement amount at issue on account of petitioner's claimed physical injuries and $80,000 of that amount on account of the nonphysical injury provisions in the settlement agreement. On that record, we further find that for the year at issue petitioner is entitled under section 104(a)(2) to exclude from his gross income $120,000 of the settlement amount at issue and is required under section 61(a) to include in his gross income $80,000 of that amount.

So how did the Tax Court get inside the head of Dennis Rodman (a daunting prospect of itself) and determine that 40% of the $200,000.00 settlement payment was paid in consideration of the various covenants? That is unclear. However, in light of the $200,000 liquidated damages provision for any breach of the covenants—most notably, the provision that Mr. Amos would not assist in any criminal prosecution (which is probably not susceptible of specific performance by injunction)—it is evident that the covenants had clear and significant value to the payor. This fact alone seems to distinguish the case from the more routine scenario in which the parties to a settlement agreement simply agree to keep the terms confidential.

C. Reporting

1. **Wage reporting.** Under I.R.C. § 6051, the employer is required to furnish information returns (Form W-2, Wage and Tax Statement) to employees reporting the amount of wages, withholding, and other information. Copies of these information returns are also required to be filed by the employer with the Social Security Administration (SSA). Treas. Reg. § 31.6051-2(a). Thus, any settlement or judgment amounts properly allocable to wages are generally reportable by the employer to the employee and to the Social Security Administration on a Form W-2.

2. **Non-Wage Income Reporting.** If a settlement or judgment payment is income but does not constitute wages, the payment will be subject to reporting under I.R.C. § 6041 on Form 1099-MISC. If the payment is excludable from gross income pursuant to § 104(a)(2) or any other section, there is no reporting required.
3. **Reporting Payments to Attorneys.** Under I.R.C. § 6045(f), every person making a payment in the course of his trade or business "to an attorney in connection with legal services" is required to report the payment on Form 1099, regardless of whether the services are performed for the payor or whether the amount is income to the attorney. As noted above, it is prudent to make an express allocation to attorney’s fees in settling claims which provide for fee-shifting, in order to avoid wage treatment of such amounts to the claimant. In these settings, it is also common to provide for payment directly by the payor to the attorney of the amount so allocated. Nevertheless, a reporting of such amount must also be made with respect to the claimant, as illustrated by Treas. Reg. 1.6045-5(f):

Example 3. Separate checks—taxable to claimant. C, an individual plaintiff in a suit for lost profits against corporation P, is represented by attorney A. P settles the suit for $300,000, all of which will be includible in C’s gross income. A requests P to write two checks, one payable to A in the amount of $100,000 as compensation for legal services and the other payable to C in the amount of $200,000. P writes the checks in accordance with A's instructions and delivers both checks to A. P must file an information return with respect to A for $100,000 under paragraph (a)(1) of this section. Pursuant to § 1.6041-1(a) and (f), P must file an information return with respect to C for the $300,000.

4. **Agreements Regarding Reporting.** It is not unheard of for a complainant to seek language in a settlement agreement to the effect that a payor will not file a Form 1099 or some other informational return at all in respect for some or all of a settlement payment. However, the case of *Duse v. IBM* 23 suggests that the violation of such a provision may not be actionable, even where the payment reported was pretty obviously not taxable income (e.g. 104(a)(2)).

5. **Disclosures by Complainant to IRS.**

(a) **Private Letter Ruling.** As noted earlier, a Private Letter Ruling (“PLR”) is a written response to a taxpayer by the IRS National Office that interprets and applies the tax laws to a taxpayer’s specific set of facts. The Service will not ordinarily rule on whether an amount received (in periodic payments or as a lump sum) in connection with a legal action or a settlement of a legal action is properly allocated (including an allocation of all payments to one category) to recovery of capital, compensatory damages, punitive damages, dividends, interest, back pay, etc., for Federal tax purposes. See Rev. Proc. 2018-3 at Section 2.02(10). However, the dearth of guidance under Section 104(a)(2) as to both what constitutes a “personal physical injury” and when payments are deemed to be “on account of” such an injury, there may be questions on which such guidance is desirable if there is significant concern about the bona fides of a taxpayer’s position.

(b) **Form 8275.** Form 8275 is used by taxpayers and tax return preparers to disclose items or positions (other than those taken contrary to a regulation) that are not otherwise adequately disclosed on a tax return to avoid certain penalties. The form is filed to avoid the portions of the accuracy-related penalty due to disregard of rules or to a substantial understatement of income tax for non-tax shelter items if the return position has a *reasonable*

---

23 252 F. 3d 151 (2d. Cir. 2001).
basis. It can be of particular use where a claimant proposes to exclude a significant portion of a settlement payment from income under 104(a)(2)—as such amounts are not otherwise disclosed on the return itself. By flagging the issue, the taxpayer might still get rung up for tax if the Service disagrees with the position, but will generally avoid accuracy-related penalties.

- Reasonable basis is a higher standard than “not frivolous,” “not patently improper,” or “arguable.” See Form 8275 Instructions at p. 2. Rather, the position must be reasonably based on certain recognized authorities set forth in Regulations section 1.6662-4(d)(3)(iii) (e.g., the Code, Regulations, Cases, and even PLRs) taking into account the relevance and persuasiveness of the authorities, and subsequent developments. The return position will generally satisfy the reasonable basis standard even though it may not satisfy the “substantial authority” standard as defined in Treas. Reg. §1.6662-4(d)(2)—which is defined as “more likely than not.”

(c) Confidentiality Considerations. To avoid any issues with respect to any confidentiality provisions of the settlement, it is advisable to include IRS filings as a permitted disclosure by the payee. If there is a laundry list of permitted disclosures (e.g., to attorneys, accountants, advisers, therapists, etc.), a sample add-on might read as follows:

... and/or (___) to the Internal Revenue Service and Wisconsin Department of Revenue in connection with a private letter ruling or disclosure statement (e.g. Form 8275 or its equivalent) in connection with establishing an exclusion from income under I.R.C. § 104(a)(2) for the non-wage portion of the Settlement Payment and a deduction under I.R.C. § 62(a)(20) for the attorneys’ fee portion of the Settlement Payment.

D. Sample Allocation and Tax Indemnity Provision

Settlement Payment. Conditioned upon Complainant’s signing of this Agreement and Complainant’s return of the Agreement to Company, and expiration of the seven (7) day revocation period without revocation, Company will pay to Complainant the total sum of ___________ Dollars ($_________) (“Settlement Proceeds”). The Settlement Proceeds, which shall be paid no later than _______ (_____) business days from the expiration of the seven (7) day revocation period without revocation, shall be made as follows:

(a) A payment of $______________, which payment is for the release of Complainant’s claim of lost wages and will be subject to all normal deductions Company is obligated by law to make for wages paid to an employee.

(b) A payment of $____________, which payment is for the release of any and all claims of emotional distress and other non-wage tort damages that Complainant would otherwise be permitted to make outside of the Action or any other administrative proceedings, for which Company will provide
Complainant with a Form 1099.

(c) A payment of $_________, which payment is in consideration of the confidentiality obligations hereunder, for which Company will provide Complainant with a Form 1099.

(d) A payment of $____________ to _________________ (“Law Firm”), Complainant’s attorneys, which payment is for alleged attorneys’ fees, costs and disbursements that may have been recoverable by Complainant under any state and/or federal discrimination laws. Company will issue a Form 1099 to each of Law Firm and Complainant for this payment.

(e) Complainant understands and agrees that Company has made no representations to Complainant regarding the tax consequences of these payments. Complainant also understands that the tax consequences of these payments are Complainant’s own sole and complete responsibility.

(i) Although it is the parties’ intent that the settlement amounts evidenced by this Agreement are properly allocated for purposes of any local, state or federal tax laws, statutes and/or regulations, in the event that any taxing agent determines that any portion of such settlement amounts should have received a different tax treatment than the treatment assigned by this Agreement, Complainant agrees to pay all taxes, interest, penalties or other amounts for which she may be subject by reason of any such determination. Further, if any taxing agent asserts any claims against, or seeks to recover any taxes (other than any employer FICA taxes), penalties, interest or other amounts from Company based upon the terms of this Agreement, Complainant agrees to fully and completely indemnify, defend, and hold Company harmless from any penalties, interest, taxes (other than employer FICA taxes), or other amounts assessed against it by such taxing agent, that may result because of the actions taken by said taxing agent.

(ii) In the event any taxing agent notifies Company in writing of any type of claim against it based on the terms of this Agreement, or seeks by way of some legal process to recover any penalties, interest, taxes or other amounts from Company based upon the terms of this Agreement, Company agrees to notify Complainant in writing following Company’s receipt of such notice or legal process and tender to Complainant the defense of such claims or legal proceeding. If Complainant accepts the tender, and fully indemnifies and defends Company from such claims, then Company shall have no right to seek to obtain from Complainant any fees or costs Company may incur to have separate representation in such proceedings. If however, Complainant fails
or refuses to accept the tender of defense, or fails or refuses to indemnify Company in accordance with this Agreement, then Company may retain its own counsel to defend against such claims, and Complainant shall be fully and completely responsible for the payment of Company’s fees (including attorneys’ fees) costs and expenses for the defense of such claims, in addition to Complainant’s other indemnification and defense obligations under this Agreement.

(iii) Any payments Complainant may make to any taxing agent in the future, or any indemnification or defense of Company that Complainant may render in the future, shall have no impact upon Complainant’s obligations under this Agreement (including without limitation Complainant’s release of claims), all of which shall remain in full force and effect despite any future payments or indemnification/defense.

IV. Section 162(q)—a/k/a “The Harvey Weinstein Tax”

A. Background

The “Tax Cuts and Jobs Act of 2017,” signed into law on December 22, 2017, created new Internal Revenue Code Section 162(q). This provision, which became effective upon enactment, purports to disallow any income tax deduction for any settlement or payment related to sexual harassment or sexual abuse if such settlement or payment is subject to a nondisclosure agreement. Additionally, new section 162(q) disallows any income tax deduction for attorney’s fees related to such a settlement or payment. The effects of this relatively obscure portion of the new tax bill may be significant—for plaintiffs as well as defendants.

New Section 162(q) reads as follows:

(q) PAYMENTS RELATED TO SEXUAL HARASSMENT AND SEXUAL ABUSE.—No deduction shall be allowed under this chapter for—

(1) any settlement or payment related to sexual harassment or sexual abuse if such settlement or payment is subject to a nondisclosure agreement, or

(2) attorney’s fees related to such a settlement or payment.

There was no legislative history to speak of, and there are not yet any regulations or other formal guidance defining the key terms “settlement or payment,” “related to,” “sexual harassment or sexual abuse” and “nondisclosure agreement”—all of which are critical to understanding how the disallowance is to be applied in practice.

It seems clear that new section 162(q) was intended as a disincentive to the use of nondisclosure agreements in the settlement of sexual harassment and sexual abuse claims.

24 See P.L. 115-97 (December 22, 2017), at Section 13307.
(whether pre-suit or post-suit)—presumably to allow claimants to name alleged harassers/abusers who might otherwise remain unknown, and to disclose specific acts of misconduct which also might otherwise remain unknown.

B. Effects of Revisions

1. Increased Cost to Defendants

Whatever the merits from a broader moral and/or public policy standpoint, a plaintiff’s offer of a nondisclosure agreement as part of a settlement has distinct monetary value in the context of an individual case. This monetary value is likely to be significant in a sexual harassment or sexual abuse case, as the allegations alone could have enormous adverse consequences for the defendant. Accordingly, the monetary value of a nondisclosure agreement will typically be at its highest when parties are engaged in “pre-suit” settlement talks—precisely because the name of the defendant and specific allegations of misconduct may be less widely known (if at all).

New section 162(q) will have the clear effect of increasing the cost to a defendant of obtaining a nondisclosure provision in a sexual harassment/sexual abuse case. More precisely, the cost will be increased by an amount equal to the product of (i) the defendant’s effective tax rate, multiplied by (ii) the value of the settlement or payment that relates to the sexual harassment or abuse claim, plus the defendant’s own attorney’s fees related to such settlement. One’s first reaction to this may be something along the lines of, “Good, make the [INSERT EXPLETIVE] pay if he wants to hush things up so badly!” Indeed, this was likely the sentiment motivating section 162(q) in the first place—that, and the fact that a disallowance of deductions likely helped the new tax bill’s CBO score. However, these revisions have the potential for some very real adverse consequences for sexual harassment or abuse claimants, too.

2. Diminished Value for Plaintiffs

If the cost of a nondisclosure agreement is put out of reach by the disallowance provisions of Section 162(q), sexual harassment and sexual abuse claims that might otherwise have been resolved pre-suit and/or at a monetary premium for a plaintiff are more likely to become contested formal proceedings and/or yield less for a plaintiff. This, in turn, may increase the overall cost (both financial and emotional) to a plaintiff. To the extent that a plaintiff must accept a lower amount in order to bridge the “gap” created by the disallowance and still obtain a pre-suit settlement, then this new provision will have deprived that plaintiff of the full monetary value of a pre-suit nondisclosure agreement.

The public policy justifications for essentially “de-valuing” a plaintiff’s right to keep silent are not without some merit. But the benefits conferred on future, potential claimants from this approach come at a real cost to current, actual claimants. Intentionally or not, new Code Section 162(q) would seem to make the “first mover disadvantage” steeper than it already is for sexual harassment and sexual abuse victims contemplating civil legal action.

3. More Complicated Settlement Dynamics

Even in a “post-suit” setting—where the names of an alleged harasser/abuser and the allegations of misconduct (either generally or specifically) are likely matters of public record—nondisclosure agreements remain a powerful tool in facilitating a negotiated settlement. Claims of sexual harassment and sexual abuse are uniquely fraught for all parties—with strong reputational concerns at stake, on both sides. A seemingly “zero sum” contest like this is hard enough already to resolve on a negotiated basis. However, with a properly crafted nondisclosure agreement, parties have a better chance to balance their competing concerns.

When confidentiality of settlement or payment terms is assured, a Plaintiff can walk away suggesting that the fact of a settlement alone validates all their claims, and a Defendant can walk away suggesting that they simply wanted to avoid the time, effort and expense of dealing with a meritless claim and move on with their life/business. No one can claim to be happy, but everyone can claim a victory of sorts. However, if the actual terms of the resulting settlement or payment could be made publicly known—including the amount of the attorney’s fees and litigation costs incurred, relative to the plaintiff’s “take home” proceeds—then both sides (not just defendants) need to worry about the resulting public perception of a “win/loss” calculus based solely on money. This perception may make a negotiated resolution infeasible.

4. Uncertainty Regarding Plaintiffs’ Attorney’s Fees

The new disallowance provision, although specifically contained in I.R.C. § 162 (regarding trade or business expenses), purports to apply to all deductions under Chapter 1 of the Code—not just deductions arising under I.R.C. § 162 itself. Thus, this new disallowance might arguably apply to disallow deductions by individual plaintiffs. This could be significant.

To the extent a settlement or payment relates to a personal “physical” injury within the meaning of I.R.C. § 104(a)(2), then such portion of the settlement or payment would be completely “excluded” from income, not merely “deducted” — so new I.R.C. § 162(q) would not affect those situations. As a practical matter, most “sexual abuse” claims (as that term is commonly understood) are likely to fall into this category. However, as noted above, it is far more difficult than one might expect to prove a “physical” injury—as distinct from “emotional distress”—in a “sexual harassment” case, especially where there is no physical contact that might otherwise be regarded as “sexual abuse” (e.g., a hostile workplace situation where there may be words or actions of a graphic sexual nature and/or displays of graphic sexually-oriented materials – but no actual touching of the plaintiff).

Again, if the amounts are not excludable under I.R.C. § 104(a)(2), the entire settlement or payment—including amounts required to be paid directly to a plaintiff’s attorney under a contingent fee agreement—are included in the plaintiff’s income, and the attorney’s fees and costs must then be deducted under some other provision of the Tax Code. As discussed above, I.R.C. § 62(a)(20) was specifically created in order afford taxpayers a special “above-the-
line” deduction for certain attorneys’ fees in a variety of cases (including sexual harassment and sexual abuse cases) in order to avoid the adverse effects of miscellaneous itemized deduction treatment. However, inasmuch as I.R.C. § 62(a)(20) is still a deduction under Chapter 1 of the Code, the disallowance under new I.R.C. § 162(q) may still be operative where there is a nondisclosure agreement.

However, there may be other protective measures that can be taken in terms of “time-keeping” (even in a contingent fee context) to maximize the deductibility of attorneys’ fees even when a confidential settlement is unavoidable. Whether these protective measures might work depends on whether and to what extent attorney’s fees are regarded as “related to” a “settlement or payment” that is subject to a “nondisclosure agreement.”

The Service may attempt to argue that all attorneys’ fees incurred throughout an entire piece of litigation—from the initial complaint to the final confidential settlement—should be regarded as the fees “related to” the resulting settlement or payment. However, this seems unduly broad—as much of the heavy lifting in any litigation matter (i.e., pleadings, discovery, pre-trial motion practice, etc.) has to be done with the assumption that there will be no settlement (confidential or otherwise) and that the parties will have to try the case.

A more rational interpretation would be that the disallowance should only be applied to those attorney’s fees associated with actual mediation activities and/or settlement discussions. For example, if a particular case takes 500 hours (from initial demand start to final settlement) and the resulting attorney’s fees (exclusive of costs) are $125,000, you’d have an average hourly rate of $250 per hour. If time sheets show 470 hours of full-tilt litigation and discovery activity of the sort necessary to prepare for a trial in all events—i.e., not specifically related to settlement—and only 30 hours of actual mediation and settlement activities, it could be argued that only $7,500 of attorney’s fees (i.e. 30 x $250) should be disallowed. 28 Again, there is a lot to unpack in the definition of “related to.”

Finally, it should be noted that “costs” would seem to be another area for planning, as the disallowance under new I.R.C. § 162(q)(2) only purports to apply to “attorney’s fees”—not court costs and other litigation expenses.29

C. Planning Concerns & Possibilities

Another significant area of uncertainty is the question of how the terms “related to” and “settlement or payment” will be applied. If an actual claim is made for sexual harassment alone, the application might be reasonably clear where there is a payment made for the express purpose of resolving the claim made. However, settlements tend to be much broader in scope than a single claim. Moreover, parties might be disposed to enter into “general releases” as part of any

28 Note: Even this approach might be overbroad, and it may be appropriate to distinguish between unsuccessful mediation work and the final mediation work actually giving rise to the settlement terms agreed in principle—particularly in cases where a court compels an early mediation before certain dispositive motions are heard, thereby reducing the chances of a meaningful settlement arising from such early mediation.

29 Cf. I.R.C. § 62(a)(20), which expressly applies to “attorney fees and court costs.”
separation – even in the absence of an actual claim made – simply to avoid future disputes. Consider the following scenario:

Employer implements a reduction in force which nominally uses a “last-in, first out” approach for identifying the employees to be terminated in each affected department. One of the employees to be terminated is the only woman in an affected department, is over the age of 40 and is also the only member of a particular race and/or national origin in that affected department. Employer unilaterally (i.e., before any claim is made) offers a severance arrangement which is conditioned upon a complete release by employee of any and all claims she might have (including, but not limited to, sexual harassment and sexual abuse) and further contains a nondisclosure provision.

If the employee accepts the severance arrangement without ever having made a claim of her own, then query:

1. Does the “severance” arrangement fall outside the definition of a “settlement” on account of the fact that there was never any claim made to be “settled” (as distinct from merely being “released”)? Does this even matter if the “severance” is still regarded as a “payment”?

2. Assuming that the severance would at least be regarded as a “payment,” is that payment properly regarded as being “related to” sexual harassment or sexual abuse if there was never any specific claim of sexual harassment/abuse made, and there is simply a general release of any and all claims? Or would some portion of the payment be “deemed” to have “related to” the sexual harassment/abuse claims released thereby—as distinct from the other gender-based, age or racial/national origin discrimination claims also released?

3. If the severance payment may be allocated among the universe of potential claims wrapped up in the general release, could the employer simply include a percentage allocation to which the employee agrees? Or would such a stipulated allocation be disregarded since both parties would seem to benefit from an allocation weighted against harassment/abuse claims—viz. there is no “tax adversity” between them?

Last, but by no means least, there is a significant question as to what sorts of contract terms might constitute a “non-disclosure agreement” for purposes of I.R.C. §162(q). This is an important consideration, as it may suggest other practical solutions that might avoid engaging I.R.C. § 162(q) in the first place. For instance, if a plaintiff agrees to retract their allegations of harassment/abuse and/or specifically deny same, would a contract provision prohibiting any statement to the contrary—but not prohibiting disclosures generally—constitute a “nondisclosure agreement”? 