Tax Issues in Employment Cases

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Tax Issues in Employment Cases

Social Security Disability Income (SSDI)

Federal Income Tax Consequences

Internal Revenue Code (IRC) Section 86

- **SSDI Benefits are Free from Federal Income Tax if:**
  - **Half of SSDI Income PLUS**
  - **All other Income is LESS THAN:**
  - **$25,000 (Single)/$32,000 (Married, Filing Jointly)**
- **Up to 85 Percent of SSI Benefits are Taxable if:**
  - **Half of SSDI PLUS**
  - **All other Income is MORE THAN:**
  - **$34,000 (Single)/$44,000 (Married, Filing Jointly)**

CAUTION: All SSDI Benefits may be Subject to Federal Income Tax for Married, Filing Separate BUT Still Living Together

Tax Issues in Employment Cases

Income from Disability Insurance Benefits

Federal Income Tax Consequences

Internal Revenue Code (IRC) Section 106

- **Employer-Provided Disability Plans**
  - **Employee Pays Premiums with After-Tax Dollars, THEN**
    - **Disability Benefits are Tax-Free to Employee**
  - **Employee Pays Premiums with Pre-Tax Dollars, THEN**
    - **Portion of Benefits Attributable to Pre-Tax Payments are Taxable**
  - **Employer Pays All or Some of the Premiums, THEN**
    - **Portion of Benefit Attributable to Employer's Share of Premiums is Subject to Tax**

NOTE: Premiums May Not be Deductible as Medical Expense

Tax Issues in Employment Cases

Income On Account Of Physical Injuries or Sickness

Federal Income Tax Consequences

Internal Revenue Code (IRC) Section 104

- **Under IRC Section 104(a)(2), All Recoveries on Account of Physical Injuries or Physical Sickness are Excludible from Gross Income**
  - **Includes Lost Wages, Emotional Distress, and Attorneys' Fees**
  - **Under 2010 Regulations, Does Not Require a Tort or Tort-Like Cause of Action**
- **Under IRC Section 104(a)(1), Amounts Received Under "Workmen's Compensation Acts" Are Similarly Excludible From Income**
  - **This Applies Even If the Compensation is for Emotional Distress (In Contrast to Section 104(a)(2), Which Requires Physical Injuries or Sickness)**

Tax Issues in Employment Cases

Tax Categories for Recoveries from Employment Claims

Includible in Income But Not Wages

- ***For example*, emotional distress and other "non-physical" injuries**
- **Associated attorneys' fees are deductible "above-the-line" under IRC § 62(a)(20) IF claim is:**
  - **To remedy unlawful discrimination;**
  - **Brought on behalf of the Government (*i.e.*, False Claims Act or as a "Whistleblower"); and/or**
  - **Otherwise statutorily specified under IRC § 62(e)**
    - **However, fees are deductible only up to the amount included in gross income; *see* second sentence under IRC § 62(a)(20)**
- **CAUTION: *Com'r v. Banks,* 543 U.S. 426 (2005): As a "general rule, when a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee."**
  - **However, *Banks* declined to address result when attorneys are paid by defendant pursuant to a "fee shifting" statute**

Tax Issues in Employment Cases

Tax Categories for Recoveries from Employment Claims

Includible in Income as Wages

- Payments made by an "employer" as "remuneration for services" in connection with the "employment relationship" are generally treated as "wages"
  - *See Social Security Board v. Nierotko*, 327 U.S. 358 (1946); IRC § § 3121, 3306(c), and 3401(a)
- Payment amounts likely to be treated as "wages" therefore include back pay, front pay, and covenants not to compete—this would be so even if the claim is for NOT hiring the claimant
- As a result, payment would be subject to:
  - FITW: Usually, but not always, based on filed Form W-4
  - FICA: 6.2% "OASDI Tax" (on "wage base" amount) + 1.45% "Hospital Tax" (on total amount)—applied against both the "Employer" and the "Employee"
  - FUTA: 6.2% on first $7,000—but "Employer" only

Tax Issues in Employment Cases

Tax Categories for Recoveries from Employment Claims

How Does the IRS Decide If the Tax Treatment is Correct?

- **Technical Advice Memorandum 200244004 describes the rationale utilized by the Government**
  - **The tax treatment of an amount received pursuant to a settlement agreement depends on the nature of the claim and not its validity**
    - **In other words, in lieu of what were the damages paid**
    - **The IRS will allocate a lump sum payment using the best evidence available, which may consist of the claimant's complaint requesting reasonable amounts of damages for each claim**
  - **The "beginning point" is whether the amount is excludible under IRC § 104(a)(2)**
  - **Whether an amount received in settlement of a dispute is remuneration for employment depends on the nature of the item for which the amount is a substitute**

Tax Issues in Employment Cases

Tax Categories for Recoveries from Employment Claims

How Does the IRS Decide If the Tax Treatment is Correct?

- The allocation in a settlement is generally binding for tax purposes to the extent that the agreement is entered into by the parties in an adversarial context, at arm's length, and in good faith
- Key Factor: Do the facts and circumstances indicate that the allocation reflects the economic substance of the settlement
  - But what if the Government determines that the parties were adversarial with respect to the dollar amounts but not on the issue of allocation? *See, e.g., Robinson v. Com'r*, 102 T.C. 116 (1994) (claimant in suit against bank for failing to release lien unilaterally allocated 95% of $10 million settlement to "tort-like personal injuries")
- Lesson: Establish the universe of potential claims early in the negotiation process and then negotiate against a backdrop that accounts for the ultimate allocation of the settlement amount

Tax Issues in Employment Cases

Tax Categories for Recoveries from Employment Claims

How Does the IRS Decide If the Tax Treatment is Correct?

- For the IRS' own use in determining the income and employment tax consequences and appropriate reporting of employment-related judgments or settlements made by the agency, John Richards, of the Office of Division Counsel/Associate Chief Counsel, issued a management technical memorandum dated October 22, 2008
- Available from Tax Analysts as 2009 TNT 129-19

Tax Issues in Employment Cases

Tax Categories for Recoveries from Employment Claims

How Should an Employer Withhold if a Payment is Wages?

- A "lump sum" payment is generally characterized as being "supplemental wages"
- For FITW on "supplemental wages," an employer may usually choose between:
  - Withholding at a flat 22% rate; or
  - Adding the "supplemental wage" payment to concurrently paid wages and withhold using the "usual method," taking into account any exemptions on the recipient's applicable IRS Form W-4
- However, if the employer did not withhold income tax from the recipient's regular wages in the current or immediately preceding calendar year, then the employer must obtain a Form W-4 and take claimed exemptions into account; see pp. 14-15 of *Circular E, Employer's Tax Guide (Publication 15*)
  - CAUTION: Regs. § 31.3402(g)-1(a)(2) mandates withholding at highest rate for portion of lump sum wage payments that exceed $1 million

Tax Issues in Employment Cases

Attorneys' Fees for "Unlawful Discrimination" Cases

Federal Income Tax Consequences

Internal Revenue Code (IRC) Section 62

- **Under IRC Section 62(a)(20), Attorneys' Fees in "Unlawful Discrimination" Cases are Deductible "Above-the-Line"**
    - **Attorneys Fees are Generally Includible in Claimant's Income Even if Contingency Fee or Paid by Respondent**
    - **IRC Section 62(e) Defines "Unlawful Discrimination" Very Broadly**
    - **In Addition to Specified Statutory Claims, Section 62(e)(18)(i) Includes any Provision of Federal or State Statutory or Common Law for the "Enforcement of Civil Rights"**
    - **Section 62(e)(18)(ii) Covers Such Laws "Regulating Any Aspect of the Employment Relationship"**

Tax Issues in Employment Cases

Attorneys' Fees for "Unlawful Discrimination" Cases

Federal Income Tax Consequences

Internal Revenue Code (IRC) Section 62

In accordance with IRS Publication 525, *Taxable and Nontaxable Income (Rev. February 2020)*, p. 30:

- **Deduct IRC § 62(a)(20) attorneys fees on Line 22 of IRS Form 1040, Schedule 1; AND**
- **As a corollary, include attorneys fees, along with all other nonpecuniary (i.e., non-wage) proceeds, on Line 8**

"Troy Aikman throws the ball over the middle to Emmitt Smith"

Tax Issues in Employment Cases

Attorneys' Fees for "Unlawful Discrimination" Cases

Federal Income Tax Consequences

Internal Revenue Code (IRC) Section 62

Information Reporting for Nonpecuniary (Non-wage) Payments on IRS Form 1099-MISC

- **All payments to client reported in Box 3**
- **All payments to attorney reported in Box 10**

USE IRS FORM 1099-NEC *only* for reporting payments made as compensation for the performance of services

Tax Issues in Employment Cases

Structured Settlements for Nonwage Payments

Federal Income Tax Consequences

IRS PRIVATE LETTER RULING 200836019

Deferral of Federal Taxation through Periodic Payments to Claimant Expressly Spelled Out in Settlement Agreement

- **Obligation to make period payments subject of "Nonqualified Assignment" to third-party, which funds an annuity (usually offshore)**
- **The Claimant has *no* rights to affect timing of periodic payments nor legal capacity to monetize them**
- **Claimant's legal rights to periodic payments are no *more* than those of an *unsecured* general creditor**

VERY IMPORTANT to consult with a professional Structured Settlement advisor.

Tax Issues in Employment Cases

Provisions Under the 2017 "Tax Cuts and Jobs Act"

Federal Income Tax Consequences

"Tax Cuts and Jobs Act "(TCJA)" – Public Law 115-97

Suspension (Until 2026) of Deduction of Miscellaneous Itemized Deductions Under IRC Section 212 Prevent Deduction of Attorneys' Fees in Other Cases

Tax Issues in Employment Cases

Provisions Under the 2017 "Tax Cuts and Jobs Act"

Federal Income Tax Consequences

Taxation of Sexual Harassment Cases

NEW IRC SECTION 162(q)

Confusions may be attributable to the brief but, arguably, imprecise drafting of this subsection, which reads as follows:

PAYMENTS RELATED TO SEXUAL HARASSMENT AND SEXUAL ABUSE.

– No deduction shall be allowed under this chapter [*i.e.,* Chapter 1 of the Internal Revenue Code, which encompasses Sections 1 through 1400Z-2] for –

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

attorney's fees related to such a settlement or payment.

Tax Issues in Employment Cases

Provisions Under the 2017 "Tax Cuts and Jobs Act"

Federal Income Tax Consequences

"Tax Cuts and Jobs Act "(TCJA)" – Public Law 115-97

- **New IRC 162(q) Forbids a Deduction for "Any Settlement or Payment Related to Sexual Harassment or Sexual Abuse If Such Settlement or Payment is Subject to a Nondisclosure Agreement"**
- **Also Disallows Deductions for "Attorney's Fees Related to Such Settlement or Payment"**
- **This Statutory Language Could be Applied to Attorneys' Fees Incurred by the Claimant - BUT, 2/28/19 IRS FAQ**

Tax Issues in Employment Cases

Provisions Under the 2017 "Tax Cuts and Jobs Act"

Federal Income Tax Consequences

"Tax Cuts and Jobs Act "(TCJA)" – Public Law 115-97

Question:

Does section 162(q) preclude me from deducting my attorney's fees related to the settlement of my sexual harassment claim if the settlement is subject to a nondisclosure agreement?

Answer:

No, recipients of settlements or payments related to sexual harassment or sexual abuse, whose settlement or payment is subject to a nondisclosure agreement, are not precluded by section 162(q) from deducting attorney's fees related to the settlement or payment, if otherwise deductible. See Publication 525, Taxable and Nontaxable Income, for additional information on when all or a portion of attorney's fees may be deductible.

Tax Issues in Employment Cases

Provisions Under the 2017 "Tax Cuts and Jobs Act"

Federal Income Tax Consequences

"Tax Cuts and Jobs Act "(TCJA)" – Public Law 115-97

- **Proposed "EMPOWHER ACT" Introduced by Senators Harris (D-CA) and Murkowski (R-AK) as S.2988**
  - **Would also create exclusion for nonpecuniary damages from IRC § 62(e) claims**
  - **However, wages would be treated as now (backpay, front pay)**
  - **Income averaging for same economic effect at if wages had been timely paid**

The bill prohibits a tax deduction for amounts paid or incurred by the taxpayer: pursuant to any judgment or award in litigation related to workplace harassment, including sexual harassment; for expenses and attorney's fees in connection with the litigation resulting in the judgment or award (other than expenses or fees paid by the workplace harassment plaintiff or claimant); or for insurance covering the defense or liability of the underlying claims in the litigation.

Tax Issues in Employment Cases

Emerging Employment Litigation Strategies
Using Federal Tax Evasion as a Sword

[Note: Credit to Richard Neuworth of Lebau & Neuworth in Baltimore, who has presented to the ABA Tax Section and done important work in this emerging area of the law.]

IRC § 7434 provides, in pertinent part:

- **If any person willfully files a fraudulent information return with respect to payments purported to be made to any other person, such other person may bring a civil action for damages against the person so filing the return.**
- **In any action brought upon a finding of liability on the part of the defendant , the defendant shall be liable to the plaintiff in an amount equal to the greater of $5,000 or the sum of any actual damages sustained by the plaintiff as a proximate result of the filing of the fraudulent information return.**
- **The costs of the action, and in the court's discretion, reasonable attorneys' fees.**

Tax Issues in Employment Cases

Emerging Employment Litigation Strategies

Using Federal Tax Evasion as a Sword

A fraudulent information return may, in turn, be any of the following:

- **W-2;**
- **1099; or**
- **Any other tax form filed with the Internal Revenue Service**

Tax Issues in Employment Cases

Emerging Employment Litigation Strategies

Using Federal Tax Evasion as a Sword

Whistleblower claims under IRC § 7623(a) or (b)

- **Claims that may be filed under 26 U.S.C. 7434 may be filed in combination with 26 U.S.C. 7623 which is a whistleblower action;**

- **Employee or Independent Contractor need not pursue litigation under this whistleblower action. IRS handles entire matter.**

Tax Issues in Employment Cases

Emerging Employment Litigation Strategies

Using Federal Tax Evasion as a Sword

Whistleblower claims under IRC § 7623(a) or (b)

- **Unlike IRC § 7434, an award may be given under Section 7623 for any type of underpayment.**
- **There is no "willful" requirement**

Tax Issues in Employment Cases

Emerging Employment Litigation Strategies

Using Federal Tax Evasion as a Sword

Whistleblower claims under IRC § 7623(a) or (b)

- **In order to receive an award, the amount owed to the Internal Revenue Service must exceed $2,000,000 (including taxes, interest and penalties).**
- **Rewards may range from 15 to 30 percent of the amount recovered by the Internal Revenue Service.**
- **If amount recovered is less than $2,000,000 by the Internal Revenue Service, reward is left strictly up to IRS to determine how much will be paid to the whistleblower based on substantial contribution made by the whistleblower.**

Tax Issues in Employment Cases

Managing IRC Section 409A Issues

Background

- Enacted under the American Job Creations Act of 2004 to target "nonqualified deferred compensation arrangements" and "nonqualified retirement plans"
- Intended to address perceived abuses with respect to the timing of elections and distribution and the acceleration of payments
- Sanctions for violations are aimed chiefly at payment recipients and include:
  - Amounts intended to be "deferred" are, instead, immediately included in income and subject to tax; and
  - An additional 20% excise tax is imposed
    - However, a "Safe Harbor" is provided for payments made within 2 ½ months after the end of the year in which the payments were earned—*i.e.,* a "short term deferral"
- Applies to severance pay plans and litigation settlements providing for deferred compensation

Tax Issues in Employment Cases

Managing IRC Section 409A Issues

Separation from Service

- **Severance payments and arrangements for "involuntary termination" of employment are generally subject to IRC § 409A unless exempted because, *for example*:**
  - **Amount paid qualifies as a "short term deferral" (*i.e.,* total amount is paid within 2 ½ months of year end)**
  - **A portion of the amount, which must be paid by the end of the second year following the year in which the "involuntary termination" occurred, does not exceed the lesser of:**
    - **2X the employee's annual compensation for the calendar year preceding the calendar year in which the termination occurred OR**
    - **2X the limit on compensation in place under IRC § 401(a)(17) for the calendar year in which the termination occurred—for 2019, this limitation amount, which is subject to COLA, is set at $280,000**
- **<u>CAUTION</u>: A public company may not pay "deferred compensation" to a "specified employee" before six months following termination**

Tax Issues in Employment Cases

Managing IRC Section 409A Issues

Exemption for *Bona Fide* Employment Claims

- **IRC § 409A does not apply to court awards or amounts paid for settlement of certain "*bona fide* legal claims" in connection with employment, such as those based on:**
  - **Wrongful termination**
  - **Employment discrimination**
  - **Fair Labor Standards Act**
  - **Workers' compensation statutes**
  - **Payment of attorneys' fees and/or litigation expenses**
    - **NOTE: This exemption is not dependent upon whether the payments are characterized as being "compensation" or "wages" for Federal tax purposes**
- **BUT, IRC § 409A does apply to amounts paid upon separation from employment that are conditioned on the recipient executing a release of claims, a nondisclosure and/or non-compete agreement, and/or the like**

Tax Issues in Employment Cases

QUESTIONS AND ANSWERS

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