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In this article, Richards examines employment litigation tax issues, with a focus on qualified settlement funds and areas that receive special tax treatment.

Employment litigation is on the rise. By one recent measure, employment litigation settlements have reached nearly $2 billion annually.[1] This has been driven, in part, by an increase in the class certification of labor and employment matters.[2] Labor and employment matters are the largest group of class action suits, representing over one-third of all class actions in 2022.[3] These actions involve a wide range of employers, plaintiffs, industries, and remedies.

Employment claims' increasing size and complexity require increasing coordination with tax counsel. How claims arise and are settled can significantly affect an employer's tax liability and tax reporting obligations.

I. Determining Nature and Character

The tax consequences of employment litigation expenses and settlement payments generally stem from the nature of the claim brought and how the claim is settled.

A. The Origin-of-the-Claim Test

The tax treatment of litigation expenses and settlement payments is determined under the origin-of-the-claim test. The Supreme Court has articulated that the tax treatment of these items, including attorney fees and settlement payments, depends on the "origin and character" of the claim from which they arose.[4] The origin-of-the-claim test considers all facts.[5] That includes "the issues involved, the nature and objectives of the litigation, the defenses asserted, the purpose for which the claimed deductions were expended, the background of the litigation, and all facts pertaining to the controversy."[6] The origin-of-the-claim test determines whether litigation expenses are deducted or capitalized, the tax treatment of the settlement payment or award, and whether payments on behalf of employee codefendants are excludable as a working condition fringe.

B. Allocation of Settlement Payments

When settlement payments are made to settle multiple claims (for example, lost wages and physical injury), the payments are allocated according to the "best evidence" available.[7]

[1] Jennifer Bennett, Patrick Dorrian, and Jacklyn Wille, "Workplace Class Settlement Values, Certifications Soared in 2022," Bloomberg Law (Jan. 6, 2023).

[2] *Id.*

[3] Carlton Fields, "2023 Carlton Fields Class Action Survey" (2023).

[4] *United States v. Gilmore*, 372 U.S. 39, 49 (1963); *see also Woodward v. Commissioner*, 397 U.S. 572 (1970).

[5] *Boagni v. Commissioner*, 59 T.C. 708 (1973).

[6] *Id.*

[7] Rev. Rul. 85-98, 1985-2 C.B. 51; *see also* LTR 200303003 ("The Service will allocate a lump sum using the best evidence available.").

Typically, this is the express allocation in the settlement agreement.[8] If the agreement has no express allocation, the allocation is based on relevant documents and letters (if there was no litigation) or any relevant pleadings, awards, and orders (if litigation commenced).[9] The purpose of this inquiry is to determine "in lieu of what" damages were paid or awarded.[10]

In general, neither the IRS nor a court will disturb a settlement agreement's express allocation if the agreement is negotiated at arm's length and the allocation is reasonable.[11] An allocation to unraised claims may be reasonable if those claims were part of the settlement negotiations and the claims had real value.[12] However, the IRS and courts will not "blind themselves to the settlement's realities," and they will ignore a settlement agreement if it is unreasonable or does not reflect the reality of the claims brought.[13] For example, if the parties do not have competing tax interests, it may be argued that the settlement was not negotiated at arm's length and that the settlement agreement's allocation should be ignored.[14]

II. Special Treatment

Some claims and payments carry special tax consequences and reporting requirements.

A. Wages

Generally, employers incur reporting and withholding obligations on wage payments made to employees. Likewise, settlement payments attributable to lost wages are subject to Form W-2 reporting and FICA, FUTA, and income tax withholding.[15] The term "wages" in this context is broad, encompassing a wide variety of settlement and damage payments. The term can include payments made to current and former employees, as well as to individuals who were not hired because of alleged discriminatory practices.[16]

For example, in LTR 200303003, the IRS advised a government department that its settlement payments demarcated as "compensatory damages and not wages" were, in fact, wages. In that private letter ruling, a class of individuals sued a government department for gender- and race-based discrimination under Title VII. The plaintiffs claimed that they received disparate treatment in hiring, performance reviews, disciplinary proceedings, assignments, bonuses, training, and promotions. The plaintiffs requested compensatory damages, back pay, lost wages, attorney fees, and compensation for emotional distress. The department settled the class action. The settlement agreement provided that the payments represented "compensatory damages and not wages." Payments to class members were determined by work performed, disciplinary actions brought, and years of service. The settlement agreement made no mention of emotional damages.

The IRS determined that the entire settlement constituted wages. The IRS noted that "wages" includes all remuneration within the employer-employee context except to the extent that it is excluded from income.[17] The IRS further noted that because the damages were derived based on employment criteria and the underlying claim — employment discrimination — stemmed from the employer-employee relationship, the settlement payments represented wages in resolution of a wage-based claim. No amount was allocated to emotional distress compensation because the settlement made no allocation to emotional distress and no evidence had been presented regarding plaintiffs' emotional distress.

[8] *Metzger v. Commissioner*, 88 T.C. 834 (1987).

[9] *McKay v. Commissioner*, 102 T.C. 465 (1994), *vacated and remanded on other grounds*, 84 F.3d 433 (5th Cir. 1996).

[10] *McKay*, 102 T.C. at 482 (quoting *Bent v. Commissioner*, 87 T.C. 236, 244 (1986), *aff'd*, 835 F.2d 67 (3d Cir. 1987)).

[11] *Green v. Commissioner*, 507 F.3d 857 (5th Cir. 2007); TAM 200244004.

[12] *Eisler v. Commissioner*, 59 T.C. 634 (1973).

[13] *Bagley v. Commissioner*, 121 F.3d 393 (8th Cir. 1997).

[14] *See, e.g., Robinson v. Commissioner*, 102 T.C. 116, 129, 133-134 (1994) (denying taxpayer's settlement agreement allocation when taxpayer had "unfettered discretion to allocate the settlement").

[15] LTR 8833014.

[16] LTR 7742028 (July 20, 1977).

[17] Reg. section 31.3121(a)-1(i); *Social Security Board v. Nierotko*, 327 U.S. 358 (1946).

It is worth noting that employment taxes paid on lost wages are attributable to the year in which the payments are actually made and not the years in which the payments would have been made (for example, the years of forgone wages).[18] As an example, in the 1980s several professional baseball clubs were sued by the MLB Players Association for colluding and interfering with free agent negotiations in violation of the Players Association's collective bargaining agreement.[19] The claim was arbitrated and the clubs made payments in the 1990s. The clubs argued that the FICA and FUTA taxes paid should have been credited to the years for which the clubs would have made the payments rather than the year in which payments were made. The Supreme Court disagreed, noting that FICA and FUTA apply to wages paid "during the calendar year" and that the damages paid were "wages" in the year of actual payment.[20]

B. Payments Representing Lost Fringe Benefits

Settlement payments and damage awards frequently compensate for lost fringe benefits. Despite a fringe benefit's tax-free status during employment, cash payments representing lost fringe benefits are taxable to plaintiffs as wages. In *McKean*,[21] a class of flight attendants sought to exclude cash payments that represented lost fringe benefits from income. Under the settlement agreement, 15.8 percent of the approximately $32 million settlement agreement was allocated to damages for lost travel passes. The court noted that while Title VII intended to restore the flight attendants to the position they would have been in without discrimination, receiving cash is not the same as receiving a fringe benefit.[22] A cash settlement in lieu of fringe benefits allowed the flight attendants "to use the cash however they see fit," resulting in income to them. Thus, cash settlements representing fringe benefits are taxable as wages with the attendant reporting and withholding requirements.

C. Sexual Harassment

As part of the Tax Cuts and Jobs Act, Congress enacted section 162(q), limiting the deductibility of specific sexual harassment claims to employers. The code provides that no deduction is allowed for (1) "any settlement or payment related to sexual harassment or sexual abuse" if the settlement or payment is subject to a nondisclosure agreement, and (2) attorney fees "related to" the settlement or payment subject to the nondisclosure agreement.[23] The prohibition on the deductibility of attorney fees are only related to the employer's payment of attorney fees, not the employee-plaintiff's (for example, plaintiffs' payments to their attorneys as part of a contingency fee arrangement).[24]

There is little IRS guidance on section 162(q), and there is significant uncertainty regarding the treatment of sexual harassment complaints. Chief among the uncertainties is whether section 162(q) applies to an entire settlement if only one claim is a sexual harassment claim. A broad reading of the text may also suggest that all attorney fees relating to the settlement agreement, including attorney fees in prior years, are nondeductible. However, a more logical approach, consistent with caselaw, would be to determine the nondeductible portion of the fees and payments allocated to a sexual harassment claim based on the settlement agreement and the origin-of-the-claim test.[25]

To illustrate the issue, assume a plaintiff brings sexual harassment and gender-based discrimination claims against their employer. A year later, the parties settle, memorialized in a settlement agreement that includes a nondisclosure agreement. Under a broad reading of the statute, the employer may not be permitted to deduct the entire settlement payment and all

[18] *United States v. Cleveland Indians Baseball Co.*, 532 U.S. 200, 220 (2001).

[19] *Cleveland Indians*, 532 U.S. at 204. Fans of both baseball and tax should see also *San Francisco Baseball Associates LP v. United States*, 88 F. Supp. 2d 1087 (N.D. Cal. 2000); and *Phillies v. United States*, 153 F. Supp. 2d 612 (E.D. Pa. 2001).

[20] *Cleveland Indians*, 532 U.S. at 209, 215-216 (quoting sections 3121, 3301, and 3306(b)(1)).

[21] *McKean v. United States*, 33 Fed. Cl. 535 (1995),

[22] *McKean*, 33 Fed. Cl. at 539.

[23] Section 162(q).

[24] *See* Joint Committee on Taxation, "General Explanation of Public Law 115-97," JCS-1-18, at 195 (Dec. 20, 2018).

[25] *See Eisler*, 59 T.C. 634, 641 ("The tax character of [the taxpayer's] legal expenses must be determined pursuant to the same principles that governed the nature of the settlement payment.").

attorney fees. A more logical approach would disallow a deduction only for the portion of the payment and fees allocated to the sexual harassment claim under the settlement agreement's allocation and the origin-of-the-claim test. A reasonable allocation under the settlement agreement would likely be respected because the parties have competing tax interests.[26]

D. Physical Injury and Emotional Distress

Settlements may include payments for physical injury and emotional distress. While payments for physical injury and emotional distress are generally deductible to the employer, the tax consequences to the employee, and the employer's attendant reporting obligations, vary.

An employer's payment of damages, other than punitive damages, paid "on account of personal physical injuries or physical sickness" are excluded from an employee-plaintiff's gross income.[27] Emotional distress and associated psychosomatic discomfort are generally not considered a physical injury or sickness.[28] However, payments for emotional distress attributed to physical injury or physical sickness are excluded from the plaintiff's income.[29] To qualify for the physical injury exclusion, payments must be made to satisfy a tort or tort-like claim.[30] Payments under this exception are not reportable because they are excluded from income. Further, because they are not wages, there are no employment tax obligations.[31]

Payments for emotional distress not derived from physical injury are generally included in an employee's gross income. These payments are not considered wage payments because they are derived from tort-like claims, not wage claims from an employer-employee relationship.[32] However, payments for emotional distress incurred as part of a claim may be excluded from an employee-plaintiff's income if the payments represent reimbursements for otherwise deductible medical expenses under section 213 incurred in a previous year.[33] Payments for emotional distress included in an employee's gross income should be reported on Form 1099-MISC.

E. Fines and Penalties Paid to Governments

Government enforcement may affect an employer's ability to deduct settlement payments. Under section 162(f), no deduction is allowed "for any amount paid or incurred . . . to, or at the direction of, a government or governmental entity in relation to the violation of any law" or any government investigations "into the potential violation of any law."[34] The statute, which was amended by the TCJA, is broad enough to cover claims brought by any government entity — state, federal, or foreign — for a violation of law, including state and federal employment claims.[35] Notably, this involves payments "at the direction of" the government to third parties if those payments are penalties or fines for a violation of law, such as disgorgement or forfeiture.[36] Thus, section 162(f) also requires employers to consider

[26] In this instance, as discussed elsewhere, payments representing the gender-based discrimination claim are likely deductible to the defendant and wage income to the plaintiff (and thus subject to employment taxes). Payments representing the sexual harassment claim are likely not deductible to the defendant (if the settlement includes a nondisclosure agreement) and nonwage income to the plaintiff. Thus, the defendant would prefer to allocate payments to the gender-based discrimination claim and the plaintiff would prefer an allocation to the sexual harassment claim.

[27] Section 104(a)(2).

[28] Reg. section 104-1(c)(2); *Lindsey v. Commissioner*, T.C. Memo. 2004-113 ("Fatigability, occasional indigestion, and difficulty sleeping . . . are the types of injuries or sicknesses that Congress intended to be encompassed within the definition of emotional distress.").

[29] Reg. section 104-1(c)(2).

[30] *Commissioner v. Schleier*, 515 U.S. 323, 336-337 (1995); and *Shaltz v. Commissioner*, T.C. Memo. 2003-173.

[31] Employers should note, however, that there is a risk of IRS challenge if an unreasonable amount of settlement payments is allocated to physical injury because of the beneficial tax consequences to both parties — the employer receives a deduction while the employee excludes physical injury payments from income. Thus, employers should be diligent in documenting and reviewing the amounts allocated in the settlement agreement so that it is not disregarded.

[32] TAM 200244004.

[33] Reg. section 1.213-1(g); *see Sanford v. Commissioner*, T.C. Memo. 2008-158 (if no deduction is claimed for treating emotional distress under section 213, reimbursement of the incurred medical expenses is not required to be included in employee-plaintiff's income).

[34] Section 162(f)(1).

[35] *Id.*; reg. section 1.162-21(e)(1), (2); *see also* P.L. 116-97, Title I, section 13306, 131 Stat. 2127 (2017) (codified at section 162(f)).

[36] *See* section 162(f); T.D. 9946.

who is bringing the claims, not just the claims brought.

A deduction is permitted, however, for amounts paid to governmental plaintiffs that constitute "restitution . . . for damage or harm" caused by a violation of law.[37] Restitution is an amount paid or incurred to "restore, in whole or in part, the person . . . harmed, injured, or damaged by" the violation of law.[38] This includes payments for economic harm, whether made directly to the individual or disbursed by the government.[39] Restitution does not include payments reimbursing a government's investigation or litigation costs.[40] Nor does restitution include "forfeiture," which is a punishment by transferring ill-gotten gains to the wronged party, as opposed to amounts paid to make a victim whole.[41]

To qualify for the restitution exception, payments must meet the requirements outlined in the regulations.[42] Employers must (1) identify an amount paid as restitution or describe the harm suffered and action required in their settlement agreements, and (2) establish through documentary evidence that the amounts paid are for restitution.[43] Failure to follow these requirements can result in the disallowance of the entire settlement payment.

As many employment-related claims, including violations of Title VII and state equivalents, represent wage-based damages, the amounts paid to settle them may constitute restitution under section 162(f). This requires, however, that payments be made or disbursed to injured employees and that the agreement is appropriately structured. Thus, employers settling employment-related claims with government agencies, like the Equal Employment Opportunity Commission, should include tax counsel in settlement negotiations, including reviewing any settlement agreements.

F. Interest Payments

In general, interest payments are includible in an employee's gross income.[44] This includes interest awarded in addition to damages that are otherwise excludable from gross income, such as payments for physical injury under section 104(a)(2).[45] Also, interest payments are not wage payments for purposes of FICA and FUTA taxes.[46] Interest payments to employee-plaintiffs should be reported on Form 1099-INT.[47]

G. Payments to Plaintiffs' Attorneys

Generally, as part of a settlement agreement, an employer pays plaintiffs' attorneys, who make distributions to the employee-plaintiffs from a client trust account. These payments carry an unusual, and somewhat confusing, double-reporting requirement. Employers must generally report these payments as payments to an attorney on Form 1099-MISC and, depending on the nature of the payment, as payments to an employee on Form W-2 or 1099-MISC.

In general, payments to lawyers that exceed $600, regardless of whether the lawyers' services were for the payer, are reported on a Form 1099-MISC.[48] That is true regardless of whether the attorney retains some of the payment (for example, as a contingency fee), and even if there are additional reporting requirements for part or all of the payment.[49] Therefore, an employer is generally required to report all payments to plaintiffs' attorneys even if the employer has a separate reporting obligation for that same payment. Thus, when making settlement payments to a plaintiff's attorney, an employer should report the payment once on a Form 1099-MISC to the attorney and, if the payment is not excluded from the employee's income, a second

[37] Section 162(f)(2)(A).

[38] Reg. section 1.162-21(e)(4)(i).

[39] *See* reg. section 1.162-21(f)(2), (4).

[40] Section 162(f)(2)(B); reg. section 1.162-21(e)(4)(iii).

[41] T.D. 9946 (citing *Nacchio v. United States*, 824 F.3d 1370 (Fed. Cir. 2016)).

[42] Reg. section 1.162-21(b).

[43] Reg. section 1.162-21(b)(2), (3).

[44] *Kovacs v. Commissioner*, 100 T.C. 124 (1993).

[45] *Rozpad v. Commissioner*, 154 F.3d 1 (1st Cir. 1998) (interest is not damages); and *Brabson v. United States*, 73 F.3d 1040 (10th Cir. 1996).

[46] Rev. Rul. 80-364, 1980-2 C.B. 294 ("The payments for interest [on back pay] and the attorney's fee are not wages, because they are not remuneration for employment."). To be excluded from wages, the interest amount should be separately stated.

[47] LTR 932901.

[48] Reg. section 1.6045-5(a)(1); IRS, "Instructions for Forms 1099-MISC and 1099-NEC" (rev. Jan. 2022).

[49] Reg. section 1.6045-5(a)(i), (ii).

time on the employee's Form W-2 (if wages) or a Form 1099-MISC (if nonwage payments).

III. Settling Claims on Behalf of Employees

In addition to making payments to settle their own claims, employers routinely settle claims brought against codefendant employees under state and federal employment laws. Payments to release employees from employment-related claims may be deductible to the employer and excluded from employee compensation as a working condition fringe. Courts have held that settlement payments and attorney fees were not income to an employee when the employer was "acting in its own interest" or was obligated to pay those fees by state law.[50] The expenses must still meet the other requirements of a working condition fringe — namely, that they be deductible to the employee as ordinary and necessary business expenses under section 162 after applying the origin-of-the-claim test.[51]

If the settlement agreement and release do not meet the requirements for working condition fringe, the settlement payments may be compensation to the employee-defendant.[52] The payments may still be deductible to the employer except to the extent that the settlement represents fines or penalties to a government or governmental entity or are otherwise disallowed as a deduction.[53]

IV. Qualified Settlement Funds

The timing of settlement deductions is another issue encountered by employers, particularly when payments are made across multiple years. Typically, liabilities — including judgments and settlements — arising out of employment litigation are deductible when paid to the plaintiff.[54] Thus, under this general rule, an employer may deduct only the portion of the settlement payment paid in a tax year, even if the entire settlement amount is fixed by the settlement agreement. Payments to a qualified settlement fund allow a taxpayer to bypass the general rule and accelerate settlement payment deductions upon payment, even if actual payment to the plaintiff occurs in another year.[55]

A. Qualified Settlement Fund Formation

Under reg. section 1.468B-1, a qualified settlement fund is a fund, account, or trust that (1) is established with the approval, or by order, of a federal or state government, agency, or instrumentality (including a court) and is subject to that governmental authority's continuing jurisdiction; (2) is established to resolve or satisfy one or more claims arising from a breach of contract, tort, or violation of law (including employment law); and (3) the entity paid is either a trust under state law or the assets are otherwise segregated from the transferor's other assets.

It is important that "liabilities" for the purposes of a qualified settlement fund do not include liabilities under a workers' compensation scheme.[56] However, the creation of a qualified settlement fund to satisfy a workers' compensation claim and other claims, such as a discrimination claim, is allowed if the claims arise from the same event or related series of events.[57] In that instance, the amounts paid to satisfy the non-workers'-compensation claims are immediately deductible, while the amounts allocable to workers' compensation payments — following the general rule — are deductible only upon payment to the plaintiff.

B. Treatment as a Separate Taxpayer

A qualified settlement fund is considered a separate taxpayer for federal income tax purposes.[58] However, a qualified settlement fund is not taxed on amounts transferred to resolve or satisfy the liability for which the fund was created.[59]

[50] *Ruben v. Commissioner*, 97 F.2d 926 (8th Cir. 1938); *Ingalls v. Patterson*, 158 F. Supp. 627 (N.D. Ala. 1958).

[51] *See* reg. section 1.132-5(a)(1).

[52] TAM 8602002.

[53] *Id.*; *see also* section 162(f) and (q).

[54] Reg. section 1.461-4(g)(2).

[55] Reg. section 1.468B-3(c).

[56] Reg. section 1.468B-1(g).

[57] Reg. section 1.468B-1(h)(2).

[58] Reg. section 1.468B-2(a).

[59] Reg. section 1.468B-2(b)(1).

A qualified settlement fund is also considered a separate taxpayer for reporting purposes.[60] A qualified settlement fund steps into the shoes of the transferor to determine whether it has withholding and reporting obligations.[61] For example, if a qualified settlement fund makes distributions to a plaintiff representing lost wages, the qualified settlement will have withholding and reporting requirements because the employer that transferred those amounts to the fund would have had reporting and withholding requirements.

V. Conclusion

The tax treatment of employment litigation expenses leaves many traps for the unwary. Tax consequences can vary based on the claims brought, the underlying facts, the plaintiffs bringing them, and how the settlement is structured. Tax practitioners should be involved at the onset of litigation and throughout settlement negotiations to ensure proper tax treatment. ■

[60] Reg. section 1.468B-2(l)(2)(i).

[61] Reg. section 1.468B-2(l)(2)(ii)(A).