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Tax considerations in settling the case at mediation

ALLOCATION OF SETTLEMENT PROCEEDS AND THE TAX CONSEQUENCES MUST BE UNDERSTOOD WHEN NEGOTIATED WITH INSTITUTIONAL DEFENDANTS

In addition to all of the other factors one has to be prepared for in the mediation process, allocations of settlement proceeds and their tax consequences must be understood and often negotiated with institutional defendants. Many large defendants are aggressively attempting to reduce recoveries of plaintiffs and their counsel by insisting on draconian tax withholding and characterizations of settlements. This article will provide an overview of the different types of damages the settlement may allocate payments between, the tax consequences of those allocations, and the best ways to maximize the net settlement proceeds and minimize the negative tax consequences to your client.

Your role as an advisor

The first thing to understand in this process is to define your role in the representation of your client. Most of you, like us, are not tax advisors, CPAs, or tax attorneys. Therefore, you should not put yourself in the role of advising your client on the tax ramifications of any settlements. Our firm has a provision in our retainer agreement that states:

> Please note that any recovery by the client, whether by settlement, verdict or award, may or may not be taxable. Client understands and agrees that it is the obligation of the client to contact a tax accountant or tax lawyer to determine what tax consequences, if any, apply to the client's situation, as the attorney is not able to provide guidance or advice in this area.

We would strongly recommend this language to you. Furthermore, either before or certainly at the mediation, you should caution your client that much of the settlement proceeds may be taxable and that they should seek out professional advice if they are concerned about the tax ramifications of their settlement.

Invariably, even with all of these precautions, clients will come back to you a year or two from the settlement telling you that they heard you say they would not have to pay taxes. These precautions will go a long way to protect you.

History and evolution of tax issues in settlements

Prior to 1996, it seemed that the IRS pretty much ignored settlements and most were construed as non-taxable. However, in that year, Congress passed the Small Business Job Protections Act, which amended IRC § 104. Section 104 of the Internal Revenue Code is the exclusion from taxable income provision of the tax code that pertains to proceeds

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received from lawsuits, settlements, and awards. With the revision to § 104(a)(2) in 1996, the tax code now excludes from taxable income the amount of any damages received "on account of personal *physical* injuries or *physical* sickness." IRC § 104(a)(2) (emphasis added). Before 1996 that exclusion clause did not contain the word "physical," and as a result, there was much more room to argue that damages were attributable to "personal injuries."

Therefore, damage recoveries received in personal injury cases "on account of personal physical injuries or physical sickness" are still excludable as exempt income (i.e., not taxable). (26 U.S.C. § 104(a)(2).) The IRS's position is that observable or documented bodily harm, e.g., bruising, cuts, swelling, or bleeding, is evidence of personal physical injury. See, IRS Chief Counsel Advice (CCA) Memorandum 2009-035. Yet, damage recoveries related to employment claims and other types of tort claims are fully taxable, unless the amount in question was paid on account of "personal physical injuries or physical sickness." (See, 26 U.S.C. § 104(a)(2); *Lindsey v. Commissioner of Internal Revenue* (8th Cir. 2005) 422 F.3d 684, 688 [taxpayer can satisfy the prerequisite of damages being paid on account of personal injuries or sickness only by establishing a "direct causal link" between damages and physical injury or physical sickness].)

Emotional distress damages, including those associated with physical symptoms, e.g., insomnia, headaches, gastrointestinal issues, weight loss, eating disorders, high blood pressure, indigestion, urinary incontinence, periodic impotency, and fatigue, are taxable income (again, unless there is a "direct causal link" to physical injury or physical sickness). (*Lindsey, supra*, 422 F.3d at 688.) In fact, the 1996 amendment to IRC § 104(a) included the following addition: "For purposes of paragraph (2), emotional distress shall not be treated as a physical injury or physical sickness." (26 U.S.C. § 104(a); *Rivera v. Baker West, Inc.* (9th Cir. 2005) 430 F.3d 1253, 1256.) However, damage recovery for medical expenses attributable to emotional distress, i.e., actual "out of pocket" medical costs, are excluded from taxable income (if those medical expenses were not previously deducted under IRC §§ 111 and 213). (See, 26 U.S.C. § 104(a).)

Damage recovery for a claim of defamation equates to compensation for injury to one's reputation, which is not a "personal physical injury," and therefore, is taxable income. (*Polone v. Commissioner of Internal Revenue* (9th Cir. 2007) 505 F.3d 966, 969-970.) Damage recovery for a loss-of-consortium claim is likewise taxable, as are damage recoveries for assault or sexual harassment where there has been no physical touching. (See, *Shaltz v. Commissioner of Internal Revenue*, TC Memo 2003-173 [sexual harassment recovery taxable because damages recovered for mental anguish, humiliation, embarrassment and loss of benefits and other economic advantages of employment did not constitute personal physical injury or physical sickness]; see also, *Shelton v. Commissioner of Internal Revenue*, TC Memo 2009-116 [plaintiff's claim that she was "not the same person physically" as a result of sexual harassment did not satisfy § 104(a)(2)'s excludability requirement because settlement proceeds did not compensate her "for that physical injury"].)

In addition, for a long time, the payment of the contingency fee to the lawyer was considered a benefit to the employee and that was considered a taxable event. Therefore, in cases where there was a large award of attorney fees in a FEHA or Title 7 case, it was conceivable that the employee's tax bill would be so large that the aggrieved plaintiff would owe money at the end of the action. That culminated in the U.S. Supreme Court case, *Commissioner of Internal Revenue v. Banks* (2005) 543 U.S. 426, 427-430, which held that 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, which was decided together with *Commissioner of Internal Revenue v. Banaitis*.

As these cases arose, Congress passed the American Jobs Creation Act of 2004, which amended the tax code to enable employees to take an "above the line" deduction for their attorney's fees and costs incurred "in connection with any action involving a claim of unlawful discrimination." (26 U.S.C. § 62(a)(20), (e).) The amendment broadly defined a claim of "unlawful discrimination" to include claims under various federal antidiscrimination statutes (e.g., the ADA, ADEA, WARN Act, FMLA, etc.), any federal whistleblower statute, and any federal, state or local law "providing for the enforcement of civil rights" or "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." (26 U.S.C. § 62(a)(20), (e).) As a result, in at least discrimination and retaliation actions, the inequitable result set forth in the Supreme Court's holding in *Banks* no longer occurs.

In class-action lawsuits, attorney's fees are not income to the class members if (a) it was an "opt-out" class action, and (b) the class member did not have a separate retainer agreement with the attorney. (See, IRS Priv.Ltr.Rul. 200518017 (May 6, 2005).) The opposite is true for "opt-in" class actions in which the class claimants can all be identified. (See, Revenue Ruling 80-364; *Sinyard v. Commissioner* (9th Cir. 2001) 268 F.3d 756.)

Tax reporting of settlement payments to employees

Another critical area of tax policy that is still unsettled is how the alleged settlement should be allocated and reported. Will the employer issue a Form 1099 for the entire amount of the settlement, or will the employer constitute the settlement as payment for "wages" and issue a Form W-2? The latter is a critical area in evaluating a settlement and in making sure the attorney is compensated fully for the attorney's contingency fee.

If part of the settlement constitutes payment of "wages" to the current or former employee, then the IRS requires

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that the employer report that portion of the settlement payment on a Form W-2. Any part of a settlement paid to the employee for lost income, including back pay, front pay, severance pay, and unpaid overtime, constitutes "wages" and is subject to income and employment tax withholdings by the employer. Another thing to bear in mind when the employee is issued a Form W-2 for a wage allocation in a settlement is the impact on the employee if that employee received unemployment insurance benefits from the Employment Development Department ("EDD") that same year; the EDD may try to recoup some or all of the benefits it paid to the employee.

If the origin of the claim is for personal physical injury or physical sickness, then *all* damage recovery arising from the physical injury (other than for punitive damages) is considered payment received on account of physical injury or physical sickness, and therefore is not taxable and not reportable. For example, a plaintiff in a personal injury case who has sued for physical injuries from a car accident would not need to include the settlement payment as taxable income and would not be reported to the IRS, even if a portion of the settlement payment was for lost wages while in the hospital, or if a portion of the settlement payment was for emotional distress or loss of consortium if related to the physical injury from the car accident.

Summary of tax characterizations, treatment and reporting of settlement payments

Back pay: (other than lost wages for personal *physical* injury or *physical* sickness): taxable income, treated as wages subject to FICA and income-tax withholdings, reported on Form W-2;
Front pay: taxable income, treated as wages subject to FICA and income-tax withholdings, reported on Form W-2;
Overtime compensation: taxable income, treated as wages subject to FICA and income-tax withholdings, reported on Form W-2;
Dismissal and severance pay: taxable income, treated as wages subject to FICA and income-tax withholdings, reported on Form W-2;
Compensatory or consequential damages: (not paid on account of personal *physical* injury or *physical* sickness): generally taxable as non-wage income, reported on Form 1099-MISC, in Box 3 (for "other income;" do not include in Box 7, which is for "non-employee compensation" over $600 and results in self-employment taxes);
Compensatory damages or consequential damages paid on account of personal physical injury or physical sickness: generally not taxable income, no reporting requirement;
Punitive or liquidated damages: taxable as non-wage income, reported on Form 1099-MISC, in Box 3 (for "other income");
Costs: taxable as non-wage income, reported on Form 1099-MISC, in Box 3 (for "other income");
Medical expenses: generally not taxable income, no reporting requirement;
Interest: taxable as interest, reported on Form 1099-INT, in Box 1 (if $600 or more).

Tax reporting of attorney's fees and costs should generally have the same income tax treatment as the damage recovery for the underlying claims, i.e., the origin of the claim doctrine applies to attorney's fees and costs.
Attorney's Fees: generally treated as taxable income to employee, and reported to employee either on Form W-2 or Form 1099-MISC in Box 3 (determined based on nature of the action; if wages, reportable on W-2, if not wages, reportable in Box 3 of 1099-MISC), and reported to attorney in Box 14 of Form 1099-MISC; however, if the settlement payment is on account of personal *physical* injury or *physical* sickness, then the attorney's fees portion of the settlement is also not taxable income and not reportable.

Tax allocations agreed to at mediation

It is important that the allocation of settlement payments is detailed in the settlement agreement, including allocation of the settlement proceeds among the various claims at issue in the case, and the tax withholding and reporting for each allocated payment. If the parties fail to specifically allocate the amount of payments to the various claims involved in the matter and the tax reporting is later challenged, then the IRS and courts conduct a "facts and circumstances" analysis to determine the tax characterization of the settlement payment, with the most important factor often being the intent of the *payor*, i.e., the employer-defendant. (See, *Rivera v. Baker West, Inc.* (9th Cir. 2005) 430 F.3d 1253, 1257.)

The IRS and courts usually defer to the allocations memorialized in a settlement agreement, however, the IRS is *not bound* by the language of any settlement agreement (even if the settlement is approved by a court, if the IRS is not a party to the settlement agreement). (*Robinson v. Commissioner* (5th Cir. 1995) 70 F.3d 34.) If there is evidence that the allocations detailed in the settlement agreement were intended as payments for reasons other than those stated, then the IRS and courts look outside of the settlement agreement. (*Certain Underwriters at Lloyd's, London v. Oryx Energy Co.* (5th Cir. 2000) 203 F.3d 898, 901 [although parties may purport to allocate settlement payments to nontaxable categories of damages, the IRS may prove the parties' allocation is a sham to conceal payment of taxable damages].)

Because the "origin of the claim" determines the tax consequences of the damage recovery, the relevant inquiry by the IRS and tax courts must be: "in lieu of *what* were damages paid or awarded?" (*Delaney v. Commissioner of Internal Revenue* (1st Cir. 1996) 99 F.3d 20, 23-24; *Getty v. Commissioner of Internal Revenue* (9th Cir. 1990) 913 F.2d 1486, 1490 [utilizing "in lieu of" test to classify, for tax purposes, components comprising settlement amount].) Additionally, the IRS and courts will consider whether there was a bona fide adversarial settlement as to the amounts allocated between types of damage recoveries. (*Robinson v. Commissioner*, 102 T.C. 116 (1994), *aff'd* 70 F.3d 34 (5th Cir. 1995), *cert. denied* 519 U.S. 824 (1996).) Thus, while the IRS and courts

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will look at the allocation in settlement agreements, they may also look beyond the terms employed by the parties in the settlement agreement. For example, the IRS and courts turn to such things as demand letters, complaints, correspondence between the parties or their counsel, documented settlement negotiations, jury instructions, experts' reports and testimony, and verdicts and judgments, in order to reveal the true origin of the claims, as well as the nature and extent of the damages for each of the underlying claims.

It's more than just the amount of the check(s)

That brings us to what is becoming the most contentious issue in settlement negotiations with defendants at mediation. When a case settles in mediation, the money can be issued in a joint settlement check, in a series of multiple checks (one to employee for wages, subject to withholdings, and for which a Form W-2 will issue; one to plaintiff's counsel for fees and costs; and one to the employee for the non-wage portion of the settlement, for which a Form 1099 will issue), or in one gross check made payable to the attorney's client trust account. The defendant or defendant's insurance company then will issue a Form 1099 either to the client, to the client and attorney, or just to the attorney. While the rule is unsettled by some CPAs, the better rule is that the attorney has no obligation to issue a Form 1099 to his client. Bear in mind that this does not relieve the attorney from the obligation to issue 1099s to other attorneys, expert witnesses, jury consultants, etc.

The biggest issue that arises in this process is when the employer takes a position that a large portion of the settlement amount should be characterized as "wages" and reported on a Form W-2. Most employers who insist on any wage reporting will take a portion of the client's share of the settlement and issue a Form W-2 for that portion. However, Walmart and numerous other large institutional defendants have a policy of issuing a Form W-2 for fifty (50%) percent of the gross settlement. That can be problematic.

For instance, in a discrimination case, if you have a proposed settlement of $75,000, a contingency fee of 40 percent, and recoverable costs of $10,000, you will have a problem. The amount to your client will be $35,000 and the amount to the attorney will be $40,000. However, by allocating 50 percent of the total settlement as "wages" for tax purposes, the defendant will issue a check for wages to your client for the gross sum of $37,500 (subject to tax withholdings), and the remainder will be issued for $37,500 to the attorney's client trust account. In that situation, the client will have to write the attorney a check, but will then have paid taxes on an amount that would have been deductible from income as an "above the line" deduction for attorney's fees.

Tax discussions pre-mediation

Determining *when* to raise tax considerations during the mediation process is a major decision. Many mediators will tell you that you should not raise these issues until you have a deal on the financial issues in the case. That is the way our firm traditionally handled these issues, and the apportionment of the settlement proceeds was just another negotiated term. However, with the aggressiveness of some defendants in this area, we do not believe that this approach works any longer. First, you will need to be able to explain to your clients how the settlement will result in a net recovery to them. Second, as stated previously, it is possible that you will find your fees cut as a result of tax allocation of the settlement.

We have therefore taken the approach with certain defendants to raise the issue in advance. In at least one case, we have refused to mediate with a defendant because of their tax allocation policy. In any event, it is best to address this issue at the outset.

Ways to approach taxation of settlements

Find a physical injury

Certainly, if you can establish that your client was the victim of a willful *physical* assault, a good portion of the settlement will not be taxable. This position will be strengthened if your client has medical records that support some physical injury (e.g., bruising, cuts, swelling, etc.). In those instances, it is best to minimize any lost earnings claim (unless you can show a direct link between the *physical* injury and the loss of income). Also, where you have a disability discrimination case, you might be able to argue that the employer's failure to accommodate a physical disability made the condition worse, such that in that instance, the physical injury would be non-taxable.

Allocate the settlement payment(s) to nontaxable damages or to non-wage claims to the largest extent possible

However, be aware that where the parties' interests regarding taxability are *not adverse*, the IRS may restructure allocations that were motivated by tax reasons other than by economic reality. (See, *Delaney v. Commissioner, supra*, 99 F.3d 20, 26-27; see also, *Robinson v. Commissioner* (5th Cir. 1995) 70 F.3d 34, 37-38.) Therefore, when negotiating the characterization and allocation of settlement proceeds with opposing counsel, be sure to articulate the reasons why only X amount should be designated as "wages" (e.g., only small amount of lost wages or unpaid compensation as compared to the emotional distress damages in the case), or why some or all of the settlement should be nontaxable income (e.g., your client's damages are on account of a personal physical injury or physical sickness). ***Structure the settlement with periodic payments rather than one lump sum payment***

Although it depends on the size of the settlement and on the amount of your client's other taxable income for the year, it is very likely that receiving settlement proceeds in one lump sum will force your client into a higher tax bracket. This negative tax consequence from a lump sum payment can potentially be reduced by spreading the settlement payments across more than one tax period. For example, the settlement could be structured so that half is paid the year of the settlement, and the remainder the

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following year, or even structured over the course of multiple years. Before doing that, however, your client should consult with a tax professional to get a breakdown of the anticipated taxes and net proceeds of a single lump sum payment versus periodic payments, in order to gauge whether the difference (if any) is significant enough to prefer periodic payments. Other considerations include: whether there is reason to believe the defendant will still be operating in future years and able to continue making payments; how any recent or anticipated changes to the tax code may affect the amount of your client's settlement that is taxed; and whether your retainer agreement explicitly states how and when your contingency fee is paid out of a settlement structured with periodic payments – do you recoup the full amount of your contingency fee before any proceeds are paid to your client, or do you recoup your contingency fee on a pro-rata basis?

Taxation of jury verdicts and court judgments

A final area of concern is what happens when there is a court or jury verdict or an arbitration award. Traditionally, the defendant sent the gross payment of the award to the plaintiff's attorney to satisfy the judgment. With regard to *former* employees who obtained a verdict (as opposed to current employees), this common practice of sending a check for the gross amount of the verdict (without any withholdings) to plaintiff's counsel was supported by the Court of Appeal's opinion in *Lisec v. United Airlines* (1992) 10 Cal.App.4th 1500.

In *Lisec*, the plaintiffs obtained a jury verdict and were awarded compensatory and punitive damages for United's retaliatory termination of their employment and for intentional infliction of emotional distress. United unilaterally withheld taxes from the awards it paid to the plaintiffs, so the plaintiffs only acknowledged partial satisfaction of the judgment. The trial court denied United's subsequent motion to compel plaintiffs to acknowledge full satisfaction of the judgment, finding that "a withholding under these circumstances" was not appropriate "regardless of whether or not the proceeds of the judgment are taxable as income." (*Id.* at 1503.) United appealed.

The sole issue on appeal was whether the damages awarded to the plaintiffs as former employees were properly characterized by United as "wages" subject to tax withholdings. The Court of Appeal determined that United, as the *former* employer, was not required to withhold payroll taxes from the award of lost wages to its former employees. In reaching its decision, the court reasoned that because payment of the award was not made within the context of an ongoing employment relationship (i.e., the award of back pay covered a period of time when the employee did not actually perform any services for the employer), the award could not constitute "wages," and thus, the award could not be subject to withholdings of state and federal income or social security taxes. The *Lisec* court concluded that the employees were therefore entitled to the total amount of the judgment as entered, and the trial court judgment was affirmed.

Unfortunately, the holding in *Lisec* has been seriously called into question by a recent appellate decision, *Cifuentes v. Costco Wholesale Corp.* (2015) 238 Cal.App.4th 65, 68-69. In *Cifuentes*, the plaintiff won a judgment on his breach of contract claim against Costco, his former employer, and Costco unilaterally withheld $116,150.84 in state and federal payroll taxes from the award of $301,378 attributed to lost wages. The plaintiff claimed that he should have been paid the full amount of the judgment, issued a 1099 tax form for the lost wages, and permitted to pay any taxes due directly to the taxing authorities, and upon that basis, he refused to acknowledge full satisfaction of the judgment (even after receiving $69,078 in tax refunds from the IRS and California Franchise Tax Board). The trial court, relying on the holding in *Lisec*, ruled that Costco's withholding was improper, that the judgment therefore had not been fully satisfied, and denied Costco's motion for acknowledgement of satisfaction of the judgment. An appeal ensued.

The Court of Appeal determined that reexamination of precedent and of subsequent developments was necessary, given that 23 years had passed since *Lisec* was decided. The *Cifuentes* court proceeded with a thorough discussion of the pre-*Lisec* and post-*Lisec* interpretations of applicable tax laws by courts in other jurisdictions, which led to the court's decision to decline to follow *Lisec* and to instead adopt the prevailing federal view and conclude that Costco properly withheld the payroll taxes, explaining, "Our review of current IRS and federal decisional authorities persuades us that an employer who fails to withhold payroll taxes from an award of back or front pay to a former employee exposes itself to penalties and personal liability for those taxes."

The court discussed the dilemma that employers face when paying a judgment and sided with the employer: "When Costco paid the judgment, it had two alternatives. It could follow *Lisec* and risk liability to the IRS and other taxing authorities for the amount of tax it failed to withhold plus penalties. Or it could follow the prevailing federal view and risk a judicial declaration that the judgment is not satisfied. We conclude it chose correctly. Costco's potential exposure for failing to withhold the payroll taxes outweighed the inconvenience to Cifuentes of seeking a refund for the excess withholding." The court also emphasized the importance of having consistency among the state and federal courts so that employers and employees have an easier time discerning whether a settlement or judgment constitutes wages subject to tax withholdings or whether the payment constitutes income from which withholdings are not necessary.

Cifuentes also tried to argue that the withholding was improper because it did not account for his obligation to pay his attorney's contingency-based fee; however, the court rejected that argument as well. Citing *Banks*, the court held that "the entire award of lost wages was taxable as income regardless of whether a portion was used to pay contingent

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attorney fees." Although Cifuentes referenced the American Jobs Creation Act of 2004 which authorizes an "above the line" deduction of attorney fees and costs incurred in connection with claims of discrimination and retaliation, Cifuentes' award was for his breach of contract claim, not for unlawful discrimination or retaliation.

Following the California appellate court's opinion in *Cifuentes*, employers now scrutinize the itemized damages in the verdict, and will issue a Form W-2 for the portion of the verdict that constitutes "wages" and withhold taxes on the "wages" before issuing a check to the plaintiff.

Authors *NOTE: Tax laws change periodically, and you should consult with a tax professional for the most up-to-date advice. The information contained in this article is not intended as tax advice and is not a substitute for tax advice.*

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