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Tax Aspects of Settlement Payments

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I. Overview and Basic Principles

- a. Gross income generally includes all income from whatever source derived. IRC 61(a). This broad definition is intentionally designed to cover all gains or accession to wealth, unless otherwise specifically excluded by another section of the federal Tax Code. *Commissioner v. Schleier*, 515 U.S. 323 (1995); *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).
- b. General rule. When a payment is made to an employee who asserts a claim, whether the payment is made by a mutually agreed and negotiated settlement or court judgment, and even if the payment due to the employee is made to a third-party for or on behalf of the employee, such as the employee's attorney, the amount paid is includable in the employee's income. *Commissioner v. Banks*, 543 U.S. 426 (2005) (litigation recovery payment includes full amount paid even if a portion is paid to an attorney under a contingency fee arrangement per the "anticipatory assignment of income" doctrine).
- c. Taxable settlement payments include:
 - i. Salary, wages, back or front pay, severance pay or overtime pay;
 - ii. Benefits;
 - iii. Damages, including punitive, liquidated or compensatory damages;
 - iv. Interest, whether pre- of post-judgment or award;
 - v. Loss of enjoyment of life, humiliation, reputational or emotional distress type payments;
 - vi. Attorneys' fees and costs of litigation
- d. Non-taxable payments which are excluded from income and, thus, need not be reported include:
 - i. Payments for personal physical injury or physical sickness;
 - ii. Emotional distress but only when accompanied by physical sickness;
 - iii. Out-of-pocket (deductible) medical expenses. IRC 104.
- e. Congress amended IRC 104 in 1996 to add the condition that payments for "injury" or "sickness" must be "physical" in nature; the legislative history makes clear that the target of this amendment was the context of employment litigation and settlements

where payments were deemed nontaxable as arising from emotional distress damages which are difficult to quantify. H.R. Conf. Rep. No. 104-737, 104th Cong., 2d Sess., 300 (1996).

II. Determining Correct Tax and Reporting Treatment of Employment-Related Settlement Payments

- a. IRS announced position: Determination requires a four-step process:
 - i. Determine both (1) the character and (2) the nature of the claim that gave rise to the payment in the first place;
 - ii. Determine whether the payment constitutes an item of gross (taxable) income to the payee;
 - iii. Determine whether the payment is wages for employment tax purposes;
 - iv. Determine the appropriate reporting for the payment, including any portion designated as or paid for attorneys' fees.
- b. As a general rule (call it the "default" position), the IRS prefers any payment be treated as wages for both withholding and reporting purposes. Such treatment results in withholding at the source of payment (employer) and the more immediate remittance of tax revenue.

III. Character of the Payment – Typical Examples

- a. Severance pay. An amount generally paid upon the involuntary termination of employment; it is calculated, typically, on an employee's length of service.
- b. Back pay. An award for a time period when the employee would have provided services but for some claimed wrongful conduct by the employer. And, for example, some federal statutes, such as Title VII of the Civil Rights Act of 1964, and the Age Discrimination in Employment Act (ADEA) of 1967, specifically provide for back pay as a recoverable remedy for wrongful conduct even if services were not actually provided by the individual.
- c. Front pay. Remuneration that would have been paid after a settlement or judgment award that failed to occur (e.g., as a result of extreme animosity between the employer and the employee) even when no actual services were provided by the individual.
- d. Damages. These include compensatory (to compensate for the actual or alleged injury) and/or consequential (to cover losses or damages that do not flow immediately or directly from the alleged injury but occur as a consequence or result of any wrongful act).
- e. Punitive damages. These are, as the name suggests, designed to punish for wrongdoing; also, a subset includes liquidated damages as a set, fixed or pre-