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Settlement Taxation

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Sample Settlement Payment Template

Claimant Name: _____

Claimant ID # (if employee): _____

University account to charge: _____

If payment is to claimant's attorney[1]:

Attorney Name: _____

Attorney Address: _____

Attorney TIN: _____

$_____ **Wages** (W-2)
Includes most payments to current or former employees, such as front pay, back pay, and amounts allocable to claims under the ADA, ADEA, and FLSA. May not include amounts allocable to a claim of emotional distress.
Submit form to Payroll.

$_____ **Non-taxable**
Includes refunds, and amounts allocable to a claim of physical injury.
Submit form to Disbursements.

$_____ **Non-wage taxable income** (1099-MISC or 1042-S)
Includes all other payments.
Submit form to Disbursements with claimant's Form W-9 or Form W-8BEN.

[1] Report payment on Form 1099-MISC Box 14 to attorney *in addition to* any required reporting of payment to claimant.

UPDATES

1. New Section 162(q) – No Deduction if Sexual Abuse/Harassment Settlement or Payment Subject to Nondisclosure Agreement

a. Under prior law, an employer could generally deduct settlement payments made to a plaintiff, related plaintiff's attorney fees, and any legal fees the employer incurred for its own defense. Because confidentiality agreements entered into in connection with these settlement payments have been characterized by many as "hush money," as part of the 2017 tax reform legislation Congress enacted new section 162(q), which provides that no deduction shall be allowed 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."

b. This new provision increases the cost of confidentiality. The employer's cost rises because it is no longer able to deduct the settlement payments or attorney fees. College and university employers generally claim deductions only in connection with an unrelated trade or business and are therefore unlikely to be impacted directly by this new nondeductibility. However, if a settlement relates to a unit that conducts an unrelated trade or business, a college or university attorney may wish to take into account the increased cost in deciding whether to request, or to agree to, confidentiality. Additionally, college and university return preparers may wish to establish a process for identifying nondeductible settlements and backing out any such amounts from the organization's deductions against unrelated business income.

c. The scope of the disallowed deductions is unclear. While it covers the settlement payment itself and attorneys' fees, does it cover other related costs, such as expert witness fees, outplacement benefits provided, or COBRA payments?

d. The statute seems to also prohibit a plaintiff from deducting fees paid to his or her own attorneys. Under prior law, when the employer paid the plaintiff's attorneys' fees, the plaintiff had income that was offset by the plaintiff's deduction for the fees, thus resulting in no net tax. But if the plaintiff can no longer deduct these fees, he/she may have income equal to the fees paid by the employer – funds that the plaintiff never received.[1] Plaintiffs may now be less inclined to request confidentiality, and less inclined to agree to an employer's request for confidentiality.

e. In any case where there is a broad settlement of a number of different claims (including one for sexual abuse or harassment) with an overall confidentiality agreement, the parties should consider making a clear and specific allocation of the amount attributable to the sexual abuse/harassment claim.

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[1] It appears that this result was unintended. *See* https://www.menendez.senate.gov/news-and-events/press/menendez-calls-on-gop-to-fix-its-tax-bill-to-protect-victims-of-workplace-sexual-misconduct- .

2. *Cosentino v. Commissioner*, T.C. Memo. 2014-186, *nonacq*. AOD 2016-01

The Tax Court held in 2014 that taxpayers were not taxed on most of the payment they received in settlement of a malpractice claim against their accountants who had advised them to use a tax-avoidance scheme to increase their basis in rental property that they then disposed of. The Court said that this part of the settlement represented a nontaxable replacement of taxpayers' capital because, but for the tax-avoidance scheme, the taxpayers would have continued to defer tax indefinitely on any gain realized on the dispositions of appreciated properties in tax-free like-kind exchanges.

In 2016, however, the IRS disagreed with this decision, finding that the settlement amount the taxpayers received was not a restoration of lost capital but was instead compensation paid by the accounting firm for a portion of the federal income tax the taxpayers properly owed, and therefore should be included in the taxpayers' gross income as an accession to wealth.

3. Cases where settlement pertains to both employee and independent business activities

In these situations, the "origin of the claim" test requires that the settlement-related expenses be directly related to the taxpayer's separate trade or business to be deductible as Schedule C business expenses. For example:

a. In *Sas v. Commissioner*, T.C. Summary Op. 2017-2, plaintiff incurred legal expenses while suing her former bank employer for unlawful discrimination. The Court held that she could not deduct those expenses as ordinary and necessary business expenses of her post-employment accounting practice, even though she maintained that her lawsuit would have an adverse effect on her professional reputation and could damage her accounting business's reputation.

b. In *Dulik v. Commissioner*, T.C. Summary Op. 2017-51, the taxpayer incurred legal fee expenses in separating from his employment position, including expenses related to a noncompete agreement. The Court held that the origin-of-the-claim test applied, and the legal fees were treated as employee business expenses related to his former job, not to the consulting business the taxpayer formed after leaving the employer. The Court rejected the taxpayer's argument that he only hired the attorneys because he was concerned that the noncompete agreement would interfere with his plans to consult for his former employer's competitors. The origin of the claim was based on his employment, and subsequent potential consequences of the settlement terms were irrelevant.

Title search: Settlement Taxation

Also available as part of the eCourse
Taxation of Litigation Settlement Payments for Colleges and Universities

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