Tax Issues in the Resolution of An Employment Dispute

BY JOEL CROUCH

Resolving employment related disputes can be a difficult and emotional process for both employees and employers. In addition to the legal and emotional implications, resolving employment disputes pose potentially significant tax implications. Failure to properly address and account for such tax issues can subject one or both parties to substantial tax liabilities. For example, if the parties attempt to avoid income tax by misclassifying the settlement proceeds, the employee may be responsible for all taxes, including the employer's portion. Likewise, the employer could have liability for failure to properly withhold taxes from any payments and submit those withheld taxes to the IRS.

This article will discuss three tax items that are common in employment dispute resolution: taxability of payments to the employee, reporting of payments to the IRS, and tax treatment of attorney's fees. Depending on the particular facts and circumstances, there may be other tax issues that should be considered and addressed in any resolution.

As a general rule, damages that are recovered in an employment-related dispute are included in the employee's income, including back pay, front pay, damages for emotional distress, punitive or liquidated damages, and interest. Excluded from income are damages for an observable or documented physical injury or sickness. However, physical symptoms resulting from emotional distress unrelated to any physical injury are not excludable from income.

Once the allocation of payments is agreed upon, the employer must determine how the payments will be reported to the IRS and whether withholding of tax by the employer is required. Payment of wages or wage equivalents, such as back pay or lost earnings, should be processed through the employer's payroll system. The payments must be reported to the IRS on a Form W-2 and the employer must withhold and remit tax to the IRS. In addition, the employer will be responsible for its portion of the FICA tax on any payments reported to the IRS on a Form W-2. An employer who fails to properly withhold and remit taxes to the IRS may have liability to the IRS for failure to do so. Payment of attorney's fees, punitive damages, damages for nonphysical injuries and interest are not wage equivalents and are reported to the IRS on a Form 1099-MISC. The employer is not required to withhold and remit payments to the IRS for these items and does not pay any portion of the FICA taxes.

In a settlement agreement, the parties can agree to allocate payments between taxable and non-taxable, how the payments should be reported to the IRS and any withholding requirements. The agreement should set forth the rationale for allocation of any payment for damages, the method for reporting to the IRS and the withholding agreement. Although the IRS is not bound by the terms of any agreement between the parties, the IRS will accept the parties' agreement if it is entered into in an adversarial contest, negotiated at arm's length and entered in good faith. In addition, both parties should report the payments consistent with the terms of the settlement agreement. Because the IRS may later challenge the terms of the settlement agreement and determine the employer failed to properly withhold and remit taxes to the IRS, an employer should include indemnification language in the settlement agreement. And if the IRS challenges the allocation in the agreement, the employee may be required to provide evidence of income tax payment.

In general, attorney's fees received in a settlement of an employment dispute are included in the gross income of the employee, even if the fees are paid directly to the attorney. However, if the attorney's fees relate to damages that are not taxable, such as for a physical injury or sickness, the attorney's fees are not includable in the employee's gross income. However, if the attorney's fees are included in the employee's gross income, the employee may be able to deduct the fees either as an above-the-line deduction, offsetting the income, or under Internal Revenue Code Section 212 as expenses incurred for the production of income.

Overall, tax issues can be a complex and important part of employment disputes. Employees and employers should work closely with their attorneys and tax advisors to make informed decisions and avoid unexpected tax consequences. **HN**

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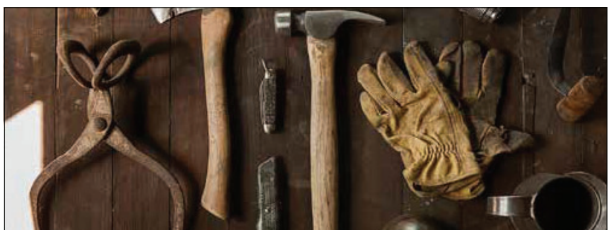

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