

April 7, 2009 - Note the law relating to the taxation of damages has continued to evolve and change since this article was written/published

# Accounting for Damage Awards

*If your company gets sued,  
here's how to book it*

*by Michael Fay, Edward Jajeh, and Gregory Wilson*

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**E**MLOYEE lawsuits have become very common. Employees sue their employers for, among other actions, fraudulent hiring practices, negligent supervision, denial of pay raises or promotions, assault and battery, defamation, breach of contract, discriminatory treatment, misrepresentation, and infliction of emotional distress.

In today's litigious business climate, an employer's exposure to liability is enormous. In 1994 alone, employees won more than one-half of the jury verdicts, and the average plaintiff's jury award in an employment case was \$875,620.<sup>1</sup>

For the accountant, the growing complexity of tax laws dealing with settlements has become a significant issue. Once the attorneys settle a case or a judgment is entered, the burden shifts to the accounting department to decide whether the payment constitutes income, and if so, how the payment should be reported. The method of payment is important because, if withholding is required, it must be done before the company pays the money. If not, the employer can face severe IRS penalties, and then must go back to the employee to regain any money erroneously paid.

This article explains the current tax law so that employers can properly characterize and report a damage award or settlement

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### Glossary of Terms

**Compensatory damages.** A monetary award equivalent to the actual value of the injuries or damages sustained by the aggrieved party, intended to make the victim whole.

**Punitive damages.** A monetary award intended to punish the wrongdoer (rather than to compensate the victim).

**Settlement.** An agreement made between two parties to settle a dispute. For purposes of this article, a settlement includes a court or jury judgment award because the tax law makes no distinction between the two. It is also immaterial whether the payments are made all at once or over a period of time, except for cash-basis employers who can only deduct payments when made.

**Tort.** A private or civil wrong or injury. A wrong independent of contract.

payment to a current or ex-employee arising from a tort. Note that the article is not intended to supplant legal advice an employer may need; it is meant to provide practical guidance to help recognize issues deserving timely legal counsel.

### Overview of the Old Laws

In 1918, Congress enacted legislation that excluded from taxable income amounts received as compensation for personal injury or illness through accident or health insurance or under workman's compensation. The Internal Revenue Code (IRC) of 1939 contained a section on personal injury awards, which became IRC Section 104 of the 1954 Code and remained in the 1986 Code. IRC Sec. 104 specifically excluded from taxable income money received in settling a personal injury lawsuit. The rationale was that such settlements merely restored the individual to his or her previous position before the injury.

Despite the above laws, there were often questions on what constituted a "personal injury." Some courts and the IRS allowed the exclusion of nonphysical personal injury awards. The IRS regulations also allowed amounts received through the prosecution or settlement of legal actions based on tort-like rights to be excluded from income.

However, by amending IRC Sec. 104 in 1989, Congress included into income punitive damages awarded in nonphysical injury cases. One of the first of several landmark Supreme Court decisions in the

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*Under the new law, damages received from a physical injury or sickness are nontaxable.*

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damages area was *Burke*, in which the Court did not allow amounts received as the result of a claim alleging racial discrimination under Title VII of the Civil Rights Act of 1964 to be excluded from income because there was no "personal injury."<sup>2</sup> More precisely, based on the lack of tort-type remedies, the Court held that the back pay was not excludable from gross income.

In another decision, *Schleier*, the Supreme Court tried again to clarify the language of IRC Sec. 104. Mr. Schleier was fired as a pilot for United Airlines because he attained 60 years of age.<sup>3</sup> He sued under the Age Discrimination in Employment Act (ADEA) and settled out of court. In this case, the Court stated that the damages awarded under the ADEA were not on account of a personal injury and were therefore taxable income. This decision established a two-part test to determine if damages may be excluded from income under IRC Sec. 104:

1. The compensation must be received because of personal injuries or illness.
2. The lawsuit must be based on common law tort or tort-type rights.

### **The New Law**

In an effort to provide guidance to the IRS and to settle disputes among different courts, Congress changed the law to be specific about what cannot be excluded from income. The Small Business Job Protection Act of 1996, signed by President Clinton on August 20, 1996, amended IRC Sec. 104 by always including punitive damages in taxable income, thereby requiring the income to be reported to the IRS on Form 1099.

In addition, the new law specifies that any damages received on account of a physical injury or sickness are nontaxable income. Furthermore, the new law allows an award for emotional distress due to personal injury or sickness to be nontaxable. For example, if a person experiences emotional distress from an injury sustained in a motor vehicle accident, the damages received for the emotional distress are nontaxable income.

However, the new law excludes emotional distress itself from being treated as a physical injury or sickness. An award for emotional distress alone is treated as taxable income, except for medical care expense reimbursements, which are nontaxable.<sup>4</sup> Similarly, damages for employment discrimination or injury to reputation accompanied by a claim of emotional distress are fully taxable and

must be reported to the IRS on Form 1099 (no withholding required).

The Small Business Job Protection Act applies to amounts received after June 30, 1996. For settlements prior to this date, the Supreme Court decision in *Ogilvy* may apply. In *Ogilvy*, the Court held that punitive damages awarded in connection with a physical injury or illness are taxable under prior law.<sup>5</sup>

### How to Report Settlements

When awards are includable as income, then *the company must report the income to the IRS.*

One of two forms may be used to report the income—Form W-2 or Form 1099. The difference between the two forms is significant.

- For income reported on a W-2, the employer is required to pay one-half of the social security taxes, which may be significant. The employer is also required to withhold federal income tax.
- For income reported on a Form 1099, the employer is required to report only the income and has no withholding requirement.

Therefore, generally, an employer paying out damage awards would want the income to fall within the Form 1099 reporting requirement. Before discussing under what conditions each form should be used, a brief discussion of the statutory requirements is helpful.

For withholding purposes, wages are defined under IRC Sec. 3401 to mean "all remuneration for services performed by an employee for his employer." Pursuant to IRC Sec. 3402, an employer is required to withhold taxes from wages. The employer is required under IRC Sec. 6051 to report wages paid to an employee and amounts withheld on Form W-2.

In addition, all persons in a trade or business who make payments to another in the course of such trade or business must report such income under IRC Sec. 6041. These payments include rent, salaries, wages, or other fixed and determinable gains, profits, and income of \$600 or more. The IRS designates Form 1099 for these payments. This form is solely an information reporting requirement imposed on an employer, and income associated with the form is not subject to any withholding requirement.

To decide which form to use, the following questions must be asked:

- What exactly are the payments for?
- Is/was the individual employed by the company?
- If back pay or lost wages are being paid, were there services rendered for the award payment?

The employer should also request the recipient's taxpayer identification number.

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*Generally, all noncompensation (nonwage-related) taxable awards are reported on Form 1099.*

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Generally, all noncompensation (nonwage-related) taxable awards are reported on Form 1099. This includes settlements not excluded from income under IRC Sec. 104 that are not related to services rendered. In other words, if the payments are income and not remuneration for services performed, the income must be reported on Form 1099. Because payments made for punitive damages are always taxable income to the recipient, they should be reported by the employer on Form 1099. Punitive damages are in no way payments or remuneration for services performed.

Similarly, lost wages are reported on Form 1099. Recall that the statutory language poses the following question: Are the payments made in remuneration for services rendered? For example, consider the case of an individual who is fired from a company and subsequently sues the company for lost wages. Any settlement or award of this claim can be reported on Form 1099, with the company not withholding any taxes. These payments are not "remuneration for services rendered" as required in the definition of wages for withholding purposes under IRC Sec. 3401.

In contrast, payments made as remuneration for services rendered by an employee for an employer are wages subject to withholding and therefore reportable on Form W-2. For example, back pay when it is the underpayment to individuals for services rendered fits in this category. Consider the case of a person who works for a company for 10 years, and the company was subsequently found to have underpaid the employee because of discrimination or other cause. In this case, the settlement or award is usually considered back pay. Therefore, an award would be considered payment for services rendered, and Form W-2 should be used. In addition, the appropriate withholding is also required.

Although there is still room for interpretation, these authors believe that reporting under Form W-2 should be specifically limited to circumstances when the payments are directly related to services rendered in an employer-employee relationship. All other payments included in income may be reported on a Form 1099.

### **Multiple Claims**

Frequently, many causes of action are included in a single complaint, and a settlement or judgment award may comprise payments for various causes of action. In some judgment awards, the amounts for wages, punitive damages, and emotional or physical injuries are identified, but in many out-of-court settlements, the various components of the award are often not broken out. When this is the case, the settlement agreement must be studied because it may categorize most of the payment as payment for nonwages or nonincludable payments, as opposed to back pay.

When determining how payments should be characterized, the accountant should begin by looking at the factual circumstances. As mentioned above, the characterization of the funds awarded by a jury or judge would most likely be upheld by the IRS. Some settlement agreements are drafted to benefit the parties by identifying the funds as (1) nonincludable income or (2) nonwages for withholding purposes. Because the IRS may recharacterize the transaction, the parties should be careful in drafting settlement language similar to the original/amended complaint.<sup>6</sup>

As a general rule, an express allocation in a settlement agreement will be respected in determining the federal income tax consequences if, and only if, the parties are adversarial, the context is arm's length, and the agreement is entered into in good faith.<sup>7</sup> But in *Robinson*, the Tax Court refused to respect the allocation of damages set forth in an approved settlement agreement because the damages did not truly reflect the actual injuries sustained, based on the original complaint and causes of action.<sup>8</sup> If the amounts do factually represent the appropriate allocation, then a court should respect the allocation.<sup>9</sup> Consequently, while settlement agreements can be a guide, a company should make sure that the allocations in the agreement reflect the actual circumstances.

### **Risk of Not Reporting**

An employer may be exposed to a statutory penalty if it fails to properly report a taxable settlement made to an individual. Under IRC Secs. 6721 and 6722, penalties are imposed on a company for failure to file correct information returns and for failure to furnish correct payee statements. The penalties for failure to file the correct information returns are currently \$50 for each return, not to exceed \$250,000 during any calendar year for a single taxpayer. For failure to furnish correct payee statements, the penalty is \$50 for each statement, not to exceed \$100,000 during any calendar year for a

single taxpayer. When the failure to file is intentional, other penalties will apply and may be significant. For example, if a \$300,000 settlement payment was intentionally not reported to the IRS or the taxpayer, a company could pay penalties amounting to \$60,000. Congress is currently contemplating an increase in these penalties.

### **Case Studies**

#### ***Case 1: Wrongful Termination Based on Age, Gender, or Race***

##### Facts

Sally Hunt filed a complaint against her employer alleging that she was terminated from her employment position because of her race. Sally included in her allegations that she suffered emotional distress from the employer's wrongdoing, which also caused her actual physical sickness (headaches, nausea, etc.).

The employer paid Sally \$50,000 in full settlement of her claim. The \$50,000 was allocated in the settlement agreement as compensating Sally in part for lost wages and in part for her emotional distress arising from the wrongful termination.

##### Analysis

The full \$50,000 payment is currently taxable to Sally under IRC Sec. 104 because the origin of Sally's claim is not an actual physical injury or sickness. Her actual sickness that resulted from her emotional distress is not considered an actual physical injury or sickness for purposes of excluding the damages under IRC Sec. 104. However, because none of the \$50,000 payment represents back pay or remuneration for services rendered, no portion of the payment constitutes wages. Accordingly, employer withholding does not apply to the payment, and the full \$50,000 payment is properly reportable by the employer on Form 1099.

This analysis would be equally applicable if Sally had been fired from her position based on age, gender discrimination, or whistle blowing. A defamation action is treated similarly to a discrimination action in that damages paid are taxable and reportable on Form 1099 because the claim is not based on an actual physical injury or physical sickness.

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*A defamation action is treated similarly to a discrimination action in that damages paid are taxable.*

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## ***Case 2: Sexual Harassment***

### **Facts**

Henry Jones filed a claim against his employer alleging sexual harassment. Specifically, Henry claimed that his supervisor repeatedly made improper offensive comments to him after he had requested that she cease such action and that the work environment was hostile. Henry also alleged that his supervisor implied that he would be demoted unless he began a relationship with her.

Henry quit his job and sued for sexual harassment claiming damages for lost wages, emotional distress (including money to compensate him for physical illness that was caused by the emotional distress), and medical expenses incurred as a result of the harassment. His employer paid Henry \$50,000 in full settlement of the claim.

### **Analysis**

Because Henry's claim did not involve an actual physical injury or sickness, the \$50,000 settlement payment is not excludable from income under IRC Sec. 104. The physical illness that resulted from his emotional distress is not an actual physical injury or sickness for purposes of IRC Sec. 104. However, the amount of the payment received by Henry for reimbursement of his out-of-pocket medical expenses is excludable because it meets the requirements of the new law under IRC Sec. 104(a).

No portion of the payment was compensation for services rendered or remuneration; consequently, no portion of the payment constitutes wages. Therefore, his employer is not required to withhold any portion of the \$50,000 payment. The portion of the payment allocated for reimbursement of Henry's medical expenses need not be reported at all by the employer (because it is excludable under IRC Sec. 104), but the remaining amount of the \$50,000 payment must be reported on Form 1099.

If the claim for sexual harassment included physical contact, arguably Henry's claim would involve an actual physical injury and thus the entire \$50,000 settlement payment would be excludable from gross income under IRC Sec. 104. For example, if Henry alleged that his supervisor physically forced him to have sex with her, this would likely constitute an actual physical injury or illness. On the other hand, if Henry alleged that his supervisor pinched, groped, hugged, or kissed him, this might not be sufficient to constitute a personal physical injury under IRC Sec. 104. Because



alleged by Henry was severe (e.g., forced sexual contact), the employer should be conservative and report the payment as taxable income.

### ***Case 3: Actual Physical Injury***

#### *Facts*

Mary Green filed a suit against her employer for an injury sustained when she was beaten by her supervisor. Specifically, Mary alleged that her supervisor repeatedly punched and kicked her. As part of her claim, Mary claimed damages for emotional distress and lost wages resulting from the supervisor's assault. A court awarded Mary \$100,000 in compensatory damages and \$200,000 in punitive damages.

#### *Analysis*

Because the origin of Mary's claim was an actual physical injury, all damages awarded (except for punitive damages) are excluded from gross income under IRC Sec. 104. Therefore, the \$100,000 compensatory damage payment is not included in Mary's gross income. Even the portions of the \$100,000 damage payment allocated to compensate Mary for her emotional distress and lost wages are excludable from gross income, because the origin of her claim was for an actual physical injury.

However, although the punitive damages do not constitute wages, the \$200,000 payment is taxable to Mary because punitive damages are always included in gross income. Accordingly, withholding does not apply to the full \$300,000 settlement payment. The employer is not required to report the \$100,000 compensatory damage portion of the award, but must report the \$200,000 punitive damage portion on Form 1099.

### ***Case 4: Gender Discrimination—Disparate Salary***

#### *Facts*

Sarah McCall sued her employer for gender discrimination claiming that, because she is a woman, she was paid \$10,000 less per year than a man in the same occupation over the past four years. Sarah also sued her employer for emotional distress caused by the gender discrimination. The employer settled Sarah's claim, paying her a full settlement of \$50,000.

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*Punitive damages are always included in taxable income.*

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### Analysis

The portion of the payment paid to Sarah to compensate her for having received \$10,000 less per year over the past four years (\$40,000) due to the gender discrimination represents back pay or compensation for services rendered. Accordingly, \$40,000 of the payment constitutes taxable wages and must be reported by the employer on Form W-2. In addition, withholding applies to this portion of the payment.

The remaining \$10,000 portion of the payment paid to compensate Sarah for her emotional distress is taxable income under IRC Sec. 104. However, this portion does not constitute taxable wages. Employer withholding does not apply to this portion of the settlement payment, and it should be reported by the employer on Form 1099.

### **Summary**

If a company settles a suit based on physical injury or sickness, the payments are not taxable to the employee, and no reporting is required. All other payments made to compensate for a nonphysical tort are reportable as income. Moreover, any punitive damages paid, whether in conjunction with a physical injury or sickness or not, are subject to inclusion as taxable income. When income is includable as taxable income, then the only time a Form W-2 is used is where the portion of the settlement is paid as wages for services rendered. Otherwise, all other settlements includable in income are reported on a Form 1099. (Note: Severance pay is a contractual damage not based upon personal physical injury; it is always taxable and must be reported to the IRS.)

Table 1 (page 41) summarizes several common scenarios and indicates whether settlement income is taxable, what form to use, and whether withholding is required.

**TABLE 1**  
**How to Report Common Settlement Scenarios**

Basis for (ex-)employee's claim	Payment made to compensate (ex-)employee for	Taxable income?	Reportable? If so, what Form?	Withholding required?
Failure to hire or wrongful termination resulting from discrimination (age, gender, or race) or whistle blowing	Lost wages and/or emotional distress	Yes	Yes — Form 1099	No
Defamation or injury to reputation	Lost wages and/or emotional distress	Yes	Yes — Form 1099	No
Sexual harassment — if (ex-)employee's claim does not include a clear assertion of actual physical injury	Lost wages and/or emotional distress	Yes	Yes — Form 1099	No
Race or gender discrimination (disparate pay)	To compensate (ex-) employee for lower wages paid or lack of promotion (i.e., back pay)	Yes	Yes — Form W-2	Yes
Physical attack by (ex-)employee's supervisor	To compensate (ex-) employee for physical injuries, emotional distress, and lost wages	No	No	No
Any payment in any action brought by (ex-)employee that represents punitive damages	To punish the wrongdoer (employer)	Yes	Yes — Form 1099	No

**NOTES**

1. *BNA Daily Labor Report*, No. 206, p. 27 (October 27, 1994).
2. *U.S. v. Burke*, 112 S. Ct. 1867 (1992).
3. *Commissioner v. Schleier*, 115 S. Ct. 2159 (1995).
4. Reimbursements for medical expenses incurred are not taxable income.
5. *Ogilvy v. United States*, 95-2 USTC ¶ 50,508 (December 10, 1996).
6. The IRS has issued rulings on this issue. See Rev. Rul. 58-418; Priv. Ltr. Rul. 96-34-002; and Priv. Ltr. Rul. 84-05-018.
7. See *Robinson v. Commissioner*, 102 T.C. 116 (1994).
8. *Ibid.*
9. See *Seay v. Commissioner*, 58 T.C. 32 (1972).