

It's Tax Time--What Does That Mean For Settling Employment Claims?

Article By:

Labor and Employment Law Department

Last summer, the **Internal Revenue Service** (IRS) issued a [Memorandum](#) regarding the reporting requirements for attorney's fees paid to settle an **employment claim**. The Memorandum makes it clear that the manner in which the settlement agreement is drafted and payments are made could impact **tax liabilities** for both the employee and the employer.

According to the IRS Memorandum, all payments for employment claims, including the specific allocation to attorney's fees, must be included in the individual's income, even if the fees are paid directly to the attorney. The IRS's position is that this includes severance pay, back pay and front pay. As recently noted by the U.S. Supreme Court's recent decision in [U.S. v. Quality Stores, Inc.](#), severance payments are subject to FICA and Medicare taxes. That said, there is a split as to whether awards for back pay and front pay constitute wages: the Ninth Circuit treats such as wages, the Fifth Circuit treats only back pay as wages, and the Eighth Circuit treats neither as wages in cases involving allegations of refusal to hire.

Despite this, there are prior IRS rulings that permit the exclusion in the individual's income for certain payments in employment cases. Specifically, payments for attorney's fees in certain class action matters can be excluded if there is no contractual agreement between the members and counsel. Additionally, payments for attorney's fees in settling litigation brought by the union against an employer to enforce a collective bargaining agreement do not constitute income to the union member. Finally, monies paid to compensate the individual for physical illnesses, personal injuries or emotional distress resulting from such illness or injury can be excluded from the individual's income. [See](#) IRC §104.

Although an individual will be taxed for the entire settlement, the individual likely will be granted a deduction for the attorney's fees paid. Section 62(a)(20) of the Internal Revenue Code permits for an above-the-line deduction for attorney's fees paid in most employment-related claims. The settlement agreement, however, must provide for a clear allocation for the payment of attorney's fees otherwise the entire settlement payment would be taxed as wages.

For employers, proper reporting of any settlement payments is key. Because the entire settlement amount, including attorney's fees, will likely be income to the employee or former employee, the full amount must be reported. This can be done either through the issuance of a Form W-2 or Form

1099, or both depending on the nature of the payment. Additionally, if the attorney is identified as a payee in the settlement agreement, the employer must send the attorney a Form 1099-MISC for all amounts paid to the attorney. Failure to properly file this information by the individual or timely furnish the correct form to the payee may result in a penalty against equal to 10% of the settlement amount.

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