

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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**CC:TEGE:EOEG:ET2
PLR-147020-02**

Date:
August 30, 2003

Legend

= Department

Dear :

This is in reply to your request for a ruling dated January 17, 2002, submitted on behalf of the Department regarding whether a settlement payment should be treated as wages subject to taxes under the Federal Insurance Contributions Act (FICA) and federal income tax withholding.¹

FACTS

A class of employees (the "class") filed a class action employment discrimination complaint against the Department. The suit was filed under Title VII of the Civil Rights Act of 1964, as amended, 42 U.S.C. § 2000 and the Civil Rights Act of 1991, 42 U.S.C. § 1981a. (Title VII). In the complaint, the class alleged that the Department had discriminated against them by disparate treatment based on race and gender "in the following areas: hiring practices, performance evaluations, initiation of disciplinary proceedings, assignments/details, awards and bonuses, access to training opportunities, selection for competitive promotions, including, but not limited to, promotions to management positions." Additionally, the class claimed that the Department had retaliated against them for filing complaints with the Equal Employment

¹Section 3306(c)(6) of the Internal Revenue Code (the "Code") pertaining to taxes under the Federal Unemployment Tax Act (FUTA), provides that services in the employ of the United States government are excepted from the definition of employment.

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Opportunity Commission. The class sought “equitable relief, including but not limited to, back pay, reinstatement (or front pay), and other lost compensation, compensatory damages, a declaratory judgment, attorneys’ fees, and an injunction directing the Department to cease and desist from, and remedy, their illegal conduct.” The complaint further alleged that as a result of the Department’s unlawful conduct, “class members (including the class agents) have experienced physical and mental distress, suffered loss of enjoyment of life . . .,” and emotional distress manifested in psychological trauma and physical symptoms.

The class signed a settlement agreement wherein they agreed to release all of their claims against the Department in exchange for a sum of money to be paid to the class of employees by the Department. The settlement agreement states that the Department will pay \$ _____ to the class in exchange for the release of any and all claims the employees’ have against the Department pertaining to any event occurring up through the date of the settlement agreement. The settlement agreement was executed and the payment is to be made within 10 days of receipt of this letter.

The settlement agreement included a formula for calculating the amount of damages each class member should receive based on various economic considerations such as awards and promotions the class members would have received but for the Department’s unlawful conduct, work performed on the class action lawsuit and past disciplinary actions involving suspension or removal. The agreement made no reference to emotional distress. Finally, the agreement stated that all payments made thereunder “represent compensatory damages and not wages.”

LAW

Settlement payments may be wages subject to employment taxes. The employment taxes that may apply include FICA and income tax withholding. FICA taxes and income tax withholding are imposed on “wages” as defined in the Internal Revenue Code (the “Code”). For income tax withholding purposes, “wages” is broadly defined as “all remuneration for services performed by an employee for his employer,” with specific exceptions (section 3401(a) of the Code). “Employment” for FICA purposes means “any service, of whatever nature, performed by an employee for the person employing him . . .”, again with specific exceptions. Code section 3121(b).

Remuneration for employment, unless such remuneration is otherwise excluded, constitutes wages even though at the time paid the relationship of employer and employee no longer exists between the person in whose employ the services were performed and the individual who performed them. Section 31.3121(a)-1(i) of the Treasury Regulations. The Supreme Court has made plain that the term “remuneration for employment” is not limited to payments made for work actually performed but

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includes the entire employer-employee relationship for which compensation is paid by the employer to the employee. Social Security Board v. Nierotko, 327 U.S. 358, 365-366 (1946).

Section 61(a)(1) of the Code provides that gross income means all income from whatever source derived, including (but not limited to) compensation for services, including fees, commissions, fringe benefits, and similar items.

Under §104(a)(2) of the Code, gross income does not include the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness. Section 104(a) also states as follows:

For purposes of paragraph (a)(2), emotional distress is not treated as a physical injury or physical sickness. The preceding sentence shall not apply to an amount of damages not in excess of the amount paid for medical care (described in subparagraph (A) or (B) of section 213(d)(1)) attributable to emotional distress.

In order to exclude a settlement recovery from gross income under section 104(a)(2), a taxpayer must meet two independent tests. Construing a predecessor of section 104(a)(2), the Supreme Court enunciated the following requirements: first, the taxpayer must demonstrate that the underlying cause of action giving rise to the recovery was based on tort or tort type rights. And second, the taxpayer must show that the damages were received “on account of personal injuries or sickness.” Commissioner v. Schleier, 515 U.S. at 337. The 1996 amendment to the statute did not eliminate the second test for exclusion.

In the context of a settlement agreement, determining the exclusion from gross income depends on the nature of the claim that was the actual basis for the settlement, not the validity of the claim. Seay v. Commissioner, 58 T.C. 32, 37 (1972). The proper inquiry is in lieu of what were damages awarded or paid. Church v. Commissioner, 80 T.C. 1104, 1107 (1983); Delaney v. Commissioner, 99 F.3d 20, 23-24 (1st Cir. 1996); Fono v. Commissioner, 79 T.C. 680, 694 (1982), aff'd without pub. opinion, 749 F.2d 37 (9th Cir. 1984). Courts must consider all facts, including the allegations contained in the taxpayer's complaint, the evidence presented and the arguments made in the court proceeding and the intent of the payor. Threlkeld v. Commissioner, 87 T.C. 1294, 1306 (1986), aff'd, 848 F.2d 81 (6th Cir. 1988); Bent v. Commissioner, 87 T.C. 236, 245 (1986), aff'd, 835 F.2d 67 (3d Cir. 1987); Church v. Commissioner, *supra*.

The Service is not necessarily bound by the allocations contained in settlement agreements to which it was not a party. See Robinson v. Commissioner, 102 T.C. 116 (1994), rev'd in part on other grounds, 70 F.3d 34 (5th Cir. 1995), cert. denied 519 U.S. 824 (1996). The allocation among the various claims of the settlement can be

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challenged where the facts and circumstances indicate that the allocation does not reflect the economic substance of the settlement. See Phoenix Coal Company, Inc. v. Commissioner, 231 F.2d 420 (2d Cir. 1956); Bagley v. Commissioner, 105 T.C. 396 (1995), aff'd, 121 F.3d 393 (8th Cir. 1997). See also Hemelt, supra, 122 F.3d at 208 (characterization of settlement proceeds cannot depend entirely on the intent of the parties).

The Service will allocate a lump sum payment using the best evidence available. This evidence may consist of the taxpayer's complaint requesting reasonable amounts of damages for each claim. Rev. Rul. 75-230, 1975-1 C.B. 93 and Rev. Rul. 85-98, 1985-2 C.B. 51 superseding Rev. Rul. 58-418, 1958-2 C.B. 18.

Whether an amount is excludable from gross income under section 104(a)(2) serves as a beginning point in analyzing whether a settlement payment is wages for employment tax purposes. There is general agreement that to the extent damages are excludable from gross income under section 104(a)(2), they are not subject to employment taxes. See Temp. Reg. § 32.1.

Whether an amount received in settlement of a dispute is remuneration for employment and subject to employment tax depends on the nature of the item for which the settlement amount is a substitute. See Alexander v. Internal Revenue Service, 72 F.3d 938, 942 (1st Cir. 1995) (the test for purposes of determining the character of a settlement payment for tax purposes "is not whether the action was one in tort or contract but rather the question to be asked is 'in lieu of what were the damages awarded?'" (citations omitted); Hort v. Commissioner, 313 U.S. 28 (1941) (holding that an amount received upon cancellation of a lease was a substitute for the rent which would have been paid under the lease and, thus, was taxable as ordinary income). Rev. Rul. 96-65, 1996-2 C.B. 6, holds that payments received by an individual in satisfaction of a claim for denial of a promotion due to disparate treatment employment discrimination under Title VII of the Civil Rights Act of 1964 are both income and wages. In addition, the ruling concludes that payments received for emotional distress in satisfaction of such a claim are not excludable from gross income under section 104(a)(2), except to the extent they are damages paid for medical care (as described in section 213(d)(1)(A) and (B)) due to emotional distress.

DISCUSSION

In the instant case, the settlement proceeds are not excludable from gross income under section 104(a)(2) because the underlying cause of action was not based on tort or tort type rights, and the damages were not received on account of personal injuries or sickness. The underlying cause of action was based on economic rights, such as the denial of promotions and awards. Although the complaint alleges emotional distress, there is no evidence of physical injuries, sickness or medical expenses related to emotional distress. Moreover, the settlement agreement calculates damages based

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solely on economic considerations. Accordingly, the settlement proceeds are includable in gross income and the entire amount or a portion of those proceeds may or may not be wages.

In this case the class asserted their claim under Title VII. The underlying claim i.e., that the class was subjected to discriminatory treatment by the Department, is a wage-based claim. The settlement agreement specifically allocates payments based on economic factors, such as lack of promotions, lack of wage increases, undeserved discipline and work on the class action lawsuit, inter alia. Additionally, the number of years of service is a factor for determining the amount of the payment to each member of the class. Accordingly, although the settlement agreement states that all payments made thereunder represent compensatory damages and not wages, this statement is inconsistent with the economic substance of the settlement. The class alleged symptoms of emotional distress as a result of the Department's discrimination. However we conclude that the Department did not intend to compensate the class for the asserted emotional distress because no portion of the payment is allocated to emotional distress and no evidence supporting the emotional distress claim has been presented. Therefore, the entire payment is remuneration for services and constitutes wages subject to employment taxes.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

Lynne Camillo
Chief, Employment Tax Branch 2
Office of the Assistant Chief Counsel
(Exempt Organizations / Employment Tax / Government Entities)