

Office of Chief Counsel  
Internal Revenue Service  
**Memorandum**

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to:

Employment Tax Specialist

from: Area Counsel (Mid-Atlantic Area)  
(Tax Exempt & Government Entities)

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subject: Reporting Requirements for Attorney's Fees Paid Pursuant to Settlement Agreements  
UIL: 3121.01-00, 3401.01-00, 6041.00-00, 6045.07-00, 6721.00-00, 6722.00-00

**This memorandum responds to your request for advice dated September 18, 2012. This advice may not be used or cited as precedent in other cases. This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.**

### ISSUES

- (1) When are attorney's fees paid by an employer as part of a settlement agreement with a former employee subject to employment taxes?<sup>1</sup>
- (2) What are the information reporting requirements for attorney's fees paid by an employer pursuant to a settlement agreement with a former employee?
- (3) What penalties can be asserted if an employer fails to comply with reporting requirements for attorney's fees paid as part of a settlement agreement with a former employee?

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<sup>1</sup> Employment taxes as referenced here include those imposed under the Federal Insurance Contributions Act ("FICA") under §§ 3101 and 3111; Federal Income Tax Withholding ("FITW") under § 3402(a); and the Federal Unemployment Tax Act ("FUTA") under § 3301.

## SUMMARY CONCLUSIONS

(1) In the absence of a specific allocation for attorney's fees in these settlement agreements, attorney's fees paid by an employer as part of a settlement agreement with a former employee, which are includable in income, are subject to employment taxes to the extent they are wages attributable to an employment-related claim. The Service's position is that payments constituting severance pay,<sup>2</sup> back pay,<sup>3</sup> and front pay<sup>4</sup> are wages for employment tax purposes.

(2) The appropriate information reporting requirements depend on the facts and circumstances of each case. Unless the attorney's fees are specifically allocated in a settlement agreement, the payments made in settlement of wage-based claims are generally considered wages that are required to be filed and furnished to the employee on Form W-2, Wage and Tax Statement. If the attorney's fees are specifically allocated, they are generally required to be filed and furnished to the employee on Form 1099-MISC, Miscellaneous Income. The reportable amounts are always filed and furnished to the attorney on Form 1099-MISC.

(3) An employer that fails to file and furnish correct information returns that report attorney's fees paid as part of a settlement agreement may be subject to penalties under §§ 6721(a) and 6722(a) of the Internal Revenue Code.<sup>5</sup> If the employer intentionally disregarded the reporting requirements, the penalties increase under §§ 6721(e) and 6722(e).

## FACTS

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<sup>2</sup> Note that there is some disagreement among the Federal appellate courts on the character of severance pay. Compare, e.g., Abrahamsen v. U.S., 228 F.3d 1360 (Fed. Cir. 2000) (holding that termination payments associated with employer-employee relationship are wages for purposes of FICA) with In re Quality Stores, Inc., et al., 693 F.3d 605 (6th Cir. 2012) (holding that severance payments that qualified as SUB payments under section 3402(o) were not wages for the purposes of FICA).

<sup>3</sup> Note that there is some disagreement among the Federal appellate circuits on the character of back pay in an illegal refusal to hire claim. Compare, e.g., Melani v. Board of Higher Ed., 652 F. Supp. 43 (S.D.N.Y. 1986), aff'd 814 F.2d 653 (2d Cir. 1987) (citing with approval Rev. Rul. 78-176, 1978-1 C.B. 303, which holds that back pay for discrimination in refusal to hire is wages for employment tax purposes) with Newhouse v. McCormick & Co., 157 F.3d 582 (8th Cir. 1998).

<sup>4</sup> Note that there is some disagreement among the Federal appellate circuits on the character of front pay. Compare, e.g., Gerbec v. U.S., 164 F.3d 1015, 1026 (6th Cir. 1999) (holding that portions of an award allocated to back wages and future wages are wages subject to FICA taxation) with Dotson v. U.S., 87 F.3d 682, 689 (5th Cir. 1996) (holding that only the back pay portion of a settlement pay was wages for purposes of FICA).

<sup>5</sup> Unless noted otherwise, all section references herein are to the Internal Revenue Code in effect for the years in issue.

The employer at issue entered into more than                    settlement agreements with former employees, which provided that the employees would waive any claims under a variety of statutes in return for specified sums. Based on the claims and complaints provided, it appears that the settlement agreements resolved a variety of claims brought by employees, including claims for violations of the Age Discrimination in Employment Act (“ADEA”), the Americans with Disabilities Act (“ADA”), and Title VII of the Civil Rights Act (“Title VII”). The employer paid out a variety of payments in settling claims, including wages, tort damages, reimbursements of medical costs, and attorney’s fees. The latter were alternatively paid directly to the employee, to the employee’s attorney, or to both.

During an examination, it was discovered that certain settlement payments were mistakenly reported to the employees on Forms 1099-MISC rather than on Forms W-2. Consequently, employment taxes were underwithheld. The employer has agreed to correct those errors.<sup>6</sup> The purpose of this memorandum is to address the proper reporting of attorney’s fees paid pursuant to the settlement agreements and the potential penalties that apply for failure to properly report. However, we have included some related general information for context.

Our conclusions may be best explained by examples. Assume the following examples, which are representative of the settlement agreements between the taxpayer and its employees.

#### Example One – Separate Checks to Claimant and Attorney, Clear Allocation

Claimant 1 (C1) and the employer entered into a settlement agreement concerning claims against the employer under the ADEA and similar state statutes. C1 agreed to waive all claims in return for \$                   , payable in two lump sums of \$                    each. The agreement also provided for \$                    in attorney’s fees, payable to Attorney 1 (A1) in two lump sums of \$                   , and \$                    in attorney’s fees payable to Attorney 2 (A2) payable in two lump sums of \$                    each. The first of each of the payments to C1, A1, and A2 were paid in 2010 and the second were paid in 2011. For each tax year, the employer filed and furnished Forms 1099-MISC that reported the \$                    payments to C1, Forms 1099-MISC that reported the \$                    payments to A1, and Forms 1099-MISC that reported the \$                    payments to A2. The taxpayer did not include the \$                    in attorney fees it paid on behalf of C1 on the Form 1099-MISC it filed and furnished to C1 each year nor did the employer file and furnish any Forms W-2 for either year.

#### Example Two – Check to Claimant for Wage Income, Joint Check to Claimant and Attorney for Other Income, No Specific Allocation for Attorney’s Fees

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<sup>6</sup> Payments to employees stemming from employment-related claims are often wage-based. Thus, they are required to be reported on Forms W-2 (not Forms 1099-MISC) and are subject to employment taxes.

Claimant 2 (C2) and the employer entered into a settlement agreement concerning claims against the employer under Title VII. C2 agreed to waive all claims in return for the total sum of \$ . The settlement was to be paid in two checks: a check payable to C2 for \$ , less statutory deductions and withholdings, and a check payable jointly to C2 and C2's attorney (A3) for \$ . The agreement provided that the employer would report the payment of \$ to C2 on Form W-2 and that the employer would issue Forms 1099-MISC to the claimant and the attorney with respect to the payment of \$ . The employer filed and furnished a Form 1099-MISC that reported the \$ payment to A3 but did not file or furnish an information return that reported the attorney's fees payment to C2.

#### Example Three - One Check to Attorney, No Specific Allocation

Claimant 3 (C3) and the employer entered into a settlement agreement concerning claims against the employer under the ADA. C3 agreed to waive all claims in return for a lump sum of \$ , in a check made payable to his attorney's (A4's) office. The employer issued a check for \$ to the order of the claimant's attorney "for [C3]." The employer filed and furnished a Form 1099-MISC that reported the \$ payment to A4.

The employer did not file or furnish an information return that reported a payment to C3 with respect to the settlement.

## **LAW AND ANALYSIS**

### In General

Determining the correct treatment of employer settlement payments is a four-step process. First, determine the character of the payment and the nature of the claim that gave rise to the payment. Second, determine whether the payment constitutes an item of gross income. Third, determine whether the payment is wages for employment tax purposes. Fourth, determine the appropriate information reporting for the payment and any attorney's fees (Form 1099-MISC and/or Form W-2).

### Inclusion in Income

Under § 61(a) of the Code, gross income generally includes all income from whatever source derived. The Supreme Court has long recognized that the definition of gross income is broad in scope and reflects Congress' intent to bring within its purview all accessions to wealth, unless excluded by another section of the Code. Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 430 (1955); Commissioner v. Schleier, 515 U.S. 323, 327 (1995).

If a claimant receives a payment that is includable in income, any amounts allocated as part of a settlement or judgment to attorney's fees are also includable in the claimant's income, even if the amount is paid directly to the attorney. See Commissioner v. Banks, 543 U.S. 426 (2005) (holding that when a litigant's recovery constitutes income, the

litigant's income includes any portion paid to the attorney as a contingent fee under the anticipatory assignment of income doctrine).

The traditional American rule is that a prevailing litigant may not ordinarily recover attorney's fees and costs unless authorized by statute. Alyeska Pipeline Service Co. v. Wilderness Society, 421 U.S. 240, 247 (1975). A statute that includes a provision allowing the court to award attorney's fees to the prevailing party is referred to as a fee-shifting statute. The Supreme Court has long held that a claim for attorney's fees under a fee-shifting statute belongs to the client, not to the attorney. See Evans v. Jeff D., 475 U.S. 717, 730-732 (1986); Astrue v. Ratliff, 560 U.S. \_\_\_, 130 S.Ct. 2521, 2529 (2010).

Thus, a prevailing plaintiff must include in gross income attorney's fees recovered under a fee-shifting statute if the underlying recovery is taxable. Sinyard v. Commissioner, 268 F.3d 756 (9<sup>th</sup> Cir. 2001) (fees awarded under the ADEA); Vincent v. Commissioner, T.C. Memo. 2005-95 (fees awarded under California FEHA). In the current matter, each statute under which claims were filed against the employer, Title VII, the ADEA, and the ADA, contains a fee-shifting provision. See 42 U.S.C. § 2000e-(5)(k); 29 U.S.C. § 626(b); and 42 U.S.C. § 12205.

Attorney's fees that are included in the recipient's income may be deductible from gross income under certain circumstances. Section 62(a)(20) provides for an above-the-line deduction from gross income for attorney's fees and court costs, paid by, or on behalf of, a taxpayer in connection with any action involving a claim of unlawful discrimination. The term "unlawful discrimination" is defined in § 62(e) as an act that is unlawful under any of a number of federal, state, or local laws including the ADEA, Title VII, and the ADA. The deduction under § 62(a)(20) is limited to the amount that is includible in the taxpayer's gross income for the taxable year as a result of a settlement or judgment resulting from the claim. I.R.C. § 62(a)(20). In addition to the statutes enumerated in § 62(e)(1) through (17), § 62(e)(18) also provides an above-the-line deduction for attorney's fees and costs incurred in an action or proceeding involving any aspect of the employment relationship.

If attorney's fees are not deductible under § 62(a)(20) because the cause of action is not one involving a claim of unlawful discrimination, fees may still be deducted as miscellaneous itemized deductions, subject to the two percent floor of § 67. However, if a taxpayer (other than a corporation) is subject to the Alternative Minimum Tax ("AMT"), no miscellaneous itemized deductions are permitted in computing alternative minimum taxable income. Therefore if a taxpayer is subject to the AMT, the taxpayer is not allowed any deduction for attorney's fees for an award of attorney's fees in a non-discrimination case in computing the taxpayer's alternative minimum taxable income. See I.R.C. § 56(b)(1)(A).

For purposes of determining whether the settlement amounts between the employer and its employees are includable in gross income, be aware that § 104(a)(2) provides that gross income does not include the amount of any damages received on account of personal physical injury or physical sickness, as long as the amounts were not deducted

under § 213 in a prior taxable year. Any payments to an employee that reimburse medical costs are not includable in gross income and no reporting requirement exists for these payments. If the entire payment an individual receives as a result of a settlement or judgment is excludable under § 104(a)(2), any amount allocated to attorney's fees is also excluded from gross income. Note, however, that § 265(a)(1) prohibits the taxpayer from taking a deduction for attorney's fees in this situation.

### Wages for Employment Tax Purposes

Sections 3121(a) and 3306(b) of the Code, relating to the FICA and FUTA taxes, respectively, provide, with certain exceptions not relevant here, that the term "wages" means all remuneration for employment. Section 3401(a) contains a similar definition for purposes of the income tax withholding requirements. The name by which the remuneration for employment is designated is immaterial. Sections 31.3121(a)-1(c), 31.3306(b)-1(c), and 31.3401(a)-1(a)(2) of the Employment Tax Regulations. Similarly, the basis upon which the remuneration is paid is generally immaterial. Treas. Reg. §§ 31.3121(a)-1(d), 31.3306(b)-1(d), and 31.3401(a)-1(a)(3).

Unless otherwise excluded, remuneration for employment 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. Treas. Regs. §§ 31.3121(a)-1(h)(i), 31.3306(b)-1(i), and 31.3401(a)-1(a)(5). The Supreme Court has made plain that the term "remuneration for employment" is not limited to payments made for work actually performed but 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, 365-66 (1946).

When attorney's fees are includable in income in a suit involving an employment-related claim, they may also be wages for employment tax purposes. The Service's position is that payments constituting severance pay, back pay, and front pay are wages for employment tax purposes. Whether an amount received in settlement of a dispute is remuneration for employment 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, 61 S. Ct. 757, 85 L. Ed. 1168, 1941-1 C.B. 319 (1941) (holding that an amount received upon cancellation of a lease was a substitute for the rent that would have been paid under the lease and, thus, was taxable as ordinary income). See also, Rev. Rul. 96-65, 1996-2 C.B. 6, (holding 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. Payments received for emotional distress in satisfaction of such a claim are not excludable from gross income

under § 104(a)(2), except to the extent they do not exceed the amount paid for medical care (as described in § 213(d)(1)(A) and (B)) attributable to emotional distress.

In Rev. Rul. 80-364, 1980-2 C.B. 294, the Service provides guidance concerning the income and employment tax consequences in three situations in which amounts paid by an employer as a result of litigation are partially used for attorney's fees. The ruling supports the proposition that when attorney's fees are clearly allocated as such by a court in a judgment awarding back pay, the attorney's fees, while includable in income, are not wages for employment tax purposes. However, in a situation in which a court order does not make a distinct allocation for attorney's fees and the claimant pays the attorney's fees out of their recovery, the entire recovery, including the amount paid to the attorney, is wages for employment tax purposes.

In Situation 1 of Rev. Rul. 80-364, in a suit by an individual against his former employer, a court awarded the individual a certain amount for back pay and a certain amount for attorney's fees. The ruling concludes that only the portion of the award for back pay is wages for federal employment tax purposes. The amount of the award specifically allocated for attorney's fees is not remuneration for employment and, thus, is not wages.

In Situation 2, in a suit by an individual against his employer, the court ordered the employer to pay the employee a certain amount for back pay, but did not allocate any portion of the award to attorney's fees or interest. The ruling concludes that the entire amount is considered wages for federal employment tax purposes, including the amount that the employee paid out of the award for an attorney's fee.

In Situation 3 of Rev. Rul. 80-364, the employer paid the union an amount in full settlement of all claims filed by the union on behalf of union members. The union used a portion of the settlement to pay attorney's fees. The ruling concludes that the amount of the settlement paid by the union for attorney's fees is not remuneration to the individual employees and, therefore, is not wages for federal employment tax purposes. Instead, the amount used for attorney's fees is a reimbursement for expenses incurred by the union.

Although Rev. Rul. 80-364 addresses court awards in the back pay context and not settlements of claims outside of court, the reasoning in the ruling can be extended to settlement payments. When an employment-related claim brought under a fee-shifting statute is settled outside of court and the settlement agreement clearly allocates a reasonable amount of the settlement proceeds as attorney's fees, the amount allocated to attorney's fees, while includable in income, is not wages for employment tax purposes. On the other hand, if the settlement agreement does not clearly allocate an amount for attorney's fees, and/or the claim is brought under a statute that does not provide for fee-shifting, the entire amount paid to the claimant-employee is wages for employment tax purposes.

#### Reporting Requirements for the Claimant

Section 6041 provides that all persons engaged in a trade or business that make a payment to another person of \$600 or more in a taxable year shall file an information return that reports the amount of the payment and the name and address of the recipient of the payee. If section 6041 requires a payor to file a Form 1099 or Form W-2, the payor must furnish each payee with a separate Form 1099 or Form W-2. Treas. Reg. §§ 1.6041-1(a)(2), 1.6041-2(a)(2).

Treas. Reg. § 1.6041-1(f) provides that when fees are deducted from an amount due to a payee, the amount to be reported as paid to a payee is the amount includible in the gross income of the payee (which in many cases will be the gross amount of the payment or payments before fees, commissions, expenses, or other amounts owed by the payee to another person have been deducted), whether the payment is made jointly or separately to the payee and another person. The regulations provide the following examples to illustrate section 1.6041-1(f):

Example 1. Attorney P represents client Q in a breach of contract action for lost profits against defendant R. R settles the case for \$100,000 damages and \$40,000 for attorney's fees. Under applicable law, the full \$140,000 is includible in Q's gross taxable income. R issues a check payable to P and Q in the amount of \$140,000. *R is required to make an information return reporting a payment to Q in the amount of \$140,000.* For the rules with respect to R's obligation to report the payment to P, see § 6045(f) and the regulations thereunder.

Example 2. Assume the same facts as in Example 1, except that R issues a check to Q for \$100,000 and a separate check to P for \$40,000. *R is required to make an information return reporting a payment to Q in the amount of \$140,000.* For the rules with respect to R's obligation to report the payment to P, see § 6045(f) and the regulations thereunder.

### Emphasis added.

Therefore, when the settlement payment that includes attorney's fees is included in the claimant's taxable income, the payor must report the entire amount of the settlement payment on an information return with the client as payee even if the check for the attorney's fees was issued directly to the attorney.

### Reporting Requirements for the Attorney

Section 6045(f) provides that any person engaged in a trade or business who makes a payment to an attorney in connection with legal services, whether or not the services are performed for the payor, shall file an information return reporting the payment. If section 6045(f) requires a payor to file an information return, the payer must furnish the attorney with either a copy of the information return or a written statement. Treas. Reg. § 1.6045-5(a)(3).



Treas. Reg. § 1.6045-5(a) provides that the requirement to report payments for legal services to an attorney applies regardless of whether a portion is kept by the attorney as compensation for services rendered or other information returns are required with respect to some or all of a payment. The reporting requirements apply whether the attorney is named as a sole, joint, or alternative payee. See Treas. Reg. § 1.6045-5(d)(4). The attorney is not a payee and thus reporting requirements do not apply if the attorney's name is included on the payee line of a check as "in care of" or the check is written to the client "c/o" the attorney. Id. Treas. Reg. § 1.6045-5(f) provides the following relevant examples:

Example 1. One check--joint payees--taxable to claimant. Employee C, who sues employer P for back wages, is represented by attorney A. P settles the suit for \$300,000. The \$300,000 represents taxable wages to C under existing legal principles. P writes a settlement check payable jointly to C and A in the amount of \$200,000, net of income and FICA tax withholding with respect to C. P delivers the check to A. A retains \$100,000 of the payment as compensation for legal services and disburses the remaining \$100,000 to C. P must file an information return with respect to A for \$200,000 under paragraph (a)(1) of this section. P also must file an information return with respect to C under §§ 6041 and 6051, in the amount of \$300,000. See Treas. Reg. §§ 1.6041-1(f) and 1.6041-2.

Example 3. Separate checks--taxable to claimant. C, an individual plaintiff in a suit for lost profits against corporation P, is represented by attorney A. P settles the suit for \$300,000, all of which will be includable in C's gross income. A requests P to write two checks, one payable to A in the amount of \$100,000 as compensation for legal services and the other payable to C in the amount of \$200,000. P writes the checks in accordance with A's instructions and delivers both checks to A. P must file an information return with respect to A for \$100,000 under paragraph (a)(1) of this section. Pursuant to § 1.6041-1(a) and (f), P must file an information return with respect to C for the \$300,000.

The examples from the regulations under sections 6041 and 6045 make clear that when a payor makes a payment to an attorney for an award of attorney's fees in a settlement awarding a payment that is includable in the claimant's income, the payor must report the attorney's fees on separate information returns with the attorney and the claimant as payees. Therefore, Forms 1099-MISC and Forms W-2, as appropriate, must be filed and furnished with the claimant and the attorney as payee when attorney's fees are paid pursuant to a settlement agreement that provides for payments includable in the claimant's income, even though only one check may be issued for the attorney's fees.

Failure to File Required Forms 1099

Section 6721 requires a person to pay a \$100 penalty with respect to each information return for any failure to timely file a required information return, any failure to include all of the information required to be shown on an information return, or the inclusion of incorrect information on an information return, up to certain limits that depend on the person's yearly gross receipts. If one or more failures subject to penalty under section 6721 are due to intentional disregard of the filing requirement (or the correct information reporting requirement), the penalty increases to \$250 per failure. I.R.C. § 6721(e). Section 301.6721-1(f)(2) of the Regulations on Procedure and Administration provides that a failure is due to intentional disregard if it is a knowing and willful failure to file timely or failure to include correct information. The determination of whether a failure was knowing and willful is based on the facts and circumstances of the case, including, but not limited to: (1) whether the failure is part of a pattern of conduct of repeatedly failing to file or include correct information; (2) whether correction was made promptly upon discovery of the failure; (3) whether the filer corrects a failure within 30 days after a written request from the Service to correct; and (4) whether the amount of the information return penalties is less than the cost of complying with the requirement to file timely or include correct information on an information return. Treas. Reg. § 301.6721-1(f)(3).

Section 6722 requires a person to pay a \$100 penalty with respect to each payee statement for any failure to furnish timely a required payee statement, any failure to include all of the information required to be shown on a payee statement, or the inclusion of incorrect information on a payee statement, up to certain limits that depend on the person's yearly gross receipts. If one or more failures subject to penalty under section 6722 are due to intentional disregard of the filing requirement (or the correct information reporting requirement), the penalty increases to \$250 per failure. I.R.C. § 6721(e). The facts and circumstances surrounding a failure, including those considered under Treas. Reg. § 301.6721-1(f)(3), determine whether the failure is due to intentional disregard. Treas. Reg. § 301.6722-1(c)(1).

I.R.M. 20.1.7.3.2 (Rev. 7-15-2011) and 20.1.7.4.1 (Rev. 7-15-2011) provide further guidance on when a § 6721 or § 6722 penalty merits an increase for intentional disregard. The IRM provides that an intentional disregard may exist when a taxpayer failed to file to avoid an administrative inconvenience or when it would be less expensive for the filer to pay the penalties under § 6721 or § 6722 than to comply with the filing or furnishing requirements.

#### Example One – Separate Checks to Claimant and Attorney, Clear Allocation

In this example, C1 agreed to waive all claims in return for \$ \_\_\_\_\_, payable in two lump sums of \$ \_\_\_\_\_ each. The agreement specifically provided for attorney's fees, payable to A1 in two lump sums of \$ \_\_\_\_\_ and to A2 in two lump sums of \$ \_\_\_\_\_.

To the extent the recovery is taxable to C1, the attorney's fees are includible in C1's income and must be reported to C1 by filing and furnishing an information return. Form 1099-MISC is the appropriate form to use in reporting the attorney fee amounts to C1

when there is a clear allocation of an amount as attorney's fees, because such clearly allocated amount is not wages subject to employment tax. The employer must also report the portion of the settlement that was paid directly to C1 by filing and furnishing a Form W-2 reporting \$ with C1 as payee for each year. Finally, the employer must report the payments to the attorneys by filing and furnishing two Forms 1099-MISC with the two attorneys as payees for each year in the amounts of \$ and \$ , respectively.

The impact of the failure to correctly report attorney's fees paid in this situation could be significant and penalties may be applicable. Because C1's claim was under the ADEA, C1 can deduct attorney's fees up to the amount includible in gross income as a result of the settlement. The amount that should have been included in gross income was \$ for each year, not \$ . C1 could deduct the amount of attorney's fees, \$ for each year, as an above-the-line deduction pursuant to § 62(a)(20). If the attorney's fees are not properly reported to C1, it is possible that C1 would include only \$ in income each year, yet deducted some amount, potentially even the full \$ , as attorney's fees pursuant to section 62(a)(20), effectively removing an amount exceeding the settlement recovery and then some from his adjusted gross income.

Example Two – Check to Claimant for Wage Income, Joint Check to Claimant and Attorney for Other Income, No Allocation for Attorney's Fees, Forms W-2 and 1099-MISC

In this example, C2 agreed to waive all claims in return for the total sum of \$ to be paid in two checks: the first payable to C2 for \$ , less statutory deductions and withholdings, and the second payable jointly to C2 and A3 for \$ . Since there is no clear allocation for attorney's fees, the fees are wages subject to employment tax. The employer should file and furnish a Form W-2 reporting \$ with C2 as payee and a Form 1099-MISC reporting the \$ payment with A3 as payee. Note that A3 is subject to information reporting because she was named as a joint payee on the check for \$ . See § 6045(f) and the regulations thereunder.

The settlement agreement itself correctly instructed the employer to report to both C2 and A3 the amount on the check issued jointly to them but incorrectly states that Form 1099-MISC was the appropriate form. Even so, the employer failed entirely to report the payment to C2. There may be an especially good argument here for the increased penalty due to intentional disregard since the employer signed an agreement stating they would report the joint payment to both parties.

Example Three - One Check to Attorney, No Allocation, Form 1099-MISC

In example three, C3 agreed to waive all claims in return for a lump sum of \$ , in a check made payable to his attorney's office. The employer issued a check for \$ to the order of the claimant's attorney "for [C3]." The employer filed and

furnished a Form 1099-MISC that reported the entire payment to the attorney. Pursuant to regulation section 6045-5(f), the attorney is not the payee and therefore the information reporting requirements do not apply if the attorney's name is included on the payee line of a check as 'in care of' the attorney. However, section 6041 and the regulations thereunder provide that the employer should have filed and furnished an information return that reported the full amount of the settlement as payment to C3. Since there was no specific allocation for attorney's fees, the amount paid constitutes wages subject to employment tax. Thus, the employer must file and furnish Form W-2 reporting \$ \_\_\_\_\_ to C3.

#### Possible Penalties/Adjustments

When an employer fails to file and furnish a required Form 1099-MISC or files and furnishes a Form 1099-MISC reporting incorrect amounts, the only penalties or adjustments that can be asserted against the employer in these situations are the penalties under sections 6721 and 6722. In each of the examples above, the employer either failed to file and furnish a required information return or filed and furnished an information return reporting incorrect amounts. In some cases, the potential impact on the individual income tax reporting of the claimants is quite significant.

It may be appropriate to assert the increased penalty for intentional disregard under sections 6721(e) and 6722(e) in some situations. If an employer has a pattern of failing to file information returns required under section 6041 that properly report attorney's fees to claimants paid pursuant to settlement agreements or made no attempts to correct its failures, the increased penalties may be asserted. If you can establish that an employer failed to file correct information returns because the cost of doing so was more than the penalty under section 6721(a), you may have a good case for asserting the increased penalty or intentional disregard.

If the employer continues to fail to file and furnish correct information returns for settlement payments after a penalty has been asserted under sections 6721(a) or 6722(a) or sections 6721(e) and 6722(e), the increased penalty under sections 6721(e) and 6722(e) for an intentional failure should definitely apply. In addition, we recommend referring the individuals for whom the employer failed to issue correct information returns to Exam for their individual income tax returns for the tax years at issue since the failure to file correct information returns likely caused some of the claimants to underreport their income for the years in which they received settlement payments.

Please call \_\_\_\_\_ if you have any further questions.

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