

IRS sets rules for taxing damage awards

Final IRS regulations exclude from taxpayers' gross income damage awards for personal physical injuries or illness received from a lawsuit or in settlement of legal claims. The regs delete the requirement that to qualify for the tax exclusion, damages must be based on a tort or tort-type right.

This small but significant change means that you no longer need to discuss the origins of an employee's lawsuit with the company's attorney before determining the tax status of a jury verdict or settlement agreement.

The final regs generally apply to damage awards issued after Sept. 13, 1995, and received after Jan. 23, 2012. (77 F.R. 3106, 1-23-12)

Review allocations carefully

Employees can sue their employers for economic damages—lost wages, for example—which are subject to payroll taxes, and noneconomic damages, such as pain and suffering. Even though the regs remove an issue that has confounded first-year law students for generations—what is a tort?—you must still carefully read the jury verdict or settlement document, since under the regs, only damages received for *physical* injury or illness are excluded from gross income.

IRS flexes its allocation muscles

If your settlement allocations among taxable back pay, compensatory damages and, say, civil penalties paid under a state wage payment law don't reflect the underlying economic substance of the settlement as the IRS sees it, the IRS can reallocate those amounts and shuffle more money into the taxable back pay category. The IRS affirmed its power to do so in legal advice issued by field attorneys.

The allocations arose from the settlement of a class-action lawsuit brought by a company's managers under a state's wage-and-hour and wage-payment laws. Each employee was allocated unpaid wages, for which the company issued W-2 forms, along with civil penalties and interest, for which the company issued 1099-MISC forms.

What piqued the IRS' interest: The settlement agreement didn't specify how the allocations were made, the allocations were evenly divided among the three categories and each employee received the same amount in civil penalties and interest, even though the state law based this portion of the settlement on a percentage of the total amount of back pay awarded. (ILM 20114704F)

Do your homework

Even worse than a class-action lawsuit is IRS scrutiny of your settlement allocations. When reviewing allocations, identify the federal or state law under which civil penalties and interest are being paid.

The reason is simple: The IRS is going to read this law to assess whether you have substantiated your allocations. For example, allocations can't be evenly distributed among employees if the law bases penalties on a percentage of employees' unpaid wages or on the amount of days or hours employees worked, but weren't

paid properly.