

**Division of Accounting
Payroll Compliance Group**

**Bulletin # 2017_002
State of Delaware
Employment-Related Settlements**

INTRODUCTION

The Division of Accounting (DOA) is responsible for working with State of Delaware (State) Organizations and State Central Offices to ensure appropriate application of regulations when determining the tax treatment and reporting of income paid to individuals and attorneys as the result of an employment-related settlement.

This bulletin provides guidance and establishes standard practices in the preparation, review, and approval of settlement payments to grievants and claimants.

FACTS

To ensure the correct tax treatment of employment-related settlement payments, it is necessary to define the character of the payment and the nature of the claim; determine if the payment represents gross income; and, determine if the payment represents wages subject to all applicable employment and income taxes. Finally, it is necessary to determine if the payments to the claimant and the attorney are reportable on either Form 1099, Form W-2, or both.

FINDINGS

The general rule is that all settlement amounts are taxable and must be reported on either a Form W-2 or Form 1099 if they are paid to a claimant who is or was an employee. There are certain limited allowable exclusions provided pursuant to IRC §104(a)(2) that are explained in the Regulatory References section below.

- All settlement payments attributable to wage-related claims must be reported on Form W-2. This includes payments for salary, wages, back pay, overtime pay, severance pay, and benefits.
- All non-wage-related taxable payments are reported on Form 1099.
- All settlement payments made to the claimant's attorney for fees are taxable to both the claimant and the attorney and reported on separate Forms 1099.

Employers must give due consideration to the character of the payment and use standard language in settlement agreements and court-ordered awards to ensure the purpose of all payments is clearly stated. Best practices discourage after-the-fact allocations of settlement amounts. This lessens the likelihood or appearance of collusion among the parties to structure a settlement with more favorable tax status.

CHARACTERIZATION OF PAYMENT

Severance Pay – compensation paid as a result of involuntary termination of employment

- Wage-related income – Subject to all applicable employment and income taxes
- Reportable on Form W-2

Back Pay – compensation for wages that would have been earned up to the time of settlement

- Wage-related income – Subject to all applicable employment and income taxes
- Reportable on Form W-2

Restoration of Benefits – employer pays health insurance premiums on behalf of employee

- Wage-related income – Subject to all applicable employment and income taxes
- Reportable on Form W-2

Compensatory Damages – compensation for physical and non-physical injury (i.e., humiliation, defamation, and emotional distress and pain and suffering)

- Non-wage-related income
- Adds to gross income
- Reportable on Form 1099

Punitive Damages – compensation intended to punish a wrongful conduct

- Non-wage-related gross income
- Reportable on Form 1099

Liquidated Damages – paid in lieu of compensatory damages due to breach of agreement or awarded by statute (i.e., FLSA, Equal Pay Act, etc.)

- Non-wage-related gross income
- Reportable on Form 1099

ATTORNEY'S FEES

When a settlement agreement includes an amount to cover attorney's fees, the agreement should specify if the check is payable to the claimant, the claimant's attorney, or to both of them jointly. Regardless of the payee designation, this payment is taxable to both the employee and the attorney. It is taxable to the employee because, even though they may not have directly received the payment, they received the benefit of the payment (attorney's services) which makes the amount part of gross income.

SETTLEMENT REVIEW & APPROVAL

In addition to following IRS tax regulations when making settlement payments, due consideration must be given to processes and programs administered by the State. For instance, settlements may include references to employee benefits or leave accruals, and special funding sources may be required to cover the settlement payment.

The *State of Delaware Employment Settlement Worksheet* ensures all potential impacts are addressed.

The list below explains the review and approval process and covers the areas that are most commonly affected. However, each settlement agreement is different and some may not require all of the processes in this list.

- Affected State Agency & Department of Justice
 - Obtain all signatures on Settlement Agreement
 - Complete and sign a State of Delaware Employment Settlement Worksheet
 - Submit settlement agreement and worksheet to the State Payroll Compliance Group
- Payroll Compliance Group
 - Review and approve income characterization
 - Determine appropriate tax treatment and reporting
 - Advise affected State agency on what other State administrative offices must be notified
- Statewide Benefits Office
 - Reinstatement of health benefits
 - Medical expenses consideration
- OMB
 - Funding sources must be approved by an OMB Budget Analyst
- Organization
 - Organization must update leave balances in PHRST
- State Pension Office
 - Back pay awards must be mapped to specific pay periods
 - State Pension Office adjusts pension creditable service according to the intent of the agreement.

REGULATORY REFERENCES

Information provided in this bulletin is supported by applicable sections of the Internal Revenue Code and Treasury Regulations cited below.

IRS

IRC §104(a)(2) – Compensation for Injuries or Sickness

This section excludes from gross income the amount of any damages (other than punitive damages) received in settlement of a claim for personal physical injuries or physical sickness. Standing alone, emotional distress is not considered a physical injury or a physical sickness for purposes of §104(a)(2). However, recoveries paid for medical care described in §213(d)(1)(A) and (B) attributable to emotional distress are excludable under §104(a)(2), provided that the recipient has not previously deducted such amounts as medical expenses under §213.

Attorney's fees are taxable to the claimant in settlement of an employment-related lawsuit as more fully provided in **Treas. Reg. §1.6041-1(f)**.

TAX ADVICE DISCLAIMER

Although the opinion provided here is presented in good faith and believed to be correct, it is general in nature and is not intended as tax advice. Furthermore, the facts and regulatory references applicable to a particular scenario may not be applicable to or suitable for other similar scenarios that may require consideration of other factors.

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