

PAYROLL: SETTLEMENT PAYMENTS

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PAYROLL: SETTLEMENT PAYMENTS

I. INTRODUCTION

This chapter provides general guidelines on the tax treatment of settlement payments, including severance payments¹, made by the University pursuant either to litigation (including an arbitration proceeding or internal or external administrative proceeding) or a claim for payment that is not made through litigation.

The withholding and reporting requirements for the types of settlement payments discussed in this chapter are provided in section V. A table detailing the tax treatment of such payments is included in Appendix A.

II. AUTHORITIES

A. SETTLEMENT OF CLAIMS AND LITIGATION

1. President

* The [Interim Policy on Separation Agreements and Settlement of Employee Claims](#) (Policy) grants the President the authority to settle non-litigated employment claims when the consideration paid by the University has a value not in excess of \$100,000. In emergency circumstances, the President may seek interim approval from The Regents for approval of up to \$200,000.

2. The General Counsel

* The Policy also requires that all separation and settlement agreements in litigated and non-litigated employment matters shall be submitted to the Office of the General Counsel for review and comment. All such settlements shall include a release approved by the General Counsel.

*¹ The Senior Management Supplemental Benefit Program is covered under Accounting Manual chapter [P-196-11](#).

3. The Regents

The Policy requires that settlements must be submitted to The Regents when the consideration to be paid by the University has a value in excess of \$100,000 or when significant questions of University policy are involved. If the President determines that emergency circumstances require approval of a separation or settlement agreement involving consideration between \$100,000 and \$200,000, the Chairman of the Board and the Chairman of the Committee on the Special Committee on Compensation may approve such an agreement as an interim action.

4. Chancellors and LBNL Director

The authority and responsibilities granted to the President for settlement of claims up to \$100,000 that are not litigated may be delegated to the Chancellors and Laboratory Director ([DA2171](#)). Chancellors and the LBNL Director have authority to approve settlement of such employment claims up to \$50,000.

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Campus and Laboratory recommendations for settlement of claims must be submitted by Chancellors and Laboratory Directors, as follows:

- Claims to be funded under the Risk Management Program to the Director--Risk Management;
- Claims that originate with Human Resources (e.g., grievances and unfair labor practice charges) but are not eligible for Risk Management funding to the Associate Vice President--Human Resources; and
- * All other claims to the Office of the General Counsel.

Each settlement agreement is individually negotiated and the General Counsel is either involved in the negotiations or in a review of the proposed agreement

II. AUTHORITIES (Cont'd.)

A. SETTLEMENT OF CLAIMS AND LITIGATION (Cont'd.)

- * for approval as to form, subject to the Interim Policy on Separation Agreements and Settlement of Employee Claims. Thus, arrangements for the General Counsel's participation in the process should be made as soon as possible.

B. FACULTY SEVERANCE COMPENSATION

A faculty member with tenure or security of employment whose resignation is deemed to be in the interest of the University may be granted severance compensation. Under Regents Standing Order 103.7, the authority for approval of such compensation rests with the President, following consultation with the respective Chancellor. There is no limit to the amount of severance compensation that may be paid; in establishing an amount each case must be dealt with based on its merits.

C. SELF-INSURANCE PROGRAM CLAIMS

All settlements involving the University's three self-insurance programs must be coordinated with the Office of Risk Management. The three self-insurance programs include the Workers' Compensation Program, the Medical Malpractice Program, and the General Liability Program.

III. OVERVIEW

An employee or former employee may file a lawsuit alleging a number of tort or tort-like claims against the University, e.g., defamation, wrongful discharge, intentional infliction of emotional distress, sexual harassment, or discrimination based on race, sex or national origin. An employee may also raise these issues by filing a grievance. Such an action may result in the University making a payment to the employee.

The General Counsel has developed several model agreement formats that may be used as a starting point in developing the language for specific settlement agreements. When preparing a settlement agreement, it must be determined whether the payments authorized under the agreement are reportable for tax purposes and whether the University is liable for withholding and reporting income and employment (e.g., FICA) taxes.

This chapter provides tax reporting and withholding guidelines for the following types of payments:

- Back Pay Under a Statute
- Back Pay--Nonstatutory
- Legal Fees and Interest
- Dismissal Pay
- Compromise on an Employment Contract
- Buyout of Tenure Rights
- * • Damages for Personal Physical Injury or Personal Physical sickness

IV. GLOSSARY

Back pay award - A cash award paid to an employee under a court order, administrative decision, or settlement agreement. The payroll tax rules depend on who must pay the award and whether the award includes amounts for penalties, punitive damages, legal fees, and interest.

Damages - The term damages means any amount received (other than workers' compensation) through prosecution of a legal suit or action based upon tort or tort-type rights, or through a settlement agreement entered into in lieu of such prosecution.

Dismissal pay - Any payment made by an employer to an employee due to the employee's involuntary separation, including severance pay, front pay, and pay in lieu of notice of termination.

Emotional distress - Mental pain and suffering due to injury to reputation, discrimination, denial of promotion, etc. Emotional distress attributable to injury to reputation, etc. is not considered a physical injury or physical sickness for tax purposes (except to the extent of certain damages paid for medical expenses).

IV. GLOSSARY (Cont'd.)

Physical injury or sickness - Includes all damages (other than punitive damages) that flow from an actual physical injury or physical sickness, whether or not the recipient of the damages is the injured party.

Severance pay - A payment made by an employer to an employee due either to the employee's voluntary or involuntary separation.

Wages - In general, the term wages includes all remuneration for services performed by an employee for an employer. All wages are subject to employment taxes unless the payments are specifically excluded from income by the Federal tax code. ***The label given to a payment is not relevant in the determination of whether the payment constitutes wages.*** Thus, salaries, fees, commissions, bonuses, pensions, retirement pay are considered wages if paid as compensation for services performed by an employee for an employer.

With respect to payments made to an individual who is no longer an employee at the time the payment is made, Treasury Regulation 1.3401(d)-1(b) states that the payor remains an employer for purposes of the withholding obligation.

V. TYPES OF SETTLEMENTS

The withholding and reporting requirements for the types of settlement payments discussed in this chapter are presented in table format in Appendix A.

*

A. BACK PAY

Back pay is defined as compensation received in one period for employment (or potential employment) in an earlier period. Back pay does not include amounts specifically designated otherwise, e.g., damages, interest, penalties, and legal fees.

1. Back Pay Under a Statute

In general, back pay awarded under a statute is a payment by an employer pursuant to an award, determination, or agreement approved or sanctioned by a court or government agency responsible for enforcing a Federal or state statute that protects an employee's right to employment or wages.

If the back pay award from such an agreement is intended to comply with the provisions of a Federal or state law that restores an employee's right to employment or wages, the award constitutes back pay under a statute. The nature of the back pay award is not changed if a court-approved or sanctioned settlement agreement includes a clause that states the agreement is not an admission of discrimination.

* Appendix B contains a number of statutes that contain examples of the tax treatment of back pay awarded under a statute.

Tax Treatment

For tax purposes, the Internal Revenue Service (IRS) treats all back pay as wages in the year the award is paid. Thus, Federal and state income tax and FICA tax are withheld at the current rates and the back pay is reported as wages on Form W-2 in the year the back pay was actually paid (Rev. Rul. 78-336, 1978-2 CB 255).

For social security coverage and benefit purposes, the Social Security Administration (SSA) also treats back pay as wages, whether or not awarded under a statute. **However, the period for which back pay is credited as wages for social security purposes is different if the back pay is awarded under a statute.** The SSA credits

V. TYPES OF SETTLEMENTS (Cont'd.)

A. BACK PAY (Cont'd.)

1. Back Pay Under a Statute (Cont'd.)

back pay awarded under a statute to an individual's record in the period(s) the wages **should or would have been paid**. (Refer to IRS [Publication 957](#), for more information on the SSA's reporting requirements).

2. Nonstatutory Back Pay

The following types of payments are not considered to be made under a statute (unless they are made under the conditions specified in Section 1 above):

- A payment for back wages negotiated between an employer and an employee without an award, determination, or sanction by a court or government agency;
- Delayed wage payments and retroactive pay increases resulting from union negotiation; or
- Payments made under local ordinances or regulations.

Tax Treatment

Back pay is treated as wages in the year an award is paid. However, the SSA credits **nonstatutory back pay** to an individual's record in the period(s) the wages were **actually** paid. Thus, Federal and state income tax and FICA tax are withheld at current rates and the back pay is reported as wages on Form W-2 in the year actually paid (Rev. Rul. 78-336, 1978-2 CB 255).

3. Back Pay Awards to Terminated or Terminated and Rehired Employees

When a settlement agreement requires that a back pay award be made to a terminated employee, he or she may be required to complete new employment documents under the following circumstances:

- Terminated - If the employee separated from service in the current calendar year, the existing Employee's Federal-State Withholding Allowance Certificate may be used to determine withholding status. However, if the employee separated in a prior calendar year, a new Form UC W-4/DE 4 should be submitted. If the employee does not submit a completed Form UC W-4/DE 4, tax should be withheld as if the employee is single, with no withholding allowances.
- Terminated and Rehired - If the employee is returning to work, standard procedures for rehired employees apply. Since a back pay award is considered compensation for services previously rendered, the Form I-9, Employment Eligibility Verification Form, and the State Oath of Allegiance and Patent Agreement that were completed originally are still applicable and need not be resubmitted.

Tax Treatment

Refer to sections 1 or 2 above, as appropriate.

4. Court-Awarded Legal Fees and Interest

Revenue Ruling 80-364, 1980-2 CB 294 provides that court-awarded legal fees and interest are not considered wages **if they are awarded in amounts distinguishable from amounts awarded for back pay.** The Ruling provides the following three examples:

V. TYPES OF SETTLEMENTS (Cont'd.)

A. BACK PAY (Cont'd.)

4. Court-Awarded Legal Fees and Interest (Cont'd.)

a. Interest and Legal Fees Not Treated as Wages

After termination of employment by a company, an individual filed a complaint against the company for back pay owed to the individual. The court awarded the individual 8x dollars as back pay, and also awarded interest of 1x dollars and legal fees of 1x dollars.

Tax Treatment

While the full amount of the award constitutes income to the employee and must be included in the employee's gross income, only the back pay award of 8x dollars constitutes wages for Federal and state income tax and FICA tax withholding purposes. Since payments for interest and legal fees are not wages, such payments are not considered remuneration for employment and therefore are not subject to Federal, state, or FICA tax withholding.

Note: The amount of legal fees (1x dollars) is reported to the attorney on a Form 1099-MISC.

b. Interest and Legal Fees Treated as Wages

An individual sued the individual's employer for 15x dollars for back pay. Pursuant to a court order the employer made a payment to the employee of 10x dollars. The court order did not indicate that a portion of the award was for legal fees or interest. The employee paid 1x dollars for legal fees, which was paid out of the award.

Tax Treatment

Since the court order did not indicate that a portion of the award was legal fees or interest, the full amount of the award is income to the employee and is also wages for Federal and state income and FICA tax purposes, notwithstanding that a portion of it was spent on legal fees.

Note: When the payment is made as a check issued to the employee's attorney, or jointly to the employee and the employee's attorney, the full amount of the payment is also reportable to the attorney on a Form 1099-MISC.

c. Legal Fees Not Treated as Wages

Due to the breach of a collective bargaining agreement, a union filed claims on behalf of its members against a company. Subsequently, the union and the company entered into a settlement agreement, later approved by a Federal district court, which provided that the company would pay the union 40x dollars in full settlement of all claims. The union paid 6x dollars of the settlement for legal fees and returned 34x dollars to the employees for back pay owed to them. The back pay was distributed among the employees in proportion to their claims.

Tax Treatment

The amount of the settlement paid by the union for legal fees is not remuneration to the individual employees and, therefore, does not constitute wages for purposes of Federal or state employment taxes. Thus, since the portion of the settlement attributable to legal fees is a reimbursement for expenses incurred by the union to enforce the

V. TYPES OF SETTLEMENTS (Cont'd.)

A. BACK PAY (Cont'd.)

4. Court-Awarded Legal Fees and Interest

c. Legal Fees Not Treated as Wages (Cont'd.)

collective bargaining agreement, the amount allocated to such fees is not includible in the gross income of the individual employees. The individual employees may not deduct the legal fees as a business expense.

Note: The amount of legal fees is reported to the attorney on a Form 1099-MISC.

Reporting of Legal Fees

When a court order or settlement agreement requires an employer to make a separate payment to a former employee's attorney, the amount of the payment is reported as gross income to both the employee and the attorney. The attorney's fee represents a non-wage payment to the former employee and should be reported as gross income to the employee, not subject to income and FICA-Medicare withholding, on Form 1099-MISC. The payment to the attorney should also be reported as gross income to the attorney on Form 1099-MISC.

When the payment that includes both a settlement amount and legal fees is made as a check issued jointly to the employee and the employee's attorney, and the amount of legal fees to be retained by the attorney is unknown, the entire amount of the payment is reportable to the attorney on Form 1099-MISC. The full amount is also reportable to the employee on Form W-2 and is treated as wages for tax purposes.

The above reporting requirements apply to both court-awarded payments and settlement agreements.

(See Section VI., Attorney Fees Associated with Nontaxable Awards)

B. DISMISSAL PAY

1. General

Dismissal pay is defined as a payment made to an employee upon termination of employment when the separation was involuntary on the part of the employee. This includes payments made in lieu of a notice of termination.

Tax Treatment

As a general rule, any payments made by an employer to an employee on account of dismissal are wages subject to employment taxes, *regardless of whether the employer is legally bound by contract, statute, or otherwise to make such payments* (Reg. Sec. 31.3401(a)-1(b)(4)).²

Following are some examples of the types of dismissal payments that are treated as wages:

- Payments made by a company in settlement of a discrimination claim brought against it by an employee whose services were terminated by the company are wages for Federal income tax withholding purposes (Rev. Rul. 72-572, CB 1972-2, 535).
- Dismissal payments made to former employees under a union contract by a company that had terminated its operations are wages (Rev. Rul. 71-408, CB 1971-2, 340).

² The Supreme Court has determined that a taxpayer's gross income includes attorney contingent fees paid out of lawsuit settlements of taxpayer's discrimination and wrongful termination-related claims against ex-employers. Such fees are reportable to both the attorney and the taxpayer on separate

* Forms 1099 (see Appendix A).

V. TYPES OF SETTLEMENTS (Cont'd.)B. DISMISSAL PAY (Cont'd.)1. General (Cont'd.)

- Amounts paid by a company to striking employees who were not reemployed after settlement of a strike are wages (Rev. Rul. 73-166, CB 1973-1, 411).
- Payments made to an employee following his involuntary termination under the terms of a three-year contract permitting the employer to terminate the employment relationship if the employee is paid an amount equal to an additional six months of salary are considered wages (Rev. Rul. 74-252, CB 1974-1, 287).

2. Buyout of Tenure Rights

Payments made to a faculty member to relinquish employment rights acquired as consequences of past service are considered wages for employment tax purposes (Rev. Rul. 75-44, 1975-1 CD 15). For example, in Private Letter Ruling 9711001 (which referred to Rev. Rul. 75-44), the IRS National Office ruled that a university's payments to induce professors to give up tenure and retire early were wages for FICA purposes because the payments were made to cancel tenure rights that related to past services, *rather than to cancel a contract right.*³

Severance payments made to tenured faculty cannot be made with Federal or State funds.

³ Although a Private Letter Ruling is only binding on the party that requested the ruling, it provides insight into how the IRS might view similar situations.

Tax Treatment

Payments are subject to Federal and state income and FICA tax withholding at the current rate.

3. Severance Payments

Severance payments are characterized as compensation in recognition of past services and are almost always considered as wages. It does not matter if the separation is voluntary or involuntary. Any payment made on account of dismissal constitutes wages regardless of whether the employer is legally bound by contract, statute or otherwise to make the payment.

Tax Treatment

Severance payments are considered to be supplemental wages subject to withholding of applicable Federal and state income tax and FICA.

4. Front Pay

Dismissal pay also includes front pay, which represents wages that an employee would have earned in future years.

Tax Treatment

Front pay is treated as wages for income and FICA/Medicare reporting purposes in the year(s) in which payments are made.

5. **Exception:** Compromise on an Employment Contract

If changes in policy, reorganization, or other factors make it expedient for an employer to terminate the employment contract of a particular employee, the employer and the employee may reach a compromise settlement regarding the amount due for the remainder of the period covered by the

V. TYPES OF SETTLEMENTS (Cont'd.)

B. DISMISSAL PAY (Cont'd.)

5. **Exception:** Compromise on an Employment Contract
(Cont'd.)

contract. (Under University policy, a contract position may be established for a fixed or variable percentage of time for a definite period. If the contract is terminated by the University for reasons other than death or disability, the University's only obligation should be limited to the terms and conditions set forth in the written employment contract.)

Tax Treatment

This type of settlement payment **does not** constitute wages for Federal employment and income tax withholding purposes. Such settlements are considered payment for the relinquishment of the employee's interest in the employment contract rather than payment for past performance of services. However, the payment is includible in gross income for Federal income tax purposes and should be reported on a Form 1099-MISC, since the employee must include the settlement in income when filing his or her Federal income tax return (Rev. Rul. 55-520, 1955-2, CB 393; Rev. Rul. 58-301, 1958-1 CB 23).

* C. DAMAGES FOR PERSONAL PHYSICAL INJURY OR PERSONAL PHYSICAL SICKNESS

1. Physical Injury or Physical Sickness

IRC Section 104(a)(2), as amended by the Small Business Job Protection Act of 1996 (the 1996 Act)⁴ provides that damages, other than punitive damages, received as compensation for personal *physical* injury or personal *physical* sickness are excluded from income, effective generally for amounts received after August 20, 1996.

This is the case irrespective of whether the damages are awarded as a result of a suit or an

⁴ The 1996 Act amendments to section 104(a)(2) apply generally to amounts received after August 20, 1996; however, prior law rules apply to amounts received (even if after August 20, 1996) under a written binding agreement, court decree, or mediation award in effect on (or issued on or before) September 13, 1995.

agreement, or paid in a lump-sum or in periodic payments. If an action has its origin in a physical injury or physical sickness, then all *nonpunitive* damages attributable to that injury or sickness are excluded from income, whether or not the recipient of the damages is the injured party.

2. Emotional Distress

Emotional distress is not considered a physical injury or physical sickness. Therefore, any payment attributable to emotional distress that is not related to a physical injury or illness is includable in gross income. However, if a claim for emotional distress is attributable to physical injury or physical sickness, then the nonpunitive damages are excludable.

**

The legislative history to Internal Revenue Code section 104 says that the term "emotional distress" includes physical symptoms (such as insomnia, headaches, stomach disorders, etc.) that result from the alleged emotional distress. But because damages received on account of physical injury or physical sickness are excludable, Congress also said that any damages based on emotional distress that are attributable to a physical injury or sickness can be excluded under section 104. For example, if someone falls and hits their head causing a physical injury, and as a result of this injury, suffers from emotional distress, any amounts allocable to the emotional distress can be excluded because the origin of the distress was the physical injury. But if the origin of the physical problem was emotional distress, the amount is taxable.

V. TYPE OF SETTLEMENTS

C. DAMAGES FOR PERSONAL PHYSICAL INJURY OR PERSONAL PHYSICAL SICKNESS (Cont'd.)

2. Emotional Distress (Cont'd.)

If a claim for emotional distress is based on a claim of employment discrimination or injury to reputation, then only the damages received up to the amount paid for medical care that is attributable to emotional distress is excludable (Code Sec. 104(a)).

3. Punitive Damages

Generally, *punitive damages* received after August 20, 1996, are taxable, regardless of the nature of the claim. However, there are two exceptions:

- The prior law exclusion for punitive damages applies to amounts received under a written binding agreement, court decree or mediation award in effect on (or issued on or before) September 13, 1995.
- Punitive damages are excludable under the prior law rules if received in a civil action that is a wrongful death action, and under applicable state law (as in effect on September 13, 1995 and without regard to later modification) which provides (or has been construed by a court to provide) that only punitive damages may be awarded in the action (Code Sec. 104(c)).

** VI. ATTORNEY FEES ASSOCIATED WITH NON TAXABLE AWARDS

If the University settles a case with a plaintiff, and if the damage award settlement payment is excludable from the plaintiff's income, then any attorney fees are not taxable to the plaintiff either. An example is a settlement for either physical injury or sickness. This type of settlement is considered excludable from income. For example, if the settlement amount of \$100,000 is paid to the plaintiff, and included in the amount is \$15,000 for

attorney fees, then the whole \$100,000 is excludable from the plaintiff's income. However, the \$15,000 attorney fee portion still must be reported by the University to the attorney on a Form 1099.

VII. SETTLEMENTS THAT INCLUDE BENEFITS

When a settlement includes a benefits arrangement, the authorities responsible for preparing and negotiating the settlement must ensure that the benefits offered, e.g., pension, health, or welfare benefits, do not conflict with the benefits provided under the University's plans. The UC Benefits Programs office (UC Benefits) may be consulted for more information, as appropriate.

Tax Treatment

With respect to the tax treatment of health benefits payments, IRC Section 106 sets forth exclusion for health insurance premiums paid by an employer for an employee. The IRS has also ruled that a retired or laid off employee, whom the employer is planning on rehiring, will be treated as an employee for purposes of the Section 106 exclusion (Revenue Ruling 62-199, 1962-2 CB 38 and Revenue Ruling 85-121, 1985-2 CB 56). This is the case even though the retired or laid off employee is not technically an employee at the time the premium payment is made.

There is no exception for terminated employees. Therefore, health premium payments such as, COBRA payments, made by the University on behalf of terminated employees, represent taxable income to the individual. These payments represent wages paid by an employer and are subject to Federal and state income tax and FICA withholding even though the person is no longer a University employee. In addition, the payments are reportable on Form W-2.

VIII. ANNUITIES IN LIEU OF LUMP SUM PAYMENTS

- ** The University occasionally enters into agreements with employees relating to workplace issues. Such agreements can sometimes result in the University's agreeing to make a payment to the employee representing past or future wages.

VIII. ANNUITIES IN LIEU OF LUMP SUM PAYMENTS (Cont'd.)

In other cases, the agreement might call for a payment to the employee in return for the employee's agreeing to release a non wage-based claim against the University, such as one for emotional distress, loss of reputation, or physical injury. In still other cases, the University might agree to make a payment to one or more employees as an incentive for the employee's agreeing to leave his or her position prior to normal retirement age. Finally, it is possible that the agreement could call for a single payment that is intended to settle several workplace issues at the same time.

- ** Sometimes, as part of the negotiations, the employee requests that, in lieu of a lump sum settlement payment, an annuity be purchased to provide periodic payments over a stated period of time, such as the employee's lifetime. For example, in early retirement situations, the employee may ask for monthly payments that represent the difference between the employee's retirement benefit following severance and the benefit the employee would have received if he or she had retired from University service at a later date.

Tax Treatment

- ** There is a strong presumption under the tax laws that any payment made to an employee as part of a settlement agreement is considered a "wage" payment and is therefore subject to Federal and state income tax and FICA tax withholding. For example, payments intended to compensate the employee for past or future wages, as well as early retirement and severance payments, are treated as wages when paid. But if the underlying dispute for which the payment is made involves a matter unrelated to the employment relationship (for example, a tort action seeking damages for physical injury or emotional distress), the payment is treated as a nonwage payment and is not subject to Federal and state income and FICA tax withholding, although the employee may still be required to pay tax on the payment received.

** There is an additional issue that arises when the settlement payment is paid over a period of time. Specifically, such periodic payments may be treated as "deferred compensation," and deferred compensation payments are subject to a special set of tax rules. Under these rules (which can be found in Internal Revenue Code sections 409A and 457), the deferral is ignored and employee is subject to immediate taxation of the deferred amounts, as well as a 20% excise tax plus interest. However, the following exceptions to these deferred compensation rules allow the employee to be taxed on the periodic payments in the years actually received:

** 1. Nonwage Exception

If the settlement payment is not treated as a wage payment (for example, because it is made for a release of tort-based claims such as emotional distress, physical injury, etc.), it is not treated as "compensation" and therefore is not subject to the deferred compensation rules.

Such nonwage settlements may be paid under an annuity agreement purchased by the University and paid over any period of time.

** 2. Severance Payment Exception

Even if the payment is treated as wages, and therefore as deferred compensation, the IRS has said that the deferred compensation rules will not apply to bona fide "severance payments." In order to qualify as a severance payment, the payment must meet **either** of the following two tests:

- a. **Collective Bargaining Test** - Under this test, the severance payment is made pursuant to a collective bargaining agreement and is provided upon an involuntary termination or a window program. (A "window program" is one providing separation pay for a particular group of employees during a limited period of time not to exceed one year).

VIII. ANNUITIES IN LIEU OF LUMP SUM PAYMENTS (Cont'd.)

2. Severance Payment Exception (Cont'd.)

b. **Two-Year Payment Test** - In order to meet this test the following conditions must be satisfied:

- The agreement must provide for payment only upon involuntary termination or under a window program (as defined above),
- The payment must not be for more than two times the lesser of (i) the employee's annual taxable compensation, or (ii) the compensation limit for qualified plans under Code Sec. 401(a)(17) for the year before the year in which the termination occurs (this amount is adjusted annually, and the amount for 2007 is \$225,000), and
- No payment may continue beyond the end of the **second calendar year** following the year in which the termination occurs. For example, if the termination occurs on July 1, 2007, no periodic payment may be made to the employee after December 31, 2009.

If the settlement payment is treated as wages and qualifies under the Collective Bargaining Test described above, payments may be paid under an annuity agreement purchased by the University and paid over any period of time. An annuity payment would not be appropriate under the Two-Year Payment Test, however, because of the short time period within which the settlement payment must be made.

Finally, as noted above, sometimes a settlement agreement will call for a single payment that is intended to settle two or more different workplace disputes, such where the employee seeks damages for lost wages and for emotional distress. In these cases, an allocation must be made to assign portions of the settlement payment to the different underlying disputes, and the tax consequences may differ with respect to each.

For example, assume that a settlement agreement that is intended to settle both a wage-based and tort-based claim calls for a payment by the University of \$100,000 to be spread over 10 years. If it is reasonable to allocate, say, \$70,000 to the wage-based claim, the deferred compensation rules discussed above would prevent paying this portion of the settlement payment over the 10 year period. But, it would be permissible to spread \$30,000 of the payment over 10 years because the deferred compensation restrictions do not apply to nonwage payments.

IX. RESPONSIBILITIES

A. ACCOUNTING OFFICE

* The Accounting Office is responsible for determining the withholding and reporting obligations for each specific settlement agreement, in consultation with Risk Management, the General Counsel, and the Office of the Executive Vice President--Business Operations.

B. RISK MANAGEMENT

Risk Management is responsible for coordinating all claims to be funded under the Risk Management self-insurance programs and for ensuring that risks within its area of responsibility are managed effectively and efficiently.

C. ASSOCIATE VICE PRESIDENT--HUMAN RESOURCES

The Office of the Associate Vice President--Human Resources and Benefits is responsible for ensuring that risks within its areas of responsibility, e.g., grievances and unfair labor practice charges, are managed effectively and efficiently.

* D. PROVOST AND EXECUTIVE VICE PRESIDENT--ACADEMIC AND HEALTH AFFAIRS

* The Office of the Provost and Executive Vice President--Academic and Health Affairs is responsible for ensuring that faculty severance claims are managed effectively and efficiently.

IX. RESPONSIBILITIES (Cont'd.)

E. VICE PRESIDENT--FINANCIAL MANAGEMENT

The Office of the Vice President--Financial Management is responsible for establishing implementing procedures

for withholding and reporting income and employment taxes.

** F. THE PRESIDENT

** The President is responsible for reporting to The Regents on all non-litigated separation and settlement agreements of \$50,000 or above.

G. THE GENERAL COUNSEL

The concurrence of the General Counsel is required in connection with any settlements over \$50,000. In addition, the General Counsel should participate in negotiations for settlement agreements or review proposed agreements as to form and provide advice on the University's obligations to withhold and report income and employment taxes.

X. REFERENCES

Internal Revenue Code, Section 104(a), 104(c), 106
Regulation Sec. 31.3401(a)-1(b)(4)).
Proposed Sec. 1.6045-5

Revenue Ruling 55-203, 1955-1 CB 114
Revenue Ruling 55-520, 1955-2, CB 393
Revenue Ruling 57-55, 1957-1 CB 304
Revenue Ruling 58-301, 1958-1 CB 23
Revenue Ruling 62-199, 1962-2 CB 38
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Outside Counsel Bertrand M. Harding, Jr. email to Michael
O'Neill Sept 30, 2003

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Settlement of Employee Claims, Approved January 17, 2006 and
Amended May 18, 2006

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and 6/30/06, 3/31/07, 9/30/07, and 3/31/08; analyst--John
Barrett.

*APPENDIX A TAX TREATMENT OF SETTLEMENT PAYMENTS

Description of Payment	Tax Code	Type of Payment	Payment Subject to Deductions for			Workers' Comp. Ins./ Unemp. Ins. (5)	Tax ID # Req'd.	Reported on
			With-hldg. (1)tax	OASDI /MED (2)	UCRP,PERS, FCSRS, OCERS, SCERA(3)			
** Annuities in Lieu of Lump Sum Payments-Wage Claims		Payroll	Yes	Yes	No	Yes	Yes	Form W-2 (9)
* Back Pay (Statutory and Non-statutory)	-	Payroll	Yes	Yes	(4)	Yes	Yes	Form W-2 (6)
Buy Out of Faculty Member's Tenure Rights	-	Payroll	Yes	Yes	No	Yes	Yes	Form W-2
COBRA payments on behalf of a separated employee	-	Payroll	Yes	Yes	No	No	Yes	Form W-2
Compromise on an Employment Contract	8	Vendor	No	No	No	No	Yes	Form 1099 MISC
** Damages for Emotional Distress Related to Personal Physical Injury or Personal Physical Sickness, and Damages for Personal Physical Injury or Personal Physical Sickness	-	Vendor	No	No	No	No	No	(Not reportable)
Dismissal Pay	-	Payroll	Yes	Yes	No	Yes	Yes	Form W-2
Emotional Distress not Related to Physical Injury or Sickness	8	Vendor	No	No	No	No	Yes	Form 1099 MISC
Legal Fees paid that are included in a settlement payment to the plaintiff in a case that is considered not taxable to the plaintiff	-	Vendor	No	No	No	No	No	
Legal Fees and Interest Paid by the Employer from a settlement or court ordered award for back pay that does not indicate that a portion of the award is for legal fees and interest (reported to employee)	-	Payroll	Yes	Yes	No	Yes	Yes	Form W-2
Legal Fees and Interest Paid by the Employer from a settlement or court ordered award for back pay that does not indicate that a portion of the award is for legal fees (reported to attorney)	2	Vendor	No	No	No	No	Yes	Form 1099-MISC (7)
Legal Fees and Interest awarded in amounts distinguishable from amounts awarded for back pay	8	Vendor	No	No	No	No	Yes	Form 1099 MISC (8)
Liquidated Damages paid under the Fair Labor Standards Act	8	Vendor	No	No	No	No	Yes	Form 1099 MISC
Severance Pay	-	Payroll	Yes	Yes	No	Yes/No	Yes	Form W-2

**Addition 9/30/07

*Change 9/30/07

Footnotes

- (1) For information on the calculation of Federal withholding, refer to [Circular E](#), Employers Tax Guide. For State withholding refer to the California Employer's Guide.
- (2) Deductions for OASDI or Medicare apply only to employees who meet the eligibility requirements for these employment taxes (see Accounting Manual chapter [P-196-30](#), Payroll: OASDI and Medicare Contributions).
- (3) Deductions for retirement apply only to employees who are contributing members of a retirement system.
- (4) Refer to the appropriate Plan Documents to determine whether the payment is covered compensation for retirement. For a UCRP member, for example, back pay that constitutes an increase in regular wages would be covered compensation for retirement, but back pay for unpaid overtime would not be.
- (5) Unemployment insurance is applicable only if both conditions apply:
 - (a) The payment constitutes covered wages, and
 - (b) The payment is made to an employee who is eligible for coverage.

All employees are covered by unemployment insurance except University of California students who are registered for a minimum number of units (as set by the location), and are not members of a retirement system (other than the Defined Contribution Plan).
- (6) The SSA credits back pay awarded *under a statute* to an individual's record in the period(s) wages should or would have been paid. Refer to IRS [Publication 957](#) for a detailed discussion of the SSA's reporting requirements.
- (7) When the payor of a *taxable* settlement or court ordered claim makes a lump-sum payment (where the amount of the attorney fees is not known) to the claimant's attorney, the full amount of the payment must be reported on a separate Form 1099-MISC to the attorney.

APPENDIX A

Footnotes (Cont'd.)

(8) When the payor of a *taxable* settlement claim makes a separate check payable to the claimant's attorney, the full amount of both the settlement claim and the attorney's fees must be reported to the claimant. The amount of the attorney's fees is not subject to withholding and must be reported to the claimant on a Form 1099-MISC. In addition, a separate Form 1099-MISC must be provided to the attorney to reflect the separate payment made to him.

** (9) Only available if collective bargaining test requirements are satisfied.

*APPENDIX B STATUTES RELEVANT TO THE TAX TREATMENT OF BACK
PAY AWARDS

Age Discrimination in Employment Act

The U.S. Supreme Court held that back pay and liquidated damages received in settlement of a claim under the Age Discrimination in Employment Act of 1967 **were includible in gross income** (*IRS v. Schleier*, U.S. Sup. Ct. Dkt. No. 94-500, 95-1 USTC).

Civil Rights Act

The U.S. Supreme Court held that back pay awards received in settlement of claims under Title VII of the Civil Rights Act **are not automatically excludable from gross income** under the Code as damages received due to personal injuries. The Court's opinion was limited to the Federal income tax question and did not address the FICA treatment of such settlements (*Burke et al. v. U.S.*, U.S. Sup. Ct. Dkt. No. 91-42, 92-1 USTC).

Back pay received in satisfaction of a claim for denial of a promotion due to disparate treatment discrimination under Title VII is **includible in gross income, and subject to Federal income tax withholding and FICA** because it is completely independent of, and is not damages received on account of, personal physical injuries or physical sickness (Rev. Rul. 96-65, IRB 1996-53, 5).

Fair Labor Standards Act

A back pay award under the Fair Labor Standards Act as the result of unpaid minimum wages or unpaid overtime compensation **constitutes wages for Federal income tax withholding and FICA purposes**. Liquidated damages paid in settlement of Fair Labor Standards Act violations are **not "wages" for Federal employment tax purposes but are includible in income**. (Rev. Rul. 55-203, 1955-1 CB 114; Rev. Rul. 72-268, 1972-1CB 313; PLR 8625054).

APPENDIX B (Cont'd.)

Higher Education Employer Employee Relations Act (HEERA)

As a California public sector higher education employer, the University is covered by HEERA, not by the National Labor Relations Act (NLRA). However, Internal Revenue Code (IRC) case law and revenue rulings regarding back pay awards ordered by the National Labor Relations board are applicable by analogy to back pay awards ordered under HEERA by the California Public Employment Relations Board (PERB). Therefore, back pay awards ordered by PERB as a result of an employer's unfair labor practices **must be treated as wages by the employer for Federal income tax withholding purposes** (Rev. Rul. 57-55, 1957-1 CB 304) and for FICA purposes as well (*Soc. Sec. Board v. Nierotko*, 327 U.S. 358 (1946); Mim. 6040, 1946-2 CB 155). This is true whether the employer alone is ordered to make the payment or both the employer and the labor organization are made responsible for the payment, regardless of which of them actually makes the payment. When the back pay order is directed exclusively at the labor organization, however, and it alone makes the payment, **the payment still constitutes gross income even though it is not treated as wages and is not subject to withholding** (Rev. Rul. 75-64, 1975-1, CB 16).

If an unfair labor practice involves a wrongful discharge, the employee involved will be deemed to have been an employee of the employer who wrongfully discharged him, even during the period the employee was not working for the employer because of wrongful discharge (*Ainsworth v. U.S.*, 399 F2d 176; Mim. 6040, 1946-2 CB 155). Back pay will be deemed **compensation for work the employee would have done** had the wrongful discharge not occurred (*Purdy v. Ribicoff*, 198 FSupp 812; Rev. Rul. 72-268, 1972-1 CB 313).