STATE OF COLORADO

GENERAL SUPPORT SERVICES
OFFICE OF THE STATE CONTROLLER

1525 Sherman Street, 2nd Floor
Denver, Colorado 80203
Phone: (303) 866-3281
Fax: (303) 866-4233

Roy Romer
Governor

Department of Personnel
André N. Pettigrew
Executive Director

Clifford W. Hall
State Controller

TO: Controllers, Personnel Administrators and Payroll Officers

FROM: Clifford W. Hall
State Controller

DATE: January 7, 1997

SUBJECT: *Updated Tax Guide for Settlement Awards*

Income tax reporting for personal injury awards has recently been clarified by the Small Business Job Protection Act (SBJPA) signed into law by President Clinton on August 20, 1996. Accordingly, page 3 and pages 5 through 7 of the attached Guide have been updated for your use.

As you recall, this Guide provides the state controller policy for federal income tax reporting and withholding for settlement awards. Settlement awards may include claims against the state for physical and property claims or for personal injury. Use of this Guide is mandatory for state agencies and institutions reporting income and withholding taxes via the state's financial system (COFRS) and payroll system (CPPS). Settlement agreements are considered to be a "contract" as set forth in Rule 3 of the State Fiscal Rules and therefore must be signed by this office. The updated Guide can also be found at the state controller's web site: http:\\www.state.co.us\gov_dir\gss\acc\accpubs.html.

Questions concerning this Guide should be directed to Phil Holtmann at 866-3809. Thank you.

Attachment

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GUIDE

FOR TAX REPORTING
AND WITHHOLDING
OF
SETTLEMENT AWARDS

Office of the State Controller
State of Colorado
Revised January, 1997

I. Purpose

The purpose of this guide is to provide information necessary to determine the state's tax reporting and withholding responsibilities for various types of settlement payments awarded by the state. This is necessary to comply with Internal Revenue Service (IRS) guidelines.

This guide is based upon State Controller's Office (SCO) knowledge of the federal tax laws and regulations. Federal tax laws and regulations periodically change. Further, court decisions frequently provide additional guidance. This guide will be updated as necessary to reflect any significant changes.

Questions concerning this guide should be addressed to Phil Holtmann at 866-3809.

II. General Information

A. Introduction

The state provides a wide range of services to its citizens, and therefore is exposed to a wide variety of claims for damages. In addition to physical and property damages, the state can be found liable for personal injury such as emotional distress or economic loss. When the state is named a party to a claim, the amount of damages awarded may be either by negotiations with the injured party or by a court of law. Once a settlement has been reached, a release or a release and settlement agreement is prepared and signed. The claimant agrees that in exchange for monetary compensation and/or the performance of a remedial action, the state is released from further liability.

B. Principles

1. Federal Law Governs

Although state law determines the nature of the legal interests and rights created by state law, the federal tax consequences pertaining to such interests and rights are solely a matter of federal law. For this reason this document focuses on federal tax law. [Brabson v. United States, 10th Cir. (1996)].

2. Reporting and Withholding Requirements for Settlements and Judgments.

For the purpose of determining the reporting and withholding requirements in settlements and judgments, it makes no difference whether the matter is concluded through an agreement of the parties or proceeds to a final court adjudication. The reporting requirements under federal tax law are the same.

3. Concept of Gross Income and Exclusions

For federal income tax purposes "gross income" means all income from whatever source, except for those sources specifically excluded by the Internal Revenue Code. (26 U.S.C. Section 61(a)). The "sweeping scope" of this section has been repeatedly emphasized by the Supreme Court. (*Schleier* v. Commissioner, 115 S. Ct. 2159, 2163 (1995); O'Gilvie, 66 F.3d at 1555) Thus, any gain constitutes gross income unless it can be demonstrated that it falls within a specific exemption. (Wesson v. United States, 48 F.3d 894, 898 (5th Cir. 1995). See Schleier, 115 S Ct. at 2163)

The exclusions are very limited but do include those shown below as set forth in Section 104(a)(relevant parts):

- amounts received under Workmen's Compensation Acts as compensation for personal injuries or sickness;

- 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. For purposes of this paragraph, emotional distress is not treated as a physical injury or physical sickness. The exclusion does apply to damages received that are not in excess of the amount paid for medical care attributable to emotional distress.

The exclusion immediately above is also interpreted to apply to any damages (other than punitive damages) received based on a claim of emotional distress that is attributable to a physical injury or physical sickness.

The State of Colorado is responsible under the law to report and withhold taxes for claimants as is necessary in accordance with the Internal Revenue Code. In instances where it is unclear if the state has a duty to report and withhold taxes, a conservative strategy will be taken by the state by withholding taxes at the source and reporting the payments on information returns. The rationale for this strategy is "the default rule of statutory interpretation that exclusions from income must be narrowly construed" (specifically excluded by a federal tax law). [*Schleier*, 115 S.Ct. at 2163 (quoting *Burke*, 504 U.S. at 248)].

4. Origin of the Claim and Allocation of the Damages Awarded

The requirement to report and withhold taxes is determined by reference to the underlying claim and the redress that is sought. The Supreme Court has repeatedly held that the origin of the claim controls the treatment of the recovery. [See U.S. v. Gilmore, 372 U.S.39 (1963); Hort v. Comr., 313 U.S.28 (1941)]. Also, Rev. Rul. 85-98 indicates that the IRS will look to the claim as the most persuasive evidence of how to characterize an amount recovered in a settlement.

"The recovery should be taxed in the same manner as the item for which it is intended to substitute. Thus, any funds generated by a lawsuit should be treated for tax purposes as if the harm and economic detriment had not occurred, and the plaintiff had continued undisturbed. Accordingly, the origin of the claim, whether it be a suit for lost profits, or for harm to capital assets, must be established." (Wood, 522 T.M.,Tax Aspects of Settlements and Judgments.)

It is state policy to examine the original claim and redress sought in order to determine whether a settlement payment or portion thereof must be reported to federal authorities. In some instances, the redress sought may include multiple claims for damages. As a result, it may be necessary to allocate the damages awarded in the settlement agreement to determine the dollar amount, if any, that must be reported and/or withheld for tax purposes. The allocation must be limited to the type of damages sought in the documented claim. Methods of allocation are limited to:

- Allocating the damages awarded proportionally among the dollar amounts of the damages claimed; or

- Allocating the damages awarded among one or more of the damages sought in the documented claim based on the state's judgment of which claim is being paid.

The rationale for the allocation must be documented in the claim file and must reflect the realities of the underlying legal action.

III. Types of Claims and Reporting Requirements

A. Back Pay Awards

An award for back pay is treated in the same manner as salary or wage payments. [CFR 1.61-2(a)(1)]. Also, such payments are subject to income tax withholding.

An action to recover back pay may be linked to more than one type of claim. For example, back pay may be linked to a discrimination claim or settlement of an employment contract. In these instances, refer to the specific types of claim to determine the reportability of such awards.

Awards for back pay not linked to other claims for compensation shall be treated as follows:

- Reportable to federal tax authorities.
- Withholding of employment taxes and PERA is required.
- A Form W-2 must be issued.
- Payment must be processed through CPPS.

Interest on back pay awards is not considered wages and is not subject to withholding. (L.Melani, DC N.Y.,87-1 USTC¶9307;652 Fsupp 43). Interest payments will be reported separately on Form 1099-INT

B. Personal Injury Claims [Small Business Job Protection Act (SBJPA) signed into law by President Clinton on August 20, 1996]

The term personal injury includes physical injuries such as broken bones and non-physical injuries such as discrimination, libel, slander, damage to reputation or character discrimination and emotional distress such as pain and suffering.

DEFINITIONS

Physical injury. Bodily harm or hurt, excluding mental or emotional distress.

Non-physical injury. Mental or emotional distress. Emotional distress, includes the physical symptoms (e.g.,insomnia, headaches, stomach disorders) resulting from such distress, and to employment discrimination or injury to reputation accompanied by a claim of emotional distress.

Non-punitive damages. Compensatory or actual damages that compensate an injured party for the injury sustained and that make good or replace the loss caused by the wrong or injury.

Punitive damages. Damages awarded over and above the amount necessary to compensate an injured party for the actual loss. Damages awarded as punishment for willful, malicious or fraudulent behavior.

1. Non-Reportable Personal Injury Awards

A. Non-punitive damages for physical personal injuries including physical sickness.

Example. Barbara Jones was awarded $20,000 for physical injuries received in an automobile accident while making a sales call for her employer. The entire award was for the actual physical injuries she suffered and therefore would not be reportable to federal tax authorities.

B. Non-punitive damages for emotional distress and other non-physical injuries or sickness to the extent attributable to a physical injury or sickness.

Example. Robert and Shirley Smith were awarded $20,000 for physical injuries Robert received in an industrial accident in his employer's plant. Half of the award was for his actual physical injuries. The remainder was for Shirley's loss of consortium with her husband resulting from his injuries. The entire award would not be reportable to federal tax authorities because the action is attributable to the physical injury.

C. Non-punitive damages for non-physical injuries to the extent of the amount paid for medical care attributable to emotional distress.

Example. Marcia Brown was awarded $30,000 for sexual harassment by her employer. Of that amount, $20,000 was for pain and suffering and $10,000 was for medical expenses resulting from treatment of the emotional distress caused by the harassment. The $10,000 payment for medical expenses would not be reportable to federal tax authorities, however the remaining $20,000 for pain and suffering is reportable to federal tax authorities. (Medical expenses must be documented by invoices, statements or other evidence for such expenses to be considered non-reportable income).

Awards for damages for non-reportable personal injuries shall be treated as follows:

- Not reportable to federal tax authorities.

- Withholding is not required.

- A Form 1099 or W-2 is not required.

- Payment shall be processed through COFRS, using object code 4112, Actual Damages-Phys Inj/Ill.

2. Reportable Personal Injury Awards

A. Damage recoveries for non-physical injuries. Emotional distress is not considered a physical injury or physical sickness.

Example. Betty Hall was awarded $10,000 for sexual harassment by her employer. The entire award was for pain and suffering. Since the payment was for a non-physical injury, the entire amount would be reportable to federal tax authorities.

B. Punitive damages received for personal injury or sickness whether or not related to a physical injury or physical sickness.

Example. Alan Black was awarded $20,000 for physical injuries received in an industrial accident in his employer's plant. Half of the award was for his actual physical injuries and the remainder was punitive as a result of repeated unsafe working conditions in the plant. The punitive portion of the award to Black would be reportable to federal tax authorities and the portion of the award for actual physical injuries would not be reportable to federal tax authorities.

Awards for damages for reportable personal injuries shall be treated as follows:

- Reportable to federal tax authorities.

- Withholding of employment taxes and PERA is necessary, if applicable.

- A Form W-2 or Form 1099-MISC must be issued to the claimant, as applicable.

- Payment shall be processed through CPPS or COFRS, as applicable. If paid through COFRS, use object code 4111, Prizes and Awards.

C. Claims Other than Personal Injury

1. Fair Labor Standards Act (FLSA) Clai ms

An award for wages or unpaid overtime compensation under FLSA is reportable. (Rev. Rul.55-203, 1955-1 CB 114). Further, such amounts are subject to withholding.

Thus, awards for wages or unpaid overtime compensation under FLSA shall be treated as follows:

- Reportable to federal and state tax authorities.

- Withholding of employment taxes is required, and PERA if applicable.

- A Form W-2 must be issued.

- Payment must be processed through CPPS.

2. Employment Contract Claims

Many employees of the state are employed under a written employment contract. As a general rule, any payments by the state to an employee on account of dismissal (i.e., involuntary separation) are reportable regardless of whether the state is legally bound by contract or for other reasons to make such payments. [Reg § 31.3401(a) - 1(b)(4)]. This general rule also applies to a payment made to an employee under the terms of a multiple year contract if the employee is paid salary for additional months in order to terminate the contract. (Rev. Rul. 74-252, CB 1974-1).

Thus, these awards are:

- Reportable to federal tax authorities.
- Withholding of employment taxes is required, and PERA if applicable.
- A Form W-2 must be issued.
- Payment must be processed through CPPS.

3. Employment Compromise Claims

Employees of the state may be employed under the state civil service system or by contract. A claim from these employees could result in a compromise settlement whereby the claimant receives payment in exchange for a waiver of claimant's rights and/or termination of a pending action, but which does not include a specific amount for back pay. For example, when a payment is made to a claimant in exchange for the claimant not filing an action or withdrawing an existing action before the State Personnel Board or a court of law.

These awards shall be treated as follows (Rev. Rul. 55-520, CB 1955-2):

- Reportable to federal tax authorities.
- Tax withholding is not required.
- A Form 1099-MISC must be issued to the claimant.
- Payment shall be processed through COFRS.

The rationale for the compromise settlement must be documented in the claim file.

4. Lost Profit Claims

A claimant may request an award for lost profits in the context of a business claim. Awards for lost profits are reportable since according to the U.S. Supreme Court the recovery (award) is to be taxed in the same manner as the item for which it was intended to substitute (profit). Although an exception could exist for a claimant request for goodwill, it is the state's policy that exclusions from gross income will be narrowly construed.

Thus, claims for lost profits or goodwill should be treated as follows:

- Reportable to federal tax authorities. A Form W-9 must be obtained from the claimant and a 1099-MISC must be issued. If the claimant refuses to provide a Form W-9, the state must back-up withhold 31% of the payment.

- Tax withholding is not required unless a Form W-9 is not provided by the claimant.

- Payment shall be processed through COFRS using object code 4113, Actual Damages-Other.

5. Property Damage Claims

A claimant may request an award for harm caused by the state to their capital assets. A payment by the state is intended to make the claimant "whole". Thus, payments to claimants for property damage shall be treated as follows:

- Not reportable to federal tax authorities.

- Tax withholding is not required.

- A Form 1099 or Form W-2 is not required.

- Payment shall be processed through COFRS using object code 4113, Actual Damages-Other.

6. Attorney Fees

A settlement between the state and a claimant may include a designated dollar amount for attorney fees. The attorney fees may be paid to the claimant and/or the attorney.

a. If the payment for attorney fees is paid by the state directly to the attorney, such fees shall be treated as follows:

   - Reportable to federal tax authorities.

- A Form 1099-MISC must be issued and a Form W-9 must be obtained from the attorney. If the attorney refuses to provide a Form W-9, the state must back-up withhold 31% of the payment.

- Tax withholding is not required unless a Form W-9 is not provided by the attorney.

- Payment shall be processed through COFRS using object code 1910, Purchased Service-Personal Service; or, 1920, Purchased Service-Professional Service.

b. If the payment of attorney fees is paid directly to the claimant and the amount of the attorney fees is not specified separately from the remainder of the award, the entire payment (including payment of the attorney fees) shall follow the same reporting requirements as the award.

c. If the payment of attorney fees is paid directly to the claimant in connection with back pay and the amount of the attorney fees is separately specified from the remainder of the award, the entire payment shall be treated as follows: (Rev.Rule 80-364, 1980-2 CB 294).

- Reportable to federal tax authorities.

- Tax withholding is required for the settlement amount less any attorney fees.

- A Form W-2 must be issued for the full amount of the award.

- Payment shall be processed through CPPS.

7. Interest

A settlement between the state and a claimant may include a designated dollar amount for prejudgment and/or post judgment interest.

The 10th Circuit Court has recently concluded that prejudgment interest is taxable because of the default rule to narrowly construe exclusions from income, the nature of prejudgment interest, the Supreme Court's recent decision in *Schleier*, and the purpose of 104(a)(2) as they discerned it. Brabson v. United States, 10th Circuit Court, (1996).

Payments for both prejudgment and post judgment interest will be treated as follows: Code Sec. 6049:

- Reportable to federal tax authorities. A certified (signed) Form W-9 must be obtained from the claimant and a 1099-INT must be issued. If the claimant refuses to provide a certified Form W-9, the state must back-up withhold 31% of the payment.

- Tax withholding is not required unless a certified Form W-9 is not provided by the claimant.

- Payment shall be processed through COFRS using object code 4116, Judgment Interest.

IV. Penalties for Noncompliance

The Internal Revenue Code imposes civil penalties for various kinds of noncompliance with the Code provisions concerning the reporting and payment of federal taxes. The principal penalties are imposed by:

- §6656 for failure to deposit employment taxes;

- §6662 when any part of any underpayment is due to negligence or intentional disregard of rules and regulations, substantial understatement of income tax, substantial valuation misstatement, substantial over-statement of pension liabilities or substantial estate or gift tax valuation understatement;

- §6672 upon the person responsible for a willful failure to collect and pay over withholding taxes; and

- §6701 for aiding and abetting the understatement of tax liability.

Civil penalties are also imposed for a variety of other failures.