Office of Chief Counsel
Internal Revenue Service
Memorandum

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to:

LMSB Team 1167
7850 S.W. 6th Court
Room 355,
Plantation, FL 33324

from: Jeremy H. Fetter
General Attorney
(Tax Exempt & Government Entities)

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subject:
issue: **Can the penalty portion of a settlement allocation pursuant to a class action lawsuit against , be converted to wages?**

Taxpayer:
EIN:

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ISSUE

1. Whether the Internal Revenue Service (IRS) is bound by the settlement allocation of payment per the class action lawsuits involving ?

2. If the IRS is not bound by the settlement allocation, can it convert penalty payments to wages, thus subject to employment taxes?

CONCLUSION

1. Based upon the facts provided, the IRS is not bound by the settlement allocation of payment per the class action lawsuits involving

2. Based upon the facts provided, the IRS can likely convert both portions of settlement allocated penalty payments and interest payments to wages per the class action lawsuits involving

FACTS

is a large company-owned and operated company with approximately $ in sales and through subsidiaries, employs approximately employees. is headquartered in , and the company's owned and operated chains include and . is a Compliance Assurance Process (CAP) taxpayer for the fiscal years ending , , and .

The lawsuits that resulted in the settlement agreements in question in this case were filed in of . The underlying disputes were between Managers (excluding general managers) and , and between Managers, Managers, and Managers and . Neither the Revenue Agent's Report (RAR) nor the administrative file contained much information regarding these lawsuits. Therefore the facts regarding the cases were gleaned from the settlement agreements provided by the taxpayer. The claims made by the managers included the following: (1) recovery of pursuant to ; (2) restitution of under ; (3) penalties under ; (4) penalties for failure to provide pursuant to ; (5) penalties for alleged failure to provide under ; and (6) attorneys fees and costs. In of , the parties met with a well-known wage and hour class action mediator and the settlement agreements in question were the result of that mediation.

There are two settlement agreements involved in this case; one between managers and and one between managers and . Both of the settlement agreements specify that neither nor admit to any wrongdoing by entering into the agreements. The agreements provide for a claims process requiring payment of settlement awards on a claims-made basis according to a specified formula on each timely and valid claim submitted. Each of the settlement agreements allocated the settlement awards as follows:

allocated to alleged unpaid wages for which IRS Forms W-2 will issue; allocated to interest for which IRS Forms 1099 will issue; and allocated to alleged civil penalties for which IRS Forms 1099 will issue. The methodology for determining the allocations was not given anywhere in the settlement agreements.

The Revenue Agent sent Form 4564 Information Document Request (IDR) on , requesting information pertaining to any payments to settle claims or suits filed against during the calendar years ending and . The taxpayer provided a limited response to the IDR on , consisting of a one page spreadsheet titled "Settlement Summary" and copies of selected settlement agreements.

A second IDR was issued on , requesting additional documentation pertaining to the settlement agreements accompanying case number . The taxpayer responded to the second IDR on , and provided its settlement fund's EIN, copies of the payment checks reflecting the gross amount received into wages, copies of W-2s and Form 1099s that were issued, and a summary of settlement payment allocations and applicable tax withholdings. The taxpayer supplemented its response on , by sending a reconciliation of payments made pursuant to the settlement agreements and the 1096 and W-3 that were provided to the taxpayer by its Internal Dispute Resolution Department.

Legal Analysis

1. Based upon the facts provided, the IRS is not bound by the settlement allocation of payment per the class action lawsuits involving

A. Authorities

The Service is not bound by the allocations contained in settlement agreements to which it was not a party. See Robinson v. Commissioner, 102 T.C. 116 (1994), rev'd in part on other grounds, 70 F.3d 34 (5th Cir. 1995), cert. denied 519 U.S. 824 (1996). The allocation among the various claims of the settlement can be challenged where the facts and circumstances indicate that the allocation does not reflect the economic substance of the settlement. See Phoenix Coal Company, Inc. v. Commissioner, 231 F.2d 420 (2nd Cir. 1956). The characterization of settlement proceeds cannot depend entirely on the intent of the parties. See Hemelt v. U.S., 122 F.3d 204 (4th Cir. 1997).

In the event of a lump sum payment, the Service will allocate the payment using the best evidence available. The evidence may consist of the taxpayer's complaint requesting reasonable amounts of damages for each claim. Rev. Rul. 75-230, 1975-1 C.B. 93 and Rev. Rul. 85-98, 1985-2 C.B. 51 superseding Rev. Rul. 58-418, 1958-2 C.B. 18.

B. Application to the Taxpayer

In this instance, the settlement amounts paid by were not in a lump sum, but rather were allocated in to unpaid wages, interest and civil penalties. As mentioned above, allocations may be challenged where the facts and circumstances indicate that the allocation does not reflect the economic substance of the settlement. The fact that each of the settlement agreements allocates the amounts in even seems arbitrary, and nothing in the settlement agreements states how the allocated amounts were determined. Each of the individual plaintiffs

who had brought suit in their respective cases sought penalties under the Code as part of their causes of action. Both the interest amount and the penalty amount should be a percentage of the total amount of the back pay awarded for the overtime that was unpaid. The current allocation of to each category essentially says that the interest and penalty amounts equal % of the amount of those unpaid wages.

It is likely that a portion of the settlement amount may be allocated to both interest and civil penalties. However, the current allocations, which also the amount allocated to wages, cannot be accurate. The taxpayer should show what rate is being used to calculate the total interest amount and the corresponding allocation should be based on that computation. Each of the penalties imposed under the Code are based upon the amount of days or hours worked by the employee. If in fact, the civil penalty allocation in the settlement agreement is meant to represent amounts that would have been awarded under the Code sections, the taxpayer should show how the allocation amount was calculated. The data provided by the taxpayer does not supply that information with respect to the individual class members who received settlement payments. The penalties contained in the state code sections do not provide for a % penalty when compared to the unpaid wages, therefore the current allocation is not correct. Therefore, we find that the IRS is not bound by allocation payments made pursuant to a settlement agreement and, based on the facts presented in the current case it is likely that the court would support a reallocation of the settlement payment amounts for both interest and civil penalties.

2. Based upon the facts provided, the IRS can likely convert both portions of settlement allocated penalty payments and interest payments to wages per the class action lawsuits involving

A. Authorities

Settlement payments may be wages subject to employment taxes. If settlement payments are considered wages, applicable federal employment taxes are imposed and are required to be withheld. I.R.C. § 3402(a)(1). The employment taxes that may apply include FICA, income tax withholding and FUTA. FICA taxes, income tax withholding and FUTA taxes are imposed on "wages" as defined in the Internal Revenue Code (the "Code"). For income tax withholding purposes, "wages" is broadly defined as "all remuneration for services performed by an employee for his employer," with specific exceptions. I.R.C. § 3401(a). Sections 3121(a) and 3306(b) of the Federal Insurance Contributions Act and Federal Unemployment Tax Act, respectively, define the term "wages", with certain exceptions not material here, as "all remuneration for employment".

Remuneration for employment, unless such remuneration is otherwise excluded, 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. Reg. § 31.3121(a)-1(i). 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, 365-266 (1946).

Whether an amount received in settlement of a dispute is remuneration for employment and 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 are the damages awarded?'").

Rev. Rul. 72-268, 1972-1 C.B. 313, concluded that certain amounts of unpaid minimum wages and unpaid overtime compensation restored by a company to its employees were considered wages, but that the liquidated damages paid were not wages, as they represented an additional penalty. The Service concluded that, because the liquidated damages were required as a penalty for failure to comply with the law, they could not be categorized as wages. The provisions of Rev. Rul. 72-268 have been found not to apply when the taxpayer failed to show the extent to which such allocation to liquidated damages would apply. See 1996 FSA LEXIS 244. Thus, in the referenced Field Service Advice Memoranda, the Service refused to conclude that a portion of the settlement was entitled to non-wage treatment.

B. Application to the Taxpayer

The settlement allocation payments allocated to civil penalties in this case included of the total amount. Whether a settlement amount is remuneration for employment and subject to employment tax depends on the nature of the item for which the settlement amount is a substitute. The amount allocated to civil penalties was likely in lieu of the penalties that would have been imposed due to the violation of and Violation by of these various state code sections was alleged in the various claims by the managers included in the class action suit.

We find that the penalties encapsulated in the violation of the various Code sections may fall under the category of liquidated or punitive damages, as applied in Rev. Rul. 72-268. The ruling found that, where amounts were required as a penalty for failure to comply with the law, they could not be categorized as wages. In the present situation, the civil penalty amounts may have been imposed based on the violation of Code sections and, therefore, may not be wholly reallocated to wages. Additionally, the settlement agreements were not silent on the amount of the total award that was allocated to the civil penalties, instead stating that a third of the total settlement amount was allocated to that category. As such, the facts of 1996 FSA LEXIS 244 are not directly on point with the facts in the present case.

However, as mentioned in the prior section regarding whether the IRS is bound by settlement allocations, we believe that the amount of the settlement payment allocated to civil penalties was not the proper amount. Any portion of that allocation that the taxpayer can show directly corresponded with penalty amounts under the Code should be respected as a proper allocation. The code provisions do not provide for what appears to be a % penalty calculation in relation to the amount of back wages awarded. As such, the amount of the allocation to civil penalties that the taxpayer cannot substantiate could likely be converted to wages, and thus subject to employment taxes. Additionally, while settlement amounts properly allocated to interest cannot be converted to wages, we do not believe that the current allocation of to interest is correct. As previously mentioned, the interest amount should be a percentage of the total amount of unpaid wages that are being awarded. Any

portion of the amount that cannot be shown to be properly allocated to interest should also be reallocated to wages, along with the correct portion of the amount allocated to civil penalties.

In summary and based on the facts provided, we find that the IRS is not bound by the settlement allocation payments made by pursuant to the settlement agreements made with managers of and . Additionally, the allocations that are properly shown to result from civil penalties under the Code sections may not be reallocated to wages if determined to be liquidated damages, but the remaining amount of the allocation likely could be reallocated to wages, and thus subject to employment taxes.

Please contact the undersigned at if you have any further questions.

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