

Department of Administrative Services - State Accounting Enterprise

Section PRE-AUDIT	Procedure Number 240.500	Page Number 1 of 1	Effective Date July 1, 2003 Revised 6/1/04
Subject MISCELLANEOUS SETTLEMENTS – CURRENT AND FORMER EMPLOYEES			

1. The Department of Administrative Services-State Accounting Enterprise (DAS-SAE) disburses settlement payments to state employees and former state employees to resolve discrimination lawsuits and other employment disputes the employees have had with state departments. One of the considerations associated with these disbursements is determining whether or not the settlement payments, also referred to as damage payments, are taxable for federal and state income tax purposes and for purposes of FICA taxes. If the payments are considered taxable, the appropriate federal and state taxes must be withheld from the payments. If a payment includes back wages, the employee's share of the contribution to IPERS or other state pension plan may also have to be made from that payment.
2. Section 104(a)(2) of the Internal Revenue Code provides that settlement payments which are made to compensate individuals for personal injury or personal illness are excluded from state and federal taxation. Therefore, if you are submitting a settlement claim related to damages for injury or illness of a state employee, the claim must include an explanation of the specific illness or injury so that federal and state taxes will not be withheld from the payment. Documentation to support the explanation may be requested from the DAS-SAE.
3. All settlement claims submitted to the DAS-SAE for back wages and benefits and for damages, including damages for emotional distress not attributable to injury or sickness, will be treated as taxable and taxes will be withheld from these payments, except when a portion of the claim is for attorney fees or other costs of litigation. If no proof is submitted with a claim that supports that the claim is nontaxable for illness or injury, the claim will be treated as taxable. Note that claims or portions of claims for nontaxable payments should be direct to the DAS-SAE-Daily Processing and claims for taxable back pay should be sent to the DAS-SAE-Centralized Payroll.
4. The DAS-SAE may ask the Internal Revenue Service to rule on the taxability of questionable settlement payments pursuant to an information exchange agreement with the DAS-SAE. If there is a question about the taxability of a settlement payment, we suggest a determination of the taxability of the payment be made before the agreement is finalized. Since federal income tax statutes control the taxability of settlements, consult with the IRS when dealing with questionable settlements. Information you receive from the IRS relating to the taxability of settlement payments should be included in the claim submitted to the DAS-SAE for the settlement.
5. If you have any questions, please contact the DAS-SAE-Daily Processing or DAS-SAE-Centralized Payroll (515) 281-3976.