

Win an Employment Lawsuit? Here Are the Good and Bad Tax News

Article Highlights:

- Physical Injury and Physical Sickness
- Wrongful Death
- Emotional Distress
- Previously Deducted Medical Expenses
- Employment Discrimination
- Age Discrimination
- Unpaid or Disputed Employment Earnings
- Interest
- Settlements
- Legal Costs

The tax laws related to the taxability of monetary settlements and damage awards as the result of employment legal actions are often complex and sometimes seemingly discriminatory. The actual taxation of the award is primarily based on the following factors:

- The nature of the legal action,
- Whether a settlement occurred before trial, and
- How the legal costs were handled.

Nature of the Legal Action – Generally, all monetary awards as the result of an employment-related legal action are fully taxable, with one exception. Under the exception, the tax code allows an exclusion from gross income for damages received due to a personal physical injury or a physical sickness. Consequently, when a lawsuit is based on a physical injury or sickness, all damages (other than punitive damages, which are always taxable) flowing from that suit are treated as payments received due to a physical injury or sickness, and are therefore excluded from income. This is true whether or not the recipient of the damages is the injured party. Here are some commonly encountered situations and their taxability:

- *Wrongful Death* – Wrongful death is considered physical injury or physical sickness for purposes of the income exclusion. In addition, punitive damages are excludable where state law provides that only punitive damages can be awarded in wrongful death suits.
- *Emotional Distress* - Emotional distress isn't considered physical injury or physical sickness for purposes of the income exclusion. However, the exclusion from gross income does apply to the amount of damages received for emotional distress that is attributable to a physical injury, but not in excess of the amount paid for medical care related to emotional distress.
- *Previously Deducted Medical Expenses* – Even though awards for physical injury or physical sickness are excludable, if any part of the award received is compensation for medical expenses deducted in a prior year, that portion of the award must be included as income, up to the amount of the deduction taken.
- *Employment Discrimination* - No exclusion is allowed for damages received in a suit involving employment discrimination or an injury to reputation that is accompanied by a claim of emotional distress. However, the exclusion would apply to a claim of emotional distress related to a physical injury or physical sickness.
- *Age Discrimination* - The law doesn't consider back pay or liquidated damages received under the Age Discrimination in Employment Act (ADEA) to be compensation for personal injuries; therefore, these payments are includable in income. But see the special treatment of attorney fees below.

- *Punitive Damages* – Punitive damages are made as a punishment for unlawful conduct and are always taxable; they cannot be excluded from income as damages received due to personal physical injury or physical sickness, except as noted above for wrongful death.
- *Unpaid or Disputed Employment Earnings* – Back pay, severance pay, overtime pay, etc., are all treated as W-2 type income and are both taxable and subject to payroll FICA withholding.
- *Interest* – Interest that may be included in an award, even one for personal injury or sickness, is not excludable and must be included in gross income.

Settlements – In legal actions, the plaintiff may frequently sue for both excludable and non-excludable damages. For example, an employee is injured on the job and sues for back vacation pay of \$10,000 and damages for personal injury in the amount of \$90,000 (a total of \$100,000). If the suit is settled for \$50,000 without a stipulation of how the settlement is applied, the settlement will need to be allocated in the same manner as the original suit. In this example, the settlement would be allocated \$5,000 for back vacation pay (taxable) and \$45,000 for personal injury (excludable).

Legal Costs – Generally, legal costs associated with employment-related legal actions can only be deducted as a miscellaneous itemized deduction on the employee's Schedule A itemized deductions. When all or some of the monetary award is excludable, the fees are prorated between the taxable and excludable award, and only the portion allocated to the taxable portion is deductible.

This is where significant tax problems are encountered because miscellaneous itemized deductions must be reduced by 2% of the employee-taxpayer's adjusted gross income (AGI), and the gross monetary award received is included in the employee's AGI, making it abnormally high. On top of that, miscellaneous itemized deductions are not even allowed for purposes of the alternative minimum tax (AMT), which is very frequently triggered in situations of this nature. This would result in the taxpayer having to include the entire monetary award in income and not being able to deduct much, if any, of the legal costs. The taxpayer, in effect, is paying taxes on just about the entire, or in some cases the total, amount, including what the attorney got.

There is a very limited exception that allows attorney fees to be deducted above-the-line (without itemizing), thus eliminating the 2% reduction and the AMT issues. However, it only applies in connection with a claim of unlawful discrimination, certain claims against the federal government, or a private cause of action under the Medicare Secondary Payer statute.

So, before you rush out and spend any of the award money you received, you had better drop by the office and see what the government's share is, because it could be substantial. In addition, with some careful analysis, it may be possible to take actions that will reduce the tax.