

TAXATION OF EMPLOYMENT SETTLEMENTS

By Karen Sutherland

The law has been evolving over the last several years in terms of how a settlement with an employee for discrimination claims is treated for federal income tax purposes. Initially, employers were often allocating 100% of any such settlement as damages for “personal injuries,” which generally made them non-taxable under Internal Revenue Code (IRC) § 104. This concept was applied to settlements of employment disputes on the theory that the emotional distress and its physical manifestations (loss of sleep, loss of consortium, depression, irritability, stomach disorders, etc.) were nontaxable personal injuries.

Effective August 1996, however, Congress amended IRC § 104 so that emotional distress is not considered a physical injury or physical sickness even if physical symptoms such as insomnia, headaches and stomach disorders result from such emotional distress. This amendment to IRC § 104 makes it highly unlikely that an employment discrimination settlement or award can be allocated to avoid taxation. (There may be exceptions for damages caused by the employer making direct physical contact with the employee, such as beating the employee up.) Thus, in most cases the award or settlement is taxable and subject to withholding for income tax and FICA, even if the employee is no longer employed by the employer.

The amount of the settlement or award that was to pay attorney’s fees and costs has been deductible, but only to the extent the taxpayer’s total miscellaneous itemized deductions exceeded two percent of adjusted gross income, and it was subject to reduction under the overall limitation of itemized deductions if the taxpayer’s adjusted gross income exceeded a threshold amount. If the employee was subject to the alternative minimum tax, no deduction was allowed.

Congress recently changed a part of how such settlements or awards are treated for tax purposes. The recently enacted American Jobs Creation Act of 2004 (AJCA) includes a provision intended to ensure that plaintiffs who win in certain civil rights cases and other lawsuits not pay income tax on parts of the recovery that are applied to pay court costs and attorneys’ fees.

Section 703 of the AJCA modifies section 62 of the Internal Revenue Code to provide an “above-the-line” deduction for attorneys’ fees and court costs paid by or on behalf of a taxpayer “in connection with any action involving a claim of unlawful discrimination” or a claim of a violation of certain other provisions of law. The net result is more money in the employee’s pocket, and less “sticker shock” regarding the effect of taxes when an employee settles a discrimination claim, which in turn makes it somewhat easier to settle claims.

The new provisions apply to fees and costs paid after October 22, 2004, with respect to any judgment or settlement occurring after October 22, 2004.

This brief article is a broad summary only. It lacks specificity about the law and about the effects of different fact patterns, and thus shall not be applied without consulting an attorney. It also focuses on Washington State law and federal law, and the laws of other jurisdictions may vary materially. The information set forth in this article is a broad and general overview of complex topics, and is not legal advice. It also does not take into account any changes to the law or in interpretations of the law that may have occurred since it was written. For more information, contact Karen Sutherland at ksutherland@omwlaw.com