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Employment Law

Taxation Without Representation

If tax implications are not considered when resolving employment claims, a good settlement or judgment could turn sour

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In 1763 James Otis stated that “taxation without representation is tyranny.” Stated differently, in the context of employment claims, unnecessary taxation due to inadequate representation by counsel arguably is malpractice.

Employment lawyers need to have a working knowledge of the tax implications when resolving disputes. Otherwise, what might have been a good settlement could turn out to be unfavorable.

A recent amendment to the New Jersey Model Jury Charges, which addresses the taxability of personal injury awards, notes an ambiguity in the law concerning whether economic and emotional distress damages in employment cases are subject to state and/or federal taxation. Lawyers must be cognizant of the present law in this area so they can litigate — and structure settlements of — employment claims in the most tax efficient manner.

With regard to gross income, the

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Internal Revenue Code of 1986, §61(a), provides, “[e]xcept as otherwise provided in this subtitle, gross income means all income from whatever source derived.” The Supreme Court has repeatedly emphasized the sweeping scope of this section and has held that all exceptions are to be narrowly construed. See *Internal Revenue Service v. Schleier*, 515 U.S. 323 (1995), and cases cited therein.

Exclusions and Deductions

The IRC recognizes certain limited exceptions to gross income relevant to employment claims. First, a taxpayer may exclude from gross income amounts that fall within five categories of monies received as “compensation for injuries and sickness.” IRC §104(a). Included in this personal injury exclusion are benefits received by an employee under the Workers’ Compensation Act. IRC §104(a)(1).

The Small Business Job Protection Act of 1996, P.L. 104-188, enacted on Aug. 20, 1996, amended IRC §104(a)(2) to provide that amounts received pursuant to a judgment or settlement of a claim for personal injuries or sickness are excluded from gross income only if the taxpayer has suffered physical injury or sickness.

The SBJPA also provides that, except for a narrow exception, punitive damages are not excludable under IRC

§104(a)(2) whether or not they relate to personal injury or sickness. Prior to the 1996 legislation, the exclusion extended to damages received on account of personal injuries or sickness and the statute did not specifically require that the injury be physical.

As employment discrimination, retaliation and wrongful-discharge claims often contain allegations of emotional distress and mental anguish, one important issue is whether such emotional injuries constitute physical injuries excludable from gross income.

Generally, emotional distress does not qualify as a physical injury, although medical expenses incurred to treat emotional distress may be excluded under IRC §104(a)(2).

Interestingly, while emotional distress resulting from wrongful-employment action is not excluded from gross income — because only damages received “on account of” personal injuries or sickness are excluded — emotional distress that arises out of a physical injury is still excludable. See Conference Committee Report to SBJPA amendments.

When settling employment claims favorably, plaintiffs may also consider certain helpful deductions. Plaintiffs may deduct from gross income all monies paid for medical expenses as a result of the alleged wrongful-employment action to the extent these amounts are not compensated for by insurance or otherwise and to the extent they exceed 7 1/2 percent of the employee’s adjusted gross income. IRC §213.

Courts have not yet addressed whether gross income earmarked for future medical expenses is deductible.

Employers and employees may also take certain deductions for legal fees.

Employers may generally deduct all legal fees paid as ordinary and necessary business expenses under IRC §162. Plaintiffs may deduct legal fees paid; however, they will not get a dollar-for-dollar deduction because these expenses are "below the line" and, thus, part of other miscellaneous itemized deductions.

Obtaining Favorable Tax Treatment

Rather than only asserting damages in the form of lost wages, lawyers should attempt to allege tort and tort-type injuries, to the extent there is a reasonable basis. For example, if as part of a sexual (or other) harassment claim there was a physical touching, the complaint should include a cause of action for battery.

Moreover, when alleging emotional distress damages, lawyers should, if supported by the facts, attempt to claim a physical manifestation of the underlying emotional distress as this may, under certain circumstances, satisfy the "personal injury" exclusion under §104(a)(2). (Alleging a physical manifestation may also implicate an employer's workers' compensation policy. See *Schmidt v. Smith*, 155 N.J. 44 (1998).)

Allocation Allocation

Lawyers should try to allocate a portion of the settlement to recovery of lost wages and the remainder as payment for physical injuries. In this way, only the portion applicable to lost wages will be includable in gross income and the remainder will be excluded.

With the amendment of IRC §104(a)(2), one should be careful that amounts excluded are properly allocated to those received for physical personal injuries or sickness only. The parties should also include the allocations in the settlement agreement. Without such express language regarding allocation, the Internal Revenue Service will examine the payor's intent behind making the settlement.

Lawyers should also remember that only those legal fees allocable to the taxable portion of the award may be deducted. See *McKay v. Commissioner*, 102 T.C. 465 (1994).

An important consideration is how best to allocate the award between

wages, such as back pay and front pay, and taxable nonwages, such as emotional distress, legal fees and interest. The entire award, other than the portion attributable to a physical injury, is subject to income tax, but only the wages — including those under the Federal Insurance Contributions Act and the Medicare and Federal Unemployment Tax Act — which are generally borne equally by the employer and employee.

If the parties improperly designate an award as nonwages and thus fail to withhold and pay employment taxes, the IRS may assess not only the additional taxes, but also interest (and in certain cases penalties) against the employer and the employee.

If you represent the employer and it is unclear whether the payment constitutes wages, it is advisable to include an indemnification provision in the settlement agreement providing that the employee will indemnify the employer for any tax liability, penalties and interest resulting from the settlement.

As the IRS reasoned in Revenue Ruling 80-364, 1980-2 C.B. 294, the nonwages portion of a settlement, including interest and attorneys' fees are not wages and, therefore, not subject to employment tax withholding because it is not remuneration for employment. For this reason, when settling employment claims, the parties should attempt to separately identify that portion of damages as nonwages in the form of interest, attorneys' fees and so on. See *Hemelt v. United States*, 122 F.3d 204 (4th Cir. 1997). Accordingly, it is useful to cut separate checks for wages and other payments, including legal fees.

Treatment of Legal Fees

When looking at legal fees, the first consideration is whether in contingency fee cases or cases where the employer has agreed to pay the plaintiff's counsel fees, the employer should issue one check payable to the plaintiff or two checks — one to the plaintiff and one to the plaintiff's law firm.

If the paid legal fees are included in income, the plaintiff/taxpayer will not have an offsetting dollar-for-dollar deduction due to the 2 percent floor.

Although this practice goes on in an effort to save the plaintiff income tax on his/her legal fees, lawyers should be aware that this is not advisable in the Third U.S. Circuit Court of Appeals.

The IRS has taken the position that the attorneys' fees portion of an award is to be included in gross income, but the Circuits are split on this issue. The Third Circuit, along with the First, Fourth, Seventh, Ninth and Federal circuits, have held that payments by the defendant of the plaintiff's attorneys' fees are includable in gross income.

Specifically, in *O'Brien v. Commissioner*, 319 F.2d 532 (3d Cir. 1963), aff'g, 38 T.C. 707 (1962), the Third Circuit affirmed the Tax Court's decision, holding that future amounts due the plaintiff and assigned to his lawyer must still be included in gross income under the assignment of income principles of *Lucas v. Earl*, 281 U.S. 111 (1930).

Until the Supreme Court definitively rules on this issue, only those taxpayers outside the Third, First, Fourth, Seventh, Ninth and Federal Circuits may properly exclude the attorneys' fees portion of an award from gross income.

Structuring the Settlement

A proper structuring of payments over time or on a delayed schedule may enable a taxpayer to take advantage of the new tax rates set forth in the Economic Growth and Tax Relief Reconciliation Act of 2001. As EGTRRA includes regular income tax rate reductions over five years, beginning July 1, 2001, and continuing through 2006, it may be advantageous to have a settlement paid over time and taxed at the plaintiff's then lower income tax rate.

Lawyers should also explore, with appropriate security, deferring a settlement payment from one year to the next to possibly take advantage of lower tax brackets. For example, where a settlement may push a plaintiff into a higher tax bracket in the year the claim is resolved, it is advisable to defer some of the settlement into years two and beyond, if possible. In this way, the plaintiff will not be taxed at the higher rate and can also take advantage of EGTRRA's reduced rates. ■