



SPOTLIGHT

Employment Litigation Pitfalls

By Richard Warner, CPA and Deborah Dickson, CPA, CFE, CFF, MAFF

Sexual harassment, discrimination, wrongful termination...in the world of employment litigation, tax issues are not the most pressing concern for attorneys. However, the consequences of not effectively planning for them can be substantial. If you are not talking to your client about the tax impact of their settlement/judgment proceeds from the onset, you could inadvertently end up with a very unhappy client who pockets as little as 20% of her gross settlement!

Consider this scenario: You successfully negotiated a settlement for your individual plaintiff client in the amount of \$1,000,000 due to claims of emotional distress from non-physical injuries at work. This total includes attorney fees of \$400,000. You call it a "win" and are certain that your client will be happy with the \$600,000 net result – until you receive a phone call from the client, complaining that her CPA has informed her that she has to pay 40% taxes on the entire \$1,000,000 of proceeds, plus \$400,000 attorney fees, so her net after tax result is only \$200,000!

Deductibility of Legal Fees

If the above scenario was a settlement awarded for physical injury or wrongful death, the entire award of \$1,000,000 would have been non-taxable. Attorney fees related to physical personal injury are correspondingly not deductible by the awarded plaintiff. However, awards in non-physical personal injury matters are taxable income; and, whether legal fees can be deducted against that income is often determined by the details.

Discrimination and Whistleblowers

Let's modify the scenario above: you successfully negotiated a \$1,000,000 settlement

in a wrongful termination due to discrimination matter for your individual plaintiff client. This total includes your legal fees of \$400,000. In this new scenario, the entire \$1,000,000 is taxable income; but the word discrimination is worth a \$400,000 legal fee deduction. This means that the client is effectively only taxed on the \$600,000 of income she realized after your fees were paid. This same treatment holds true in whistleblower cases: the settlement or judgment is taxable, but attorney fees are deductible.

Sexual Harassment and Hush Money

The deductibility of legal fees in sexual harassment matters depends on whether the settlement paid can be viewed as "hush money." In sexual harassment or abuse cases where there is a nondisclosure agreement executed, the defendant is precluded from deducting related legal fees and settlement payments. In contrast, the IRS has issued informal guidance indicating that plaintiff recipients of settlements are not precluded from deducting attorney fees related to the settlement when there is a nondisclosure agreement.

Modifying our sample scenario again for a sexual harassment case: you successfully negotiated a \$1,000,000 settlement in a wrongful termination matter involving sexual harassment for your individual plaintiff client. This total includes your legal fees of \$400,000. Similar to the discrimination and whistleblower scenarios, the entire \$1,000,000 is taxable income, but the client can deduct the \$400,000 in legal fees paid related to settle the matter. This means that the client is effectively only taxed on the \$600,000 of income she realized.

The flow chart summarizes the taxation of personal injury settlements.

Taking Taxation into Account in Litigation

Nearly every piece of litigation eventually sprouts tax issues although the courts do not often take those into account. It is tempting to just bring a dispute to an end without giving adequate consideration to the tax consequences. Whether one is a plaintiff, a defendant, or counsel, it can be a costly mistake to disregard the ultimate tax consequences of a settlement. The rules described in this article relate to Federal taxation only; some states conform to these new rules, and some states including California do not. Before you resolve the case and sign, consider the tax aspects to prevent a rude awakening later.



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TAXATION OF PERSONAL INJURY SETTLEMENTS

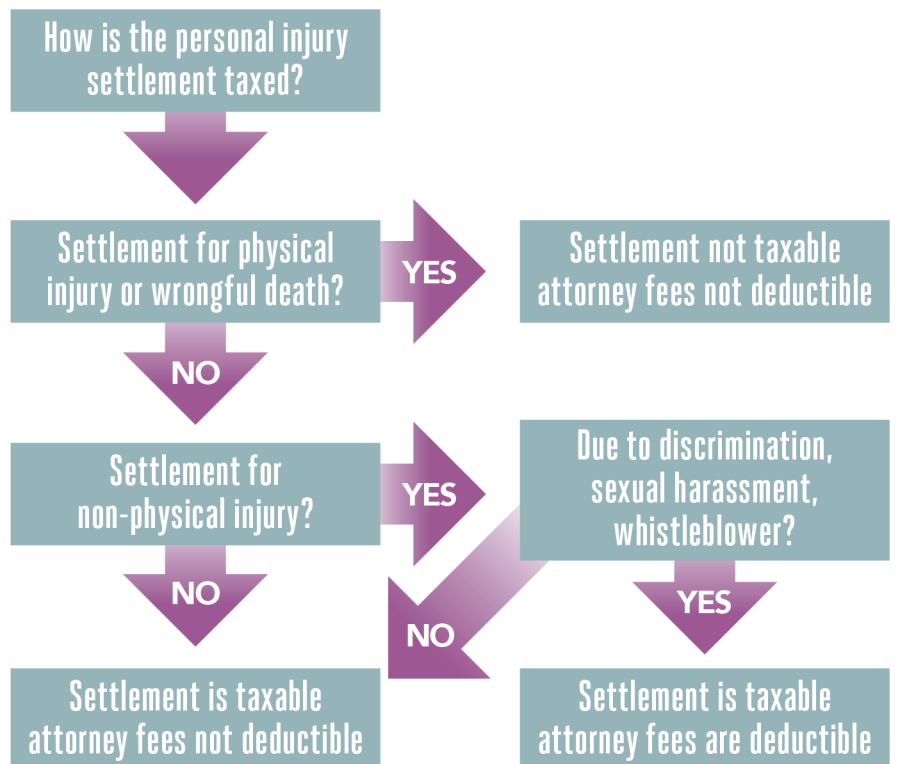


CHART ILLUSTRATION BY ORANGE COUNTY LAWYER

SMITH DICKSON

FOUNDED: 1982

MANAGING PARTNER:
Deborah Dickson

BUSINESS: Litigation Support,
Tax, and Accounting

LOCATION: Irvine

NOTABLE: A leading locally-based CPA firm in litigation support field

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