Creative ways to settle employment litigation cases

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Ever since the Supreme Court decision in *Commissioner v. Schleier*, the vast majority of employment settlements have been deemed taxable. Attempts to get employment recoveries excluded from income have met with near-universal failure in Tax Court.

As tax rates increase, whether federal, state or both, at some point in the settlement process, the tax consequences of the damages should be examined. After all, a settlement that is fully taxable to the claimant results in fewer dollars than a claim that is tax deferred, partially taxable, or tax exempt. To enhance the settlement offer on an employment claim, using structured settlements (periodic payments) to lower the amount the claimant loses to taxes can achieve a better outcome for both sides and get claims settled for a reasonable amount.

Compensation for personal physical injuries or sickness is excluded from income under Section 104 of the Internal Revenue Code. The Small Business Job Protection Act of 1996 (the "Act") was aimed at employment claims and restricted the scope of Section 104 to physical, as opposed to personal, injuries. The Act also singled out emotional distress injuries, providing that they are not considered a physical injury or sickness, even when those emotional distress injuries that result in physical symptoms, such as headaches and ulcers, firmly close the door on the possibility that purely emotional or mental injuries that do not originate in a physical injury be excluded from taxation.

Given that employment-related recoveries are generally taxable, the question becomes how does the negative tax ramifications of a settlement help a claims handler? In many cases, the answer is to settle the case with a structured settlement or periodic payment plan as opposed to a lump sum.

As a general rule, it is most often advantageous to receive and be taxed on income in a later tax year rather than an earlier tax year. It makes far more sense to defer recognition of income than to receive large sums of money at once and pay taxes at a higher rate immediately. For example, the tax consequences of a $500,000 recovery spread into 10 equal installments over 10 years are substantially less than the tax consequences on the payment if it is all received and taxed in one year. The concept of deferred income recognition has been around for decades with deferred compensation agreements for highly compensated executives.

By dealing with the taxation issues through a structured settlement consultant, the claims handler can negotiate for periodic payments that result in a much better outcome from an income tax perspective for the claimant. A structured settlement consultant versed in taxable damage issues can help the claimant avoid certain pitfalls like constructive receipt and improper allocation. Making the claimant aware of these issues, and how deferring the taxation of all or part of the award can be done through a structured settlement, enables the claim to be resolved sooner.

For example, let's say the demand to settle a harassment claim in California is $400,000 (not including attorney fees). Without adjusting the tax liability for deductions and credits, the federal tax liability would be 35 percent, and the state tax liability 9.3 percent if the claimant were to receive the $400,000 in a lump sum, losing over $177,000 to taxes immediately. Instead of a lump sum, let's say the defense offered to pay him $40,000/year for 10 years at a cost of $360,000. By spreading payments out over a 10-year period, the claimant could lower their tax bracket to 25 percent federal and 6 percent state, all while earning money on the 44.3 percent that would have been lost to taxes. It is this deferral that allows for higher net dollars to the claimant than an equivalent amount paid in cash. Plainly stated, by using periodic payments, a defendant can pay less, but a claimant will receive more.

It is vitally important to examine the tax ramifications of a recovery in the employment context and explore viable alternatives to improve the chances of settling the claim. The use of periodic payments for taxable damages allows the claimant to achieve a better bottom-line outcome by taking advantage of deferred recognition of income. Structured settlement consultants who specialize in taxable settlements are a free resource available to any claims handler or risk manager and can help make a significant financial difference when settling employment and other taxable claims.

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1 *Commissioner v. Schleier,* 515 U.S. 323, 132 L. Ed. 2d 294, 115 S. Ct. 2159, 95-1 U.S. Tax Cas. (CCH) ¶95-2675, 95 T.N.T. 116-8 (1995)