Tax Benefits Of Structured Settlements In Employment Cases

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Employment cases are on the rise. With statutory provisions skewing these cases in favor of plaintiffs, including that plaintiffs can recover significant attorney fees if they prevail at trial, defendants can be eager to settle. Settlements often climb into five, six or even seven figures. Attorneys representing plaintiffs in these cases should be aware of the tax implications and plan accordingly.

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Generally, settlement proceeds in employment cases are taxable. The post-tax recovery to the client is substantially less than the gross settlement. One strategy to reduce taxes is to structure the settlement proceeds. By spreading the settlement proceeds over several years, in smaller increments, the income taxes are often much lower. It can save the client thousands of dollars in the long run.

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Taxes on Employment Settlements

Employment settlements typically consist of compensation for damages including lost wages and benefits, emotional distress, and sometimes even punitive damages. Wage-related settled proceeds are treated as W-2 income, subject to withholding, Federal Insurance Contributions Act, unemployment and disability taxes.[1] The employee also pays ordinary income taxes. Non-income-related proceeds such as for emotional distress and punitive damages are treated as nonwage miscellaneous income. Again, the plaintiff/employee pays income taxes. The gross settlement amount, including attorney fees and costs, is reported as income to the employee. However, attorney fees and costs are deductible either above or below the line. There is a narrow exemption for compensation “on account of personal physical injuries or physical sickness,” which is not taxable.[2] But true physical injury or physical sickness settlements in employment cases are rare. Physical symptoms related to emotional distress generally do not qualify.[3] Also, states like California treat employment settlements the same as the IRS. Settlement proceeds are taxable as income at the state level too.

The impact of taxes on employment settlements is now greater following the tax reforms signed into law by President Donald Trump in December of 2017. Among other things, this new law reduced the amount taxpayers can deduct from their federal income taxes for state and local taxes. While a taxpayer could previously deduct any state and local taxes paid, including property and state income or sales taxes, the new law caps state and local deductions at $10,000. For any taxpayer in California, where state income and property taxes are relatively high, the changes in the new tax law amounted to a dramatic increase in federal income tax liability.

Structured Settlements

Structured settlements can drastically reduce the plaintiff's tax liability in employment cases. This is because the settlement proceeds are not paid directly to the plaintiff. The money is paid to fund an annuity which then provides a future income stream to the plaintiff. Only the payments that come from the annuity are treated as income, and only when received. If that income (in combination with any other income to the plaintiff outside of the settlement) keeps the plaintiff at a lower marginal income tax level, the plaintiff enjoys significant tax savings. Without this settlement device, the plaintiff receives the full settlement proceeds, but gets hit with the income tax rate applicable to the entire settlement amount, which can be much higher. Currently, in 2018, the highest marginal tax rates are 37 percent at the federal level and 13.3 percent in California. The lowest rates are 10 percent and 1 percent, respectively. Reducing the tax rate applicable to your client's recovery can make a big impact on the client's net recovery.

Of course, the downside to structured settlements is that the client does not receive all the proceeds at once. In theory, the client could invest the full settlement proceeds in the first year and obtain a return on that money. But in most cases, this isn't enough to forgo the structure. In bigger cases, a significant chunk of the settlement goes to the IRS and state tax collectors right off the bat. The employee has a much smaller amount to invest when paying all the taxes upfront. Also, with structured settlements, the client does earn a return on the money used to fund the annuity. Those earnings are not taxed until realized. The annuity rates are fairly competitive when compared with other potential investments, especially given that the income is guaranteed and not taxed until paid. In the end, for most significant employment settlements, structuring the settlement is a no-brainer.

Keep in mind that the plaintiff does not have the automatic right to structure a settlement. This must be negotiated. If settlement is reached at a mediation, the attorney representing the plaintiff/employee should insist on inserting language preserving the right to structure. This should be done even if the plaintiff has not yet decided to structure the proceeds, and even if the parties plan on exchanging a more detailed settlement agreement after the mediation. It is not uncommon for a defendant to refuse to structure a settlement after mediation even though the parties intend on later negotiating a long-form agreement.

Conclusion

In general, settlements secured in employment cases are taxable. In bigger cases, the taxes on the settlement can be significant. One way to reduce the plaintiff's tax liability is to secure a structured settlement. By having the settlement proceeds paid to the client over time in smaller increments, the plaintiff avoids being hit with higher, marginal tax rates. The plaintiff pays a smaller percentage of the settlement to taxes, resulting in a larger net recovery. Remember, to take advantage of this option, the plaintiff must reserve the right to structure any settlement proceeds at the time of the settlement agreement. A few minutes of careful planning can save your client thousands of dollars.

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[1] (26 USC § 61(a)).

[2] (26 USC § 104(a)(2)).

[3] Rivera v. Baker West Inc. (9th Cir. 2005) 430 F.3d 1253, 1256; Lindsey v. Commissioner of Internal Revenue (8th Cir. 2005) 422 F.3d 684, 688; Green v. Commissioner of Internal Revenue, TC Memo 2014-23.