Ann: Heather -
any views?
what can we/should we
do
Shirley

National Partnership
for Women & Families

Judith L. Lichtman
President

Katie -

These are the materials you & I talked about that you might have Shirley look at. Let me know what, if anything we can do about this "grave situation"!

Warm regards
J

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Taxation of Back Pay Awards in Discrimination Cases

Problem:

One element of damage awards under employment statutes such as Title VII, ADEA, and the ADA, is compensation for back pay, i.e., wages that would have been earned by employees in the normal course of their employment had they not been discriminated against by their employer. While in some ways it seems logical that any compensation received through judgment or settlement of employment disputes designed to compensate for wages that are taxable should accordingly be taxable, compensation for wage loss in personal injury cases is not taxable. In discrimination cases, this matter was in some dispute until fairly recently, as it was unclear whether employment law statutes should be considered tort-like in nature, compensating for personal injury (in which case back wages would not be taxable) or more economic and/or contractual in nature, and thus taxable.

In *Commissioner v. Schleier*, 515 U.S. 323 (1995), the U.S. Supreme Court held that recoveries for back wages under the ADEA were not excludable from taxable income. Given that *Schleier* is in accord with the Internal Revenue Service's previously held position that back pay awards in sex and race discrimination cases should be considered taxable income as well, it would appear that little conflict remains over whether back pay awards are taxable.

This taxability of wage awards presents some problems when the plaintiff receives the proceeds of a settlement or judgment. One recurring concern is whether the employer is required to deduct legally required withholding amounts, for FICA and other purposes and the corollary concern about whether an employer who fails to do so could be subjected to future liability. This problem is the subject of ongoing dispute between plaintiffs' and defense attorneys, especially when cases are settled, and is often resolved by either the plaintiff consenting to withholding on all or part of the settlement amount, or agreeing to indemnify the employer if any future liability arises from the failure to withhold.

A second and often more financially serious concern is the taxation impact of a lump sum back pay award. As the income received must be declared in the tax year in which it was received by the plaintiff, it often serves to force the plaintiff into a significantly higher tax bracket than he or she would have been in otherwise, had his or her wages been earned in the course of employment during that year. Efforts to mitigate the effects of this problem by filing amended tax returns for previous years have generally been unsuccessful. See *Lewis D. Price v. Commissioner*, 52 T.C.M. 1038, P-H TC Memo ¶86,553 (1986).

National Employment Lawyers Association
Advocates for Employee Rights℠

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Frequently Asked Questions about The Taxation of Damage Awards In Discrimination Cases and HR 1997, The Civil Rights Tax Fairness Act

When did emotional distress damages become taxable? I always thought they weren't taxable.

In the Small Business Job Protection Act of 1996, which increased the minimum wage, Congress made taxable all damage awards not based on "physical injuries or physical sickness." Therefore, unlike personal injury awards for wages and emotional distress, discrimination awards involving either back wages or non-physical injuries (including emotional distress) are now taxable, regardless of how the injuries are designated in the settlement agreement. This discriminates against those who bring civil rights cases. While damages received because of a barroom brawl or slip-and-fall, often caused simply by *negligence*, are tax free, damages to compensate for the very same types of psychological injury caused by *intentional discrimination,* are not.

Is the rest of the discrimination award taxable?

Yes. A person who successfully brings a civil rights action is also taxed on the following:

Wages: Back and front wages are considered taxable income, and current IRS regulations also require that a lump-sum back or front pay award be attributed to and taxed in the year in which it is actually received, even if it was awarded to compensate for several years worth of wages. This often places individuals in a higher tax bracket than they would have been in had they not been discriminated against and received their wages over a number of years while continuing to work for the employer. There is currently no averaging of the award over the intended wage period, so individuals are in a worse situation financially as a result of discrimination, even when they receive an award designed to make them whole for their injuries.

Attorneys' Fees: Those bringing civil rights cases can also be taxed on the portion of the award paid to their attorney as attorneys' fees. The same award is ***taxed twice***, since attorneys are taxed on it as well. Cases from the 1st Circuit, 9th Circuit and Tax Court have held that attorneys' fees cannot be subtracted from an individual's gross income, but must instead be included in gross income, then deducted as a "miscellaneous itemized deduction," subtracted after gross income is calculated. Due to the limitations on such deductions, and the existence of the alternative minimum tax, individuals may be ultimately be taxed on the entire award, even the percentage which is the attorney's fee, based upon a contingency agreement. Under current law, large deductions can trigger the alternative minimum tax, so that more of the award, including the attorneys' fees portion, is taxable.

Doesn't this make cases harder to settle?

Absolutely. Both plaintiffs' and defense attorneys opposed the 1996 provision because the parties can no longer designate a certain portion of the award as "nontaxable," thus significantly increasing the amount needed to compensate clients fully for their losses. This means fewer cases settle, and more cases go to trial, wasting judicial resources and clogging our courts. Under current law, it costs a defendant **$107,000** to settle a case that would net the person who brought the suit the same amount as a **$50,000** settlement under a new proposed bill, the "Civil Rights Tax Fairness Act." In another example, it costs the defendant **$910,000** to compensate the individual bringing the discrimination suit the same amount as a **$450,000** settlement if this law were reformed.

Is anyone trying to change this unfair tax on civil rights awards?

NELA supports HR 1997, the **"Civil Rights Tax Fairness Act,"** a bill introduced by Rep. Deborah Pryce. This bill applies to all types of discrimination cases, including employment, housing and public accommodations cases, and will apply to damages received via settlement or verdict, starting with the 1999 tax year.

The bill's provisions include:

- income averaging of back pay awards, which would permit workers receiving back wage awards to be taxed over the number of years for which the award was designed to compensate;
- the elimination of taxation of emotional distress awards in discrimination cases, by excluding such damages completely from taxable gross income.
- eliminating taxation of attorneys' fee awards completely, by eliminating attorneys' fees from gross income, which keeps the problems with deduction limitations and the alternative minimum tax from arising.

What are the chances of the Act's passage this year?

1999 provides a unique opportunity to obtain passage of tax legislation. Based upon information we are getting, we have a real opportunity this year that we may not have again. Last year's bills were not heavily pushed by their sponsors, while Rep. Pryce (a member of the Republican leadership) and her staff have already demonstrated that they intend to work very hard on moving this bill forward. Rep. Archer, who was a principal foe in 1996, appears to be more open to changing this law in light of the budget surplus. It is extremely difficult to pass tax bills in an election year, so our chances next year are weaker. We may never have a budget surplus again, where the revenue loss caused by this bill will be less important. We might have a Republican president in the future, unlike President Clinton, who has already articulated (in his '96 signing message) support for changing this inequity. For those reasons and others, this has to be the year--we have to give it our best effort NOW.

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HR 1997, THE CIVIL RIGHTS TAX FAIRNESS ACT: TAX EQUITY for TARGETS OF DISCRIMINATION

The Civil Rights Tax Fairness Act restores real remedies for discrimination cases by eliminating taxes on emotional distress awards.

In the Small Business Job Protection Act of 1996, which increased the minimum wage, Congress made taxable all damage awards not based on "physical injuries or physical sickness." Unlike personal injury awards for wages and emotional distress, discrimination awards involving either back wages or non-physical injuries (including emotional distress) are now taxable, regardless of how the injuries are designated in the settlement agreement. This discriminates against those involved in civil rights cases. While damages received because of a barroom brawl or slip-and-fall, often caused simply by *negligence*, are tax free, damages to compensate for the very same types of psychological injury caused by *intentional discrimination,* are not. As a result, the government and attorneys often take a higher percentage of the award than the person whose rights were violated.

- The Civil Rights Tax Fairness Act ***eliminates taxation of emotional distress awards*** in discrimination cases, by excluding such damages completely from taxable gross income.

The Civil Rights Tax Fairness Act prevents workers subjected to illegal discrimination from paying higher taxes on lump-sum wage awards.

Back pay awards are considered taxable income, and IRS regulations require that they be taxed in the year received, though the award covers many years worth of wages. This can place workers in a higher tax bracket than would have applied if they had not been discriminated against and received their wages over the years they worked. No income averaging of the back pay award is allowed. This puts workers in a worse situation and defeats the purpose of the law.

- The Civil Rights Tax Fairness Act provides for ***income averaging of back pay awards***, which would permit those individuals recovering back wage awards to be taxed over the number of years for which the award was designed to compensate.

The Civil Rights Tax Fairness Act ends the double taxation of attorneys' fee awards, so individuals bringing civil rights cases no longer pay taxes on money they do not even receive.

People who bring civil rights cases can also be taxed on the portion of the award paid to their attorney as attorneys' fees. The same award is ***taxed twice***, since attorneys are taxed on it as well. Cases from the 1st Circuit, 9th Circuit and Tax Court have held that attorneys' fees cannot be subtracted from an individual's gross income, but must instead be included in gross income, then deducted as a "miscellaneous itemized deduction," subtracted after gross income is calculated. Due to the limitations on such deductions, and the existence of the alternative minimum tax, individuals bringing civil rights cases are commonly taxed on their entire award, even the portion paid to their attorneys. Under current law, deductions for attorneys fees often trigger the alternative minimum tax, making more of the award, including the attorneys' fees, taxable to the individual whose rights were violated.

- The Civil Rights Tax Fairness Act ***eliminates the taxation of attorneys' fee awards*** completely, by eliminating attorneys' fees from the individual's gross income, which keeps the problems with deduction limitations and the alternative minimum tax from arising.

The Civil Rights Tax Fairness Act benefits both individuals and businesses.

- An individual who settles a civil rights case for **$50,000** under current law, with a court-awarded **$75,000** attorney fee, now receives as little as **13.2 %** of the total award, or **$16,707**. Under HR 1997, this person would receive **$4[illegible],624**, a difference of al[illegible]ost [illegible]! Moreover, for this person to receive the latter amount under current law the case would have to be settled for **$107,000**.

HR 1997 List of Endorsing Organizations (as of 8/2/99)

American Association of Retired Persons
Leadership Conference on Civil Rights
National Employment Lawyers Association
National Partnership for Women & Families
National Whistleblower Center
Public Citizen's Critical Mass Energy Project
Public Employees for Environmental Responsibility

American Small Business Alliance
Connecticut Business and Industry Association
U.S. Chamber of Commerce

Broward County (FL) Human Rights Board

ABA Labor and Employment Section
District of Columbia Bar's Labor and Employment Section
New York County Lawyers' Association Labor and Employment Committee
Ohio State Bar
State Bar of California, Labor and Employment Section
State Bar of Wisconsin, Individual Rights and Responsibilities Section
New York State Bar Assn LABOR + EMployment Section

Taxation of Discrimination Damage Awards: Civil Rights Barrier and IRS Windfall

Our Taxpayer:

William Curtis is 38 years old, married, with one child; his tax status is married filing jointly. In his current job, he earns $25,000 per year.

(Insert factual situation here): (ADA/reasonable accommodation case?)

William's Lawsuit:

In 1999, William settled his XXXX lawsuit for $50,000. The settlement agreement allocated the damage award equally between back pay and emotional distress, at $25,000 each. The parties agreed to petition the court for attorneys' fees. William's attorney was awarded $75,000 in fees by the court.

Tax Consequences Under Current Law:

Under current law, William must include in his gross income the full amount of the settlement and the court-awarded attorneys' fees amount. While William can deduct the attorneys' fees as a miscellaneous itemized deduction, this deduction is subject to a limitation of 2% of adjusted gross income. This means that only expenses in excess of 2% of the taxpayer's income are deductible, and William loses part of the deduction for the attorneys' fees amount, even though the full amount of the settlement is taxable.

Another consequence of using the miscellaneous itemized deduction is that its use often forces taxpayers to pay the alternative minimum tax (AMT), an additional tax designed to ensure that at least a minimum amount of tax is paid by an individual. AMT adds back certain deductible items, including miscellaneous itemized deductions, that are ordinarily deductible in determining regular income tax. The income for AMT purposes is determined and is then taxed at a flat rate of 26%, paid in addition to the taxpayer's regular tax. In this example, William pays $13,169 additional tax as a result of the AMT alone.

William also pays additional ta... as a result of receiving a lump sum settlement for back wages, as this artificially forces him into a higher tax bracket. Our graduated income tax system is designed to tax individuals with higher income levels at increasingly higher rates, ranging from 15% to 39.6%. When several years' worth of back pay is included as income in one tax year, William pays a higher rate than he would have had he earned the income over several years. In the example illustrating Rep. Pryce's bill, his income is averaged over a two-year period.

(What is the tax rate o the settlement amount?)

Analysis of Tax Consequences:

Tax Scenario:	Net Settlement/ Verdict (After Subtracting Attorney Fees)	Federal and State (Ohio) Tax Paid	Net After-Tax Award
A: No Settlement	-0-	$1,104 (on income only)	-0-
B: Current Law	$50,000	$33,293	$16,707 (13.4% of total award)
C: Rep. Pryce's Bill	$50,000	$5,376	$44,624 (35.7% of total award; 89.2% of award without fees)

Scenario A:

This scenario assumes that William did not settle his lawsuit, and was taxed only on $25,000 in earned income in 1999. This scenario is presented to illustrate his otherwise-low marginal tax bracket (15%) and the deductions to which he would be entitled as a married parent.

Scenario B:

This scenario illustrates the impact of the following: a large lump-sum wage award on top of his income for the year, taxation and non-deductibility of the emotional distress award, use of the miscellaneous itemized deduction for attorneys fees, and imposition of the alternative minimum tax.

Scenario C:

This scenario assumes the following: 2-year income averaging for the back wage award, non-taxability of the emotional distress award, no alternative minimum tax.

Our Taxpayer:

Keisha Baldwin is 32 years old, and a single mother of one child. Her tax status is head of household. In her current job, Keisha earns $20,000 per year.

(Insert factual situation here): (race/sex discrimination case?)

Keisha's Lawsuit:

In 1999, Keisha settled her XXXX lawsuit for $100,000. The settlement agreement allocated the damage award equally between back pay and emotional distress, at $50,000 each. Keisha's attorney, pursuant to their retainer agreement, took one-third of Keisha's settlement, $33,000, as a contingency fee payment.

Tax Consequences of Current Law:

Under current law, Keisha must include in her gross income the full amount of the settlement, $100,000, even though she did not receive $33,000 of this amount, which went to her attorney. While Keisha can deduct the attorneys' fees as a miscellaneous itemized deduction, this deduction is subject to a limitation of 2% of adjusted gross income. This means that only expenses in excess of 2% of the taxpayer's income are deductible, and Keisha loses part of the deduction for the attorneys' fees amount, even though the full amount of the settlement is taxable.

Another consequence of using the miscellaneous itemized deduction is that its use often forces taxpayers to pay the alternative minimum tax (AMT), an additional tax designed to ensure that at least a minimum amount of tax is paid by an individual. AMT adds back certain deductible items, including miscellaneous itemized deductions, that are ordinarily deductible in determining regular income tax. The income for AMT purposes is determined and is then taxed at a flat rate of 26%, paid in addition to the taxpayer's regular tax. In this example, Keisha pays $4,005 additional tax as a result of the AMT alone.

Keisha also pays additional taxes as a result of receiving a lump sum settlement for back wages, as this artificially forces her into a higher tax bracket. Our graduated income tax system is designed to tax individuals with higher income levels at increasi ly higher rates, ranging from 15% to 39.6%. When several years' worth of back pay is included as income in one tax year, Keisha pays a higher rate than she would have had she earned the income over several years. In the example illustrating Rep. Pryce's bill, her income is averaged over a two-year period.

(What is the tax rate on the settlement amount?)

Analysis of Tax Consequences:

Tax Scenario:	Net Settlement/ Verdict (After Subtracting Attorney Fees)	Federal and State (Ohio) Tax Paid	Net After-Tax Award
A: No Settlement	-0-	$333 (on income only)	-0-
B: Current Law	$66,667	$29,253	$37,414 (37.4% of total award)
C: Rep. Pryce's Bill	$66,667	$8,534	$58,133 (58.1% of total award; 89.1% of post-fee award)

Scenario A:

This scenario assumes that Keisha did not settle her lawsuit, and was taxed only on $20,000 in earned income in 1999. This scenario is presented to illustrate her otherwise-low marginal tax bracket (15%) and the deductions to which she would be entitled as a single parent head of household.

Scenario B:

This scenario illustrates the impact of the following: a large lump-sum wage award on top of her income for the year, taxation and non-deductibility of the emotional distress award, use of the miscellaneous itemized deduction for attorneys fees, and imposition of the alternative minimum tax.

Scenario C:

This scenario assumes the following: 2-year income averaging for the back wage award, non-taxability of the emotional distress award, no alternative minimum tax

Our Taxpayer:

Sandra Smalley is 42 years old, and the single mother of two children. Her tax status is head of household. In her current job, Sandra earns $50,000 per year.

Insert facts here: (sexual harassment suit?)

Sandra's Lawsuit:

In 1999, Sandra settled her XXXX lawsuit for $450,000. The settlement agreement allocated the damage award between back pay ($250,000) and emotional distress ($200,000). Sandra's attorneys, pursuant to their retainer agreement, took one-third of Sandra's settlement, $150,000, as a contingency fee payment.

Tax Consequences of Current Law:

Under current law, Sandra must include in her gross income the full amount of the settlement, $450,000, even though she did not receive $150,000 of this amount, which went to her attorneys. While Sandra can deduct the attorneys' fees as a miscellaneous itemized deduction, this deduction is subject to a limitation of 2% of adjusted gross income. This means that only expenses in excess of 2% of the taxpayer's income are deductible, and Sandra loses part of the deduction for the attorneys' fees amount, even though the full amount of the settlement is taxable.

Another consequence of using the miscellaneous itemized deduction is that its use often forces taxpayers to pay the alternative minimum tax (AMT), an additional tax designed to ensure that at least a minimum amount of tax is paid by an individual. AMT adds back certain deductible items, including miscellaneous itemized deductions, that are ordinarily deductible in determining regular income tax. The income for AMT purposes is determined and is then taxed at a flat rate of 26%, paid in addition to the taxpayer's regular tax. In this example, Sandra pays $16,120 additional tax as a result of the AMT alone.

Sandra also pays additional taxes as a result of receiving a lump sum settlement for back wages, as this artificially forces her into a higher tax bracket. Our graduated income tax system is designed to tax individuals with higher income levels at increasingly higher rates, ranging from 15% to 39.6%. When several years' worth of back pay is included as income in one tax year, Sandra pays a higher rate than she would have had she earned the income over several years. In the example illustrating Rep. Pryce's bill, her income is averaged over a four-year period.

(What is the tax rate on the settlement amount?)
(Is Adjusted Gross Income right on this example? (35K printout v. 50 K in fact pattern))

Analysis of Tax Consequences:

Tax Scenario:	Net Settlement/ Verdict (After Subtracting Attorney Fees)	Federal and State (Ohio) Tax Paid	Net After-Tax Award
A: No Settlement	-0-	$2,943 (on income only)	-0-
B: Current Law	$300,000	$169,228	$130,772 (29.1% of total award)
C: Rep. Pryce's Bill	$300,000	$47,344	$252,656 (56.1% of total award; 86.7% of post-fee award)

<u>Scenario A</u>:

This scenario assumes that Sandra did not settle her lawsuit, and was taxed only on $35,000 in earned income in 1999. This scenario is presented to illustrate her otherwise-low marginal tax bracket (15%) and the deductions to which she would be entitled as a single parent head of household.

<u>Scenario B</u>:

This scenario illustrates the impact of the following: a large lump-sum wage award on top of her income for the year, taxation and non-deductibility of the emotional distress award, use of the miscellaneous itemized deduction for attorneys fees, and imposition of the alternative minimum tax.

<u>Scenario C</u>:

This scenario assumes the following: 4-year income averaging for the back wage award, non-taxability of the emotional distress award, no alternative minimum tax.

Our Taxpayer:

Ralph Barner is 62 years old, single with no dependents. In his current job, he earns $45,000 per year.

(Insert factual situation here): (age discrimination?)

Ralph's Lawsuit:

In 1999, Ralph settled his XXXX lawsuit for $640,000. The settlement agreement allocated the damage award between back pay ($200,000) and emotional distress ($440,000). Ralph's attorneys, pursuant to their retainer agreement, took one-third of Ralph's settlement, $213,333, as a contingency fee payment.

Tax Consequences Under Current Law:

Under current law, Ralph must include in his gross income the full amount of the settlement and the court-awarded attorneys' fees amount. While Ralph can deduct the attorneys' fees as a miscellaneous itemized deduction, this deduction is subject to a limitation of 2% of adjusted gross income. This means that only expenses in excess of 2% of the taxpayer's income are deductible, and Ralph loses part of the deduction for the attorneys' fees amount, even though the full amount of the settlement is taxable.

Another consequence of using the miscellaneous itemized deduction is that its use often forces taxpayers to pay the alternative minimum tax (AMT), an additional tax designed to ensure that at least a minimum amount of tax is paid by an individual. AMT adds back certain deductible items, including miscellaneous itemized deductions, that are ordinarily deductible in determining regular income tax. The income for AMT purposes is determined and is then taxed at a flat rate of 26%, paid in addition to the taxpayer's regular tax. In this example, Ralph pays $11,387 additional tax as a result of the AMT alone.

Ralph also pays additional taxes as a result of receiving a lump sum settlement for back wages, as this artificially forces him into a higher tax bracket. Our graduated income tax system is designed to tax individuals with higher income levels at increasingly higher rates, ranging from 15% to 39.6%. When several years' worth of back pay is included as income in one tax year, Ralph pays a higher rate than he would have had he earned the income over several years. In the example illustrating Rep. Pryce's bill, his income is averaged over a five-year period.

(What is the tax rate on the settlement amount?)

Analysis of Tax Consequences:

Tax Scenario:	Net Settlement/ Verdict (After Subtracting Attorney Fees)	Federal and State (Ohio) Tax Paid	Net After-Tax Award
A: No Settlement	-0-	$8,637 (on income only)	-0-
B: Current Law	$426,667	$237,949	$188,718 (29.5% of total award)
C: Rep. Pryce's Bill	$426,667	$101,965	$324,702 (50.7% of total award; 79.5% of post-fee award)

<u>Scenario A</u>:

This scenario assumes that Ralph did not settle his lawsuit, and was taxed only on $45,000 in earned income in 1999. This scenario is presented to illustrate his marginal tax bracket (28%) and the deductions to which he would be entitled as a single adult with no dependents.

<u>Scenario B</u>:

This scenario illustrates the impact of the following: a large lump-sum wage award on top of his income for the year, taxation and non-deductibility of the emotional distress award, use of the miscellaneous itemized deduction for attorneys fees, and imposition of the alternative minimum tax.

<u>Scenario C</u>:

This scenario assumes the following: 5-year income averaging for the back wage award, non-taxability of the emotional distress award, no alternative minimum tax.