



Tax Planning for Sexual Harassment Claims

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Gary S. Wolfe has over 34 years of experience, specializing in IRS Tax Audits and International Tax Matters including: International Tax Planning/Tax Compliance, and International Asset Protection.

As of July 2016, Gary Wolfe has internationally published 15 books and 28 articles. Gary has received 14 international tax awards from five different Global expert societies in LONDON/UK including being voted one of the 100 leading world's law firms with votes from over 150,000 voters in over 160 countries with the following award: Global 100 (2016) (KMH Media Group) - CA/US International Tax Planning Law Firm of the Year.

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Tax Planning for Sexual Harassment Claims

2016 has been a watershed year. For the first time, wealthy and powerful American men (e.g. Bill Cosby, Roger Ailes) are being sued, publicly scrutinized and facing major civil and/or criminal consequences for their alleged predatory sexual conduct in which they allegedly used their power and influence to sexually harass (or rape) many women.

In past times, these members of America's elite could hide behind an army of attorneys immune to consequences, exempt from punishment and smugly acting "above the law". When legendary attorney, Gloria Allred, entered the fray the rules changed and now lawsuits over sexual harassment appear to be proliferating.

The victims in these cases are often young women who are both defenseless and overmatched by the power, wealth and position of their alleged attackers. Evidence in these cases is often opaque since these "crimes" may only be known to the two people involved with no other witnesses. The women complain about being assaulted. The men often standard response was that the "interaction was consensual" hiding behind this defense while simultaneously attacking the women's history, motives and credibility.

For those women brave enough to face the expected onslaught in response they are often left without money, friends or resources fighting an uphill, precarious battle against a well-armed, well-financed male adversary. If they sue there is no guarantee of victory. Even if they win a lawsuit there is no guarantee on collecting on their judgment against the defendant.

Even if they collect the judgment they may see very little of the money between legal fees (up to 1/3 to 1/2 of the recovery if on percentage plus costs and fees), and taxes (in California the top tax rates for high earners for federal/CA income taxes may be as high as 55% "blended income tax rates").

So after many years of battle and stress they may wind up with less than 1/3 of the gross settlement (which may be further diminished by personal

loans required, unpaid medical & psychiatric bills, and living expenses while in the lawsuit when their income may be severely diminished).

What to do? PLAN THE ATTACK

If a woman has been victimized by another she should immediately consider filing a police report and allege the crime (e.g. assault, battery, rape et al.) A police investigation at the outset may preserve evidence, bring in a professional investigator to examine the circumstances, and pre-empt a "consensual defense" by the alleged attacker. It will also let the offending party know the matter is serious and not to be taken lightly.

The victim should at the outset receive a complete medical examination by expert doctors. Any physical damage should be documented at the outset including both short-term and long-term consequences.

Extensive medical records with date, condition and consequences should be maintained as evidence in a digital database instantly retrievable to be given to civil attorneys who may file lawsuits for redress of the victim's damages. Emotional damages should be both reviewed and categorized separately as a separate component part of the case at issue.

Under the law, personal injuries for physical damages are non-taxable but fully taxable for emotional damages (including depression and related symptoms). So if the judgment or settlement is for sexual harassment and the damages claim is allocated to emotional damages the recovery is fully taxable (up to 55% "blended" federal/state income tax rate for CA residents at maximum tax rate).

If the damages claim is for physical injuries then no tax. The difference may be up to 55 % of the total net recovery so it should be carefully considered.

The payment of damages is subject to IRS (or other) tax audit. If the payment is substantial it may trigger a tax audit. A general statement in a court judgment or a confidential settlement agreement may be sufficient to file a tax return but may not withstand tax audit without the extensive records required as fully described above.

Loss at audit level may be a crushing blow including tax, penalty and interest which could further diminish the settlement (and with fees for audit representation could easily eliminate all settlement/judgment proceeds).

Sounds bleak? Yes, it can be very bleak. However, based on a trade secret tax planning strategy which I have finalized the settlement may be entirely tax free and win an IRS or other tax audit. Since the claims are often contested if there is a settlement of the sexual harassment claim the following language if negotiated effectively may render the entire settlement tax-free as follows:

The parties are entering into this Settlement Agreement without admission of liability by either party. All payments under this Agreement shall be considered binding consideration for this agreement. The Defendant has requested for tax purposes the payment be classified as a gift and is fully aware and intends that the gift once received will be tax-free to the Plaintiff.

Defendant agrees to file all appropriate gift tax or other required tax returns and pay any gift tax or other tax which may become due. The parties agree that the receipt of the settlement proceeds will be received as a tax-free gift by the Plaintiff who will have no obligation to report the gift to any tax authorities.

The Plaintiff has no knowledge of the Defendant's tax status for US gift tax purposes whether a citizen, a dual citizen (with another country), or with a US domicile which would require him to report the gift (even if for income tax purposes he is a non-resident alien).

The Defendant agrees that the Plaintiff is under no obligation to report the gift under IRS Form 3520 as a gift received from a non-US person.

In the event, the IRS or other taxing authority audits the Plaintiff and imposes either income tax, penalty, or other tax due the Defendant agrees to indemnify, defend and hold Plaintiff harmless. Penalties include but are not limited to: substantial understatement of income tax penalty, civil fraud tax penalty, Report of Foreign Bank Account (FBAR) penalty, up to 25% penalty for failure to report foreign gift under IRC 6039 F, penalty imposed

under IRC 6662(j) for undisclosed foreign financial asset understatement, up to 35% penalty under IRC 6677 for failure to report receipt of distribution from a foreign trust, tax or penalty imposed from IRS recharacterization of gifts received from foreign partnerships/corporations by US taxpayer under IRC 672(f)(4).

IRS Tax Audits/Sexual Harassment Claims (The Law)

The US Supreme Court has defined income as an undeniable accession to wealth, clearly realized over which the taxpayer has complete dominion (See *Glenshaw Glass Co.* S CT, 55-1, USTC 9308).

The Supreme Court emphasized that it is Congress' intent to "tax all gain unless specifically exempted". In the case of sexual harassment claims they fall under the taxation of damages which is summarized as follows: damages, other than punitive damages, that compensate an injured person for personal physical injuries or physical sickness are excludable from gross income.

Damages received for personal nonphysical injuries (e.g. employment discrimination, injury to reputation) are generally taxable.

Under IRC Sec. 104 (a) (2), amounts received as damages, other than punitive damages, on account of personal physical injuries or sickness are excludable from income. Damages for emotional distress, including the physical symptom of emotional distress, may not be treated as damages on account of a personal physical injury or sickness, except to the extent of amount paid for medical care attributable to emotional distress.

Interest included in an award of damages for physical injury is includible in gross income. Punitive damages arising out of personal physical injury are includible in gross income (IRC Sec. 104(a)(2)).

The full amount of a litigant's award, including the attorney's contingent fee, regardless of whether paid directly to the attorney or to the individual, is includible in the litigant's gross income under the anticipatory assignment of income ruling (See US Supreme Court *J.W. Banks II*, Supreme Court 2005-1, USTC 50,155).

In addition the deduction of legal fees and court costs are subject to the tax rules for miscellaneous itemized deductions. Under IRC Sec. 67(a) certain itemized deductions are treated as miscellaneous itemized deductions which are allowed only to the extent their total exceeds two per cent of the taxpayer's adjusted gross income (which include legal fees and costs).

If a payment is considered for legal fees/costs the taxpayer may not receive a full tax deduction (i.e. the payment as attributed to legal fees/costs may not be deducted up two per cent of the taxpayer's adjusted gross income).

The donor of a gift is required to file all appropriate gift tax returns for gifts in excess of the annual exclusion amount (\$14k per donee). In 2016, a donor may give unlimited donees \$14k each, and has a total estate/gift tax exclusion of \$5.45m in 2016 i.e. can give \$5.45m in gifts tax-free (with a 40% gift tax imposed on gifts over \$5.45m).

For the donee the value of the gift is excludable from gross income but any income from the gift, including profit upon sale, is taxable (IRC Sec. 102).

A US Taxpayer who receives a gift from a foreign person/estate (over \$100k in aggregate gifts during the tax year), a foreign corporation or partnership (over \$15,601 in aggregate gifts during the tax year) is required to disclose the gifts by filing Form 3520 or will be subject to a penalty of up to 25% of the amount of the gift (computed as 5% of the amount of the gift for each month in which the failure to file Form 3520 continues).

Other penalties may apply including a penalty under IRC 6662(j) for undisclosed foreign financial asset understatements. In addition, under IRC Sec. 672(f)(4) gifts from foreign corporation or partnerships are subject to recharacterization by the IRS (i.e. may be recharacterized as taxable income not a tax-free gift).

If the US Taxpayer receives a distribution from a foreign trust and fails to report the distribution received under Form 3520, the penalty is 35% of the gross value of the distribution received.

The US Taxpayer is only subject to filing Form 3520 and reporting the gifts/trust distributions if they "know, or have reason to know" that the gift is from a foreign person/estate or trust".

