



Tax Planning for Settlement of Sexual Harassment Claims

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September 2016

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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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Unlike many civil lawsuits, sexual harassment claims include the risk of criminal prosecution. During civil discovery evidence may be introduced which is admissible for

Eventual criminal prosecution for a multitude of crimes: rape, assault and battery. The “stakes” are very high, tensions may run very hot and those involved may be willing to play “scorched earth” and seek the destruction of their adversary.

Given the risks involved it is best from the outset to evaluate settlement issues as follows:

1. Is it in the best interests of the parties to litigate the matter before a judge or jury or seek a private binding arbitration? The advantage of the jury trial is greater punitive damages exposure for the defendant which may play into the Plaintiff’s case more effectively. An arbitration may be better suited for the defendant who does not want the “gory details” to be part of a public record.
2. In the civil claim what are the causes of action? There is no civil claim for sexual assault. Who are the defendants? For example, it could be the perpetrator of the alleged sexual assault and include additional parties for negligence (ie. If the assault occurred at a place of business under either a negligent supervision claim or failure to provide adequate security).
3. The Plaintiff may sue for assault and battery (which could lead to physical injuries which are not taxed as damages). The Plaintiff may sue for infliction of emotional distress which emotional damages are

subject to tax. If the claim includes intentional infliction of emotional distress it may include punitive damages (which according to the US Supreme Court may up to 9 times the actual damages alleged).

Punitive damages exposure before a jury may cause a defendant to seriously review a pre-trial settlement. Insurance policies, which exclude intentional acts, will not cover punitive damages which makes the perpetrator's assets the only source of compensation.

4. For the victim, the evidentiary standard in a civil case is a lower standard of proof (preponderance of the evidence ie. "more likely than not") than for a criminal case (beyond a reasonable doubt). If the incident gives rise to both civil litigation and criminal prosecution the differences are substantial: in a civil case there are both actual and punitive damages, in a criminal case there is jail time, fines but not monetary damages.
5. In a civil case, the Plaintiff may introduce evidence that a trier of fact in the criminal case found convicts the defendant of committing the sexual abuse. The defendant, in the civil case, under the doctrine of collateral estoppel, would be estopped (prevented) from objecting to the evidence at the civil trial.
6. In a civil case, the Plaintiff may file a lawsuit at their own volition. In a criminal case, whether to criminally prosecute is the decision of the prosecutor not the Plaintiff.
7. If a civil case and a criminal case are pursued simultaneously, the civil case may be settled under a confidentiality clause which may preclude the Plaintiff from testifying against the Defendant at a criminal trial.

The complex civil and criminal issues as enumerated may make one or both of the parties amenable to a settlement. The payor (ie. The defendant) is not allowed an income tax deduction for the payment to the Plaintiff. The

payor may elect to classify the payment as a non-taxable gift (Up to \$5.45m/2016 may be given as estate/gift Tax free). The payor is using up a valuable tax benefit ie. Their estate/gift tax exclusion up to \$5.45m since all gifts in excess of that amount are taxed 40% to the payor. Yet the relinquishment of the gift tax exclusion (in whole or in part) is a valuable negotiating tool for the payor since they have the ability to make the payment to the payee effectively tax free (compared to fully taxable, with a 55% top "blended" US/California income tax rate/2016).

The payor may be able to offer a "gift" in settlement of disputed claims which gives a significant net after income tax benefit to the payee ie. They get to keep 100% of the Settlement payment not 45%. A million dollar settlement becomes a net payment of \$1m to the payee not \$450k (after tax). The payor may take the negotiating position that the recipient saves \$550k in tax on a \$1m settlement proposal so the parties may agree to "split the difference" (ie. The offer is \$725k tax free subject to negotiated settlement of the final payment amount so each of the parties may share in the \$550k tax savings on a *pari passu* basis).

Since the payor is requesting the gift tax strategy, which may lead to a lower ultimate sum paid in settlement, the payee should request they be indemnified, defended and Held harmless in the event of an audit. Since the payor has to declare the gift on Form 709 it may be their gift tax return that would first be subject to an audit (ie. they file Form 709 gift tax return declaring the gift, while the plaintiff does not declare the receipt of the payment as a gift on their Form 1040 income tax return). In the event of an IRS audit on the payor's Form

709 gift tax return, by the time the audit is concluded the statute of limitations may have run out on the recipient's income tax return.

The audit rates for gift tax returns are generally lower than income tax returns (and many less gift tax returns are filed). According to most recent statistics (IRS 2012 Data Fact Book for Fiscal Year 2012 (thru 9/30/12) the IRS employed 97,941 employees with a \$12.1B budget (since reduced by Congress) collected \$2.5 trillion in taxes and processed 237m tax returns.

Form 709 Gift Tax Returns had a 1.42% IRS tax audit rate (223,090 gift tax returns filed, 3,164 audited) compared to Form 706 Estate Tax Returns (12,582 tax returns filed, 3,762 audited (29.9%). Estates between \$5m-10m audited nearly 60%, estates over \$10m had a 100% audit rate.

In contrast, Form 1040 income tax returns had 143.4m tax returns filed, an audit rate of 1.03% (reduced to less than 1% in 2015 ie. .084%). The higher the income level the greater the risk of audit (over \$200k to \$1m: 4% rate (1 in 25); \$1m-5m 12.5% rate (1 in 8), \$5m-10m 16% rate (1 in 7), over \$10m 24% rate (1 in 4).

The filing by the payor of the gift tax return has a 1.42% audit risk which is much less than the 12.5% audit rate for income over \$1m. The payee may be subject to audit if their bank who receives the "gift" in their account files a Suspicious Activity Report (SAR) to report a suspicious transaction (ie, a deposit over \$5k). Therefore it is good tax planning for the recipient to require the payor indemnify, defend and hold them harmless in the event of a tax audit of their tax return once filed.

The Tax Planning Strategy for Settlement of Sexual Harassment Claims has numerous benefits:

1. "Optics": since the claim is disputed and neither party admits liability, the payor's "gift" may be viewed more favorably than a payment for settlement of claims (particularly by the payor's spouse or "significant other");
2. Since the payor cannot deduct the payment for income tax purposes, by using up all or part of their \$5.45m (2016) gift tax exclusion they have no income tax issues, can offer a tax-free payment to the recipient and negotiate for a share of the projected income tax savings by virtue of the gift to the recipient (payee).
3. Since it is the payor, not the payee (recipient), who is requesting the gift tax free nature of the transaction (which should be stipulated in the settlement agreement), under audit the payee may not be considered as recharacterizing taxable income as a tax free gift. The business purpose of the gift is that the payor may negotiate a lower settlement amount by the payment of a tax-free gift (not taxable emotional injury damages).

