PERSPECTIVE

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Transgender Discrimination, Video Games And The Gig Economy

By Robert W. Wood and Scott B. Weese

A lawsuit against video game developer Valve Corporation raises interesting tax issues, even if none of the parties is thinking about taxes at this point. *See A.M. v. Valve Corp.*, BC616766 (L.A. Super. Ct., filed Apr. 12, 2016). Far too many litigants fail to consider taxes until tax time the year after a case is resolved. Often, it is too late at that point to try to plan around them.

Valve is the clever developer behind the "Half-Life" futuristic first-person shooter series of games. Valve is also the developer behind "Steam," a popular online video game store. The latter raises all sorts of other tax issues about how terribly complex online sales tax can be. But forget sales tax for today.

Valve is a fairly large company with a diverse workforce. Perhaps that makes a few workplace disputes and even the occasional lawsuit practically inevitable. A person with the initials A.M. was a translator who worked at Valve in 2012. A.M. is transgender, and decided to undergo sex reassignment surgery.

Her surgeons were in Los Angeles, so she asked to be transferred there. She also wanted to work part-time while she recuperated. Valve agreed, but as a condition of the move, she was reportedly required to be reclassified as an independent contractor rather than an employee. Employees have tax withholding and benefits, and independent contractors do not, so that was a big change. In any case, A.M. continued to work at Valve until 2016, when she reportedly filed a complaint alleging that Value was taking advantage of unpaid translators who were interested in Valve and its products. A.M. was fired, and shortly thereafter she filed a lawsuit seeking $3.1 million.

The complaint sets out eight separate grounds for relief: (1) wrongful termination; (2) gender identity discrimination; (3) failure to provide reasonable accommodation; (4) hostile work environment; (5) retaliation; (6) unpaid overtime; (7) unpaid wages; and (8) misclassification as an independent contractor. The complaint also offers a neat breakdown of the requested award: $1 million for general damages, $1 million for special damages, $150,000 of unpaid wages, lost earnings estimated at $1 million, and additional costs, punitive damages and interest.

Valve denies all of these claims, and asserts several affirmative defenses. Regardless of whether the case has merit on the facts, it raises a number of interesting tax points. Again, litigation lawyers and parties often do not even think about taxes until the end.

Most lawsuit recoveries are taxable income for state and federal purposes. We all have to self-report our income, but those little Forms 1099 help you along in the right direction — basically giving you no choice. Rest assured, when you sue big companies, they are going to report that income to the government (hopefully they do it right).

The type of income, and the ensuing tax consequences depend on something called the "origin of the claim test." At its most basic level, it means that when you recover money in a lawsuit, that money is taxed based on the items it was replacing. If you sue for wages, your recovery is wages subject to income and payroll taxes.

If you sue for the destruction of a capital asset, say a collector's edition of "Half-Life" memorabilia, your recovery is generally taxable as capital gain. If you sue for physical injuries, though, that payment is tax-free. The tax code singles out compensatory damages for physical injury and physical sickness as tax-free.

Punitive damages and interest are always taxed, even in physical injury cases. And there is plenty of gray area. For example, is post-traumatic stress disorder (PTSD) physical sickness (tax-free) or simply emotional distress (taxable)? The courts and IRS haven't yet ruled. And the courts and IRS often use breakdowns from the complaint as evidence to determine which dollar amounts are for each claim, which is why the breakdown in A.M.'s complaint is potentially useful from a tax planning perspective.

A.M. seems to be suing Valve for multiple items, requiring multiple tax determinations. The lost wages, overtime and earnings are stand-ins for salary. That probably means it is all going to be wage income. However, there's an employee vs. independent contractor issue here.

If A.M. was *really* an employee as the complaint says, Valve failed to pay over the employer's share of Social Security and Medicare taxes. Valve could have to reimburse A.M. for the employer's share she had to pay while she was misclassified as an independent contractor. Valve might even face liability for unpaid benefits like healthcare or other perks.

Employers often have to provide such benefits for employees but not for independent contractors. Still, these would be another form of wage income, and thus ordinary. The discrimination and retaliation claims may involve another tax twist. Damages for discrimination (such as emotional distress) are taxable.

However, the tax code allows you to take a deduction for attorney fees when they are incurred fighting a discrimination suit. A similar provision allows attorney fees to be deducted for whistleblower claims, which could be applied to the retaliation that A.M. alleges. You might think that deducting attorneys' fees is a no-brainer.

After all, most contingent fee plaintiffs who win $100, do not even think about the $40 or so their lawyer collects. Normally, the client never sees that $40, so does not think about taxes on them. Yet the IRS rule is clear that the client has $100 of income and must deduct the fees to the lawyer, even if the lawyer has received them directly from the defendant.

In employment cases, like the A.M. suit, the tax deduction means that only the $60 is taxable. But in many types of cases, plaintiffs have trouble deducting legal fees and can even be taxed on fees paid directly to their contingent fee lawyer. It is one of the more maddening quirks of the taxation of litigation.

If Valve eventually must pay, it will have tax issues too. Lawsuit payouts and settlements are often a deductible business expense, which can help lessen the pain. Normally, like pulling off a band aid, the money is paid all at once. But what if A.M. insists on payments over time?

Ideally, Valve would pay all at once and be done with the matter, while A.M. will hopefully not have income — and tax liability — until she actually receives each payment. Valve not only wants a complete release, but wants a full and immediate tax deduction too. After all, a tax deduction today is worth more than one tomorrow. But if Valve's full and immediate deduction forces A.M. to accept full payment now when she may not want it, the settlement can fall apart at the finish line. The tax code can make squaring the timing issue complex, but if you consider taxes from the start you can avoid these kinds of problems down the line.

One possible solution might be to use a Qualified Settlement Fund, or QSF. They are more common with multiple party cases, but they essentially allow defendants to claim tax deductions when the money goes in. But plaintiffs do not have income until they actually receive payment from the QSF. QSFs can help narrow the gap between litigants.

Any lawsuit is more about the claims and details than about taxes. A.M.'s dispute with Valve surely is too. But parties are often surprised at just how confused the taxes can become. It is rarely too early to start planning!

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