Forbes

Robert W. Wood
THE TAX LAWYER

TAXES 7/12/2016

Transgender Discrimination Suit In Video Gaming Raises Tax Issues

A lawsuit against video game developer Valve Corporation raises interesting tax issues, even if none of the parties is thinking about taxes. Litigants may fail to consider taxes until it is too late. Valve is the clever developer behind the Half-Life 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.

Valve has a diverse workforce, which may make the occasional lawsuit practically inevitable. In fact, the company faces a $3 Million transgender discrimination suit from a person with the initials A.M., who was translator 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.

Credit: Shutterstock

Employees have tax withholding and benefits, and independent contractors do not, so that was a big change. A.M. continued to work at Valve until 2016, when she alleged that Value was taking advantage of unpaid translators. A.M. was fired, and thereafter 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.

Most lawsuit recoveries are taxable, except compensatory damages for physical injuries or physical sickness. 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. Punitive damages and interest are always taxed, even in physical injury cases. And there is plenty of gray area, including whether post-traumatic stress disorder (PTSD) is physical (tax-free) or simply emotional distress (taxable).

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 v. 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 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.

The discrimination and retaliation claims may involve another tax twist. Damages for discrimination (such as emotional distress) are taxable. However, the tax code allows a deduction for attorneys' fees. Most contingent fee plaintiffs do not even think about the fees their lawyer collects. Yet the IRS rule is clear that the client must report all of the income, even if the lawyer is paid directly by the defendant.

In employment cases, like the A.M. suit, the tax deduction for legal fees would mean that only A.M.'s net would taxable. But in many cases, plaintiffs have trouble deducting legal fees. Some plaintiffs are taxed on fees paid directly to their contingent fee lawyer. It is one of the more maddening quirks of the taxation of legal settlements and judgments.

If Valve eventually must pay, it may have tax issues too. Lawsuit settlements are often a deductible business expense, which can help lessen the pain. One issue will be tax withholding, which may put A.M. and Valve in opposite corners. Another issue for Valve may be tax reporting on Form 1099. And there are inevitably issues about how much to put in each category.

Some money may be wages, some non-wage damages on IRS Form 1099, some legal fees paid to the lawyer, and perhaps even some tax-free damages for physical injuries or physical sickness. Even settling a simple lawsuit can sometimes be complex. Of course, it is far better to hammer it out at settlement time than to ignore it until tax time next year.

It is not clear if Valve or A.M. is correct or if the merits lie somewhere in the middle. Clearly, any lawsuit is more about the claims and details than about taxes. But parties are often surprised at just how confused and confusing the taxes can become. Some early planning can pay off.

Thanks to Scott Weese of Wood LLP who contributed to this article. For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.