Address Taxes When You Mediate Civil Disputes

By Robert W. Wood

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This article addresses how to handle tax issues in mediating civil disputes and it notes why taxes need consideration and how the parties can avoid disputes at the conclusion of the mediation and thereafter. In general, a term sheet setting out the major economic points should be used, followed by a fully negotiated settlement agreement that addresses tax issues. There are a range of available choices among binding and nonbinding term sheets and those that are explicitly neither.

Lawyers and clients today seem more willing to pursue mediation and alternative dispute resolution than in the past. In part, this may be attributable to the time and expense necessary to try a case, the unpredictability of the courts and the attendant publicity. While I am only a tax adviser, having spent much of my career advising litigants and their attorneys about the tax treatment of litigation payments, I too am seeing more cases resolved through consensual, nonadversarial means.

All parties should be ready to deal with the tax issues arising from alternative dispute resolution. As in more litigious contexts, plaintiffs should ask their lawyers how taxes will be handled if the mediation is successful. Defendants should consider whether they can agree to any tax accommodation in settling the case. All the lawyers (especially those on the plaintiff's side) should question whether there will be time to address tax issues during mediation or afterward. Mediators should think about what should be signed if the mediation is successful and whether that document should include tax language.

This is a tall order, of course. All parties and counsel will not be entirely tax savvy when the mediation starts. Indeed, that will probably still be true when the mediation concludes. However, since the goal of mediation is the resolution of the case, we all should be aiming higher.

Mediation Versus Arbitration

First, let's begin with some nomenclature. "Mediation" is by definition nonbinding.[1] The mediator's role is to bring the parties to the bargaining table, and once there, to probe for weaknesses in each side's arguments and eventually get them to compromise. Mediators vary in their approaches to this herculean task. Many spend time in a joint session and then in separate sessions with each party alone.

Sometimes the entire mediation is conducted with the mediator shuttling between rooms, never holding a joint session. We may think of mediation as involving two parties, but many multiparty disputes are also resolved in this way. The nonbinding nature of mediation may appear to be a weakness, but frequently the parties would not be willing to discuss their case in anything but a nonbinding context.

However, the nonbinding nature of mediation also gives rise to some tax problems. The terms of a case that resolves in mediation must be reduced to writing. As part of that documentation, the tax details should be considered.

"Arbitration," as distinguished from mediation, may be binding or nonbinding depending on the nature of the matter, prevailing contracts, and relevant law. Even in binding arbitration, however, some aspects of a decision can be overturned by the courts.

Finally, let me be clear about what I mean by tax issues. This article does not discuss the mediation of substantive tax issues. Instead, my focus is on the inevitable tax consequences that will flow from resolving a nontax dispute. Examples include:

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[1]*See Black's Law Dictionary* (8th ed. 2004), which defines mediation as "a method of nonbinding dispute resolution involving a neutral third party who tries to help the disputing parties reach a mutually agreeable solution."

- **Employment disputes.** Suppose an executive has been fired and sues the company for wrongful termination, age discrimination, or other related causes. There are no tax issues in the dispute, but there will invariably be tax consequences when the dispute is resolved. Are all the payments wages subject to withholding? What is the appropriate allocation between wage and nonwage damages? Is any equity or stock option compensation to be paid? Can any equity feature be taxed as equity rather than ordinary income? How will withholding, IRS Forms 1099, and similar issues be handled?
- **Intellectual property disputes.** Suppose one company absconds with the intellectual property of a competitor and the dispute is mediated. If the defendant agrees to pay the plaintiff $5 million, how will the parties characterize the payment for tax purposes? Will the plaintiff insist on it being treated as capital gain? Will the defendant agree?
- **Personal physical injury cases.** Suppose a plaintiff is injured in a serious automobile accident in which the defendant manufacturer's vehicle malfunctions. The dispute may be mediated pretrial or posttrial while the case is on appeal. Assume there was an award at trial for compensatory damages ($5 million), punitive damages ($20 million), and interest ($1 million). The case is mediated on appeal and the parties agree to resolve the dispute for $10 million. How will the payment be treated for tax purposes? Will it all be tax free as compensatory damages, or is some of it punitive damages or interest? What will the plaintiff and defendant provide in the settlement agreement?
- **Property damage claims.** Suppose the plaintiff homeowner has insurance issued by the defendant and suffers a significant loss due to mold in the home. The plaintiff sues for property damage, relocation expenses, and personal physical injury (or sickness) damages from mold inhalation. If this dispute is mediated, what will the parties request and what should the settlement agreement say about tax treatment?

The list of comparable examples is almost infinite. Yet the similarities in those cases are more striking than their differences. In each case, if a settlement can be reached, money will be paid and documents will need to be prepared. The plaintiff and defendant must consider tax issues before filing returns the following year.

In so doing, many fundamental questions will arise. How much in the way of tax-related documentation should be prepared at the conclusion of the mediation? How much should be prepared later, and precisely what is binding? If the case settles in mediation for $1 million, what should be signed before the parties leave the room?

Term Sheets

In my experience, the parties generally sign some kind of term sheet at the conclusion of the mediation indicating that they have tentatively resolved the case for a specified payment. The document states that the parties will cooperate to produce a final settlement agreement that both parties will also sign. However, that is often where the term sheet stops.

But what happens if the final settlement agreement is never executed? Practice on this point varies widely. Is the term sheet itself binding if a more comprehensive settlement agreement is not completed? It is best if the term sheet specifies the outcome. It may say that if a settlement agreement cannot be executed, the parties agree that they have not settled the case. Conversely, the term sheet may say that the case will be considered settled based on the term sheet as a binding agreement. It is even possible for the term sheet to invoke the mediator for help in reaching a final settlement agreement. However, if the term sheet is silent on the consequences of a failure to execute a more comprehensive settlement agreement, a court may have to decide.

I have seen plenty of binding and nonbinding term sheets, and some that did not specify which they were. Yet after 30 years of practice, I have witnessed only one case in which a term sheet settlement was later derailed during negotiations over a more comprehensive agreement. Even that case ultimately settled, so I am not sure it is fair to list it as a failure of the term sheet process.

The primary issues in structuring a term sheet are how the dispute should be resolved, the enforceability of the agreement, and the completeness of releases. Plainly, these are not tax related. No matter how the parties decide to proceed, however, they may ultimately have to address tax issues.

Binding Settlement Agreements

In some cases, the parties will not sign a term sheet at all, but will proceed directly to a binding settlement agreement negotiated and signed before the parties leave the mediation room. This approach has both advantages and disadvantages.

On the plus side, if the parties hammer out a complete settlement agreement, by definition, the binding versus nonbinding term sheet issue will not arise. There simply will be no term sheet. Also, when the case is concluded via mediation (and a full settlement agreement is signed), it will *really* be

concluded. The possibility that a term sheet will not blossom into a full settlement agreement cannot arise.

On the minus side, the parties will almost certainly be rushing to address many issues and to complete a settlement agreement, perhaps after many hours (or even days) of mediation. It may be late at night. Everyone may be tired.

Proximity and resources can also influence the proceedings. Often the mediation will take place in a third-party location such as a mediator's office. The lawyers for the plaintiffs and the defendants may be drafting a settlement agreement on their laptops, or even worse, by hand. In any case, they probably will not have their full resources available, much less the time to reflect on all of the provisions and issues.

If a binding settlement agreement is signed and there is no further documentation, there will not be much opportunity to catch errors or reflect on a draft agreement. Moreover, there will be little time to discuss the tax points or to solicit and implement tax advice. Almost inevitably there will be tax issues, but when will they be addressed?

In some of the cases I see, there has been tax input by one or both sides *before* the mediation. In these cases, it may be possible to anticipate the tax matters that may arise. For example, in an employment dispute, the parties will probably have considered the wage versus nonwage question in at least a general fashion. This tax issue is so prevalent in employment cases that it seems unthinkable not to be prepared to address it.

Also, if there are arguments for excluding some damages under section 104, the parties should think about this in advance. The plaintiff should be prepared to assert how much of an exclusion seems reasonable and how it can be documented. The defendant should be prepared to develop a position about what it is willing to do.

Unfortunately, in most cases, the parties do not seriously consider the tax issues unless a dollar figure is agreed on by both sides. Although I would like to think that the parties are tax savvy before the mediation begins, the reality seems to be otherwise.

Realistically, it is unlikely that all the appropriate tax issues will be vetted and that the tax guidance will be implemented even by the end of the mediation. Moreover, even if there has been some level of tax discussion, it is almost inevitable that some tax issues will be mishandled if the settlement agreement is signed in haste. The defendant may agree to things it may later regret. The plaintiff may not even ask for the right concessions. Tax misinformation is often rampant at bargaining sessions.

If a complete settlement agreement must be signed before the parties have the time or expertise to consider tax issues, problems will arise. In extreme cases, the defendant will not know whether it should withhold on some or all of the payment. The defendant may be unclear whether it can or should issue Forms 1099 for some or all of the payments, and if so, to whom they should be issued. The plaintiff may be equally uninformed. As a result, the plaintiff may be shocked and dismayed the following January when Forms 1099 and W-2 must be completed and filed.

Ambiguous Information Returns

The information returns that are prepared can have a huge impact on the plaintiff's tax position. If the term sheet and subsequent comprehensive settlement agreement are silent on the tax reporting issues, the plaintiff will have no recourse if the forms are not prepared the way the plaintiff thinks they should be. Every year I receive numerous phone calls and e-mails around January 31 from plaintiffs who received Forms 1099 for settlements they thought were tax free.

When plaintiffs receive tax reporting forms in January or February that they think are wrong, there is often little recourse. If the settlement agreement prescribes (or proscribes) specific reporting forms, it is generally easy to contact the defense lawyer and assert that the settlement agreement has been breached. If errant Forms 1099 have not yet been sent to the IRS, the defense can destroy the erroneous forms. If the forms have already been sent to the IRS, however, there is a procedure for correcting erroneous Forms 1099.[2] In either event, the mishap can be remedied.

The question of tax reporting forms may be addressed in a binding term sheet. If the term sheet is not binding, however, or if the term sheet leaves the tax reporting details for the settlement agreement, these reporting issues should be addressed. If the settlement agreement that finalizes the mediation is not specific, calls to the defense attorney or defendant the following January are likely to fall on deaf ears. When debating the legal requirements for issuing reporting forms, it is likely that whatever position the defendant has taken is either within the law or within a reasonable interpretation of it. It is difficult to convince signatories to a binding contract to undo something when they have no legal obligation to do so.

Understandably, defendants do not wish to debate such points after they have signed a binding settlement agreement and paid settlement money.

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[2]*See* the IRS publication *General Instructions for Certain Information Returns (Forms 1098, 1099, 3921, 3922, 5498, and W-2G)* (2010), pp. 6-7.

The plaintiff has no bargaining power and is usually not well liked by the defendant. It is much better to have a definitive statement in the term sheet or settlement agreement that resolves any debate about exactly what tax forms will be issued and to whom.

I believe it is more likely for the settlement agreement to include fully considered tax language if it is not signed the night of the mediation. For this reason, I believe mediations should generally conclude with a term sheet. The parties can decide whether they want a binding term sheet, a nonbinding term sheet, or an ambiguous term sheet.

Why Include Tax Provisions?

Since litigants and their counsel commonly question the merits of tax provisions in settlement agreements, it is worth addressing this topic. It underlies much of the mediation debate. First, it is axiomatic that one cannot bind the IRS in a settlement document.[3]

Clearly, the plaintiff and the defendant may agree in a settlement agreement that the settlement is intended to be for personal physical injuries and therefore should not constitute income for tax purposes. The IRS can always disagree. Similarly, the plaintiff and the defendant in an employment action might agree that 50 percent of the settlement amount constitutes wages and the other 50 percent is income but not wages (to be reported on a Form 1099). Again, the IRS can always disagree with this allocation.[4]

After 30 years of representing clients in these circumstances, I find it downright foolish not to address taxes in settlement agreements. The mere fact that the parties cannot bind the IRS does not mean that no attempt should be made to address tax issues. Many IRS agents and Appeals officers will not look behind a settlement agreement to ask questions about the tax issues. In fact, having a general settlement agreement that says nothing about taxes or tax reporting can be more likely to prompt inquiry than one that is specific. I've had IRS personnel look askance at a general release, saying, ''If this payment was intended to be for personal physical injuries and therefore tax free, why doesn't the settlement agreement say so?''

Whatever one's practical experience may be in dealing with the IRS, a settlement agreement almost invariably represents an opportunity to shape the tax treatment of the payments. Failing to grasp this potential benefit represents an enormous lost opportunity one can never get back. Do not fail to take advantage of it.

National Taxpayer Advocate Nina Olson has suggested that legal settlement recoveries have crowded the Tax Court's docket.[5] One reason for the logjam is the mess that section 104 has become. Another is the lack of consensus on tax issues in settlement agreements.

Defendants, Too

Some defendants may nevertheless assert that it is only in the plaintiffs' interest to set forth tax provisions in a settlement agreement. This is not true. First, defendants may have to address deductibility issues. Even more importantly, however, defendants need to know what they can and should do concerning withholding and information returns.

I have seen defendants withhold employment taxes on settlement payments only to find that the plaintiff will not accept the payment or, even worse, will refuse to sign all appropriate forms and file them with the court to dismiss the case. I have seen defendants issue Forms 1099 in the year following a settlement only to find themselves in court again fighting with the plaintiff over tax reporting. However, such lawsuits are rare and most may be regarded as spurious.

Nevertheless, they are expensive and maddening fights, particularly when the settlement agreement should have made everything clear. A defendant who ends up litigating tax and withholding issues separately after a case is ostensibly resolved will not be happy with anyone, including his own lawyers.[6]

Are Taxes Essential?

Only a few courts have considered whether tax provisions are essential to a settlement agreement. In 1995 the Eighth Circuit decided *Sheng v. Starkey Laboratories Inc.*,[7] which had its beginning in a simple employment dispute. The underlying claim was made by Beihua Sheng, a former employee of Starkey who sued for sexual harassment and retaliation. The parties met for a settlement conference before a magistrate on December 20. After discussion, the attorneys for Sheng and Starkey shook hands on a figure of $73,500.

Unfortunately, the attorneys could not agree on the tax treatment of the settlement. Sheng's attorney

[3]*See, e.g., Basle v. Commissioner*, T.C. Memo. 1957-169.

[4]*See Bagley v. Commissioner*, 121 F.3d 393 (8th Cir. 1997), *Doc 97-23130*, *97 TNT 153-8*, *aff'g* 105 T.C. 396 (1995), *Doc 95-11034*, *95 TNT 241-12*.

[5]*See* Nina Olson, National Taxpayer Advocate 2009 Annual Report to Congress, p. 446, *Doc 2010-174*, *2010 TNT 4-19*.

[6]*See Redfield v. Insurance Co. of North America*, 940 F.2d 542 (9th Cir. 1991).

[7]53 F.3d 192 (8th Cir. 1995), *after remand, rev'd in part and aff'd in part*, 117 F.3d 1081 (8th Cir. 1997).

asked for an assurance that Starkey would not withhold taxes. Starkey asked for indemnity in the event the IRS thought withholding was required. According to Sheng's lawyer, the parties agreed to meet again to iron out this nettlesome tax question.

Later that day, the parties learned that the judge (not the magistrate) had granted summary judgment to Starkey on December 17, 1993 (three days before the settlement conference with the magistrate). When the judge became aware of the settlement on December 20, he withdrew his grant of summary judgment. On December 21, he issued a new order endorsing the settlement and dismissing the plaintiff's case.

The plaintiff tried to enforce the $73,500 settlement while the defendant sought to reinstate the December 17 summary judgment ruling. Starkey argued that there could not have been an enforceable settlement because (a) the parties were negotiating without the knowledge that summary judgment had already been granted or (b) they had failed to reach a complete agreement because the tax treatment of the settlement proceeds had not been addressed. The district court determined that the summary judgment ruling had not matured into a court order before the settlement was reached and that the failure to agree on tax consequences did not preclude a settlement.

Taxes Are Material

Starkey appealed, contending that no settlement was ever reached because the parties had not agreed on tax consequences. A ''mutual mistake of fact'' existed, Starkey argued. The Eighth Circuit reversed, holding that there was no contract unless the parties agreed to all material terms.

What is material must be evaluated when the contract is formed, and subsequent events cannot make terms nonmaterial that were material at the time a deal was being considered. The tax and indemnity issues were material here, and that vitiated the settlement.[8] The final chapter in *Sheng* came on remand, when the court found the parties had reached agreement on all essential terms. The court rescinded the dismissal order and reinstated summary judgment in Starkey's favor.

Still not satisfied, Sheng appealed again. Considering the case for a second time, the Eighth Circuit said the settlement did not hinge on tax issues. Moreover, the Eighth Circuit found that the summary judgment motion did not give rise to a mistake of fact discrediting the settlement.[9]

Sheng is an unusual tale of woe. Yet it illustrates how much time and money can be spent on relatively minor tax issues that can usually be dealt with calmly and reflectively.

Conclusion

Plaintiffs, defendants, their counsel, and mediators all have something to accomplish in alternative dispute resolution. Taxes may seem to be a low priority, but they are important to consider if the mediation goes well. One way or another, try to address the tax issues sooner rather than later. Whether you represent plaintiffs or defendants, or are a mediator, you'll be glad you did.

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[8]*See* 53 F.2d 192 (8th Cir. 1995).
[9]*See Sheng v. Starkey Laboratories*, 117 F.3d 1081 (8th Cir. 1997).