Can Settlement Checks Obviate Withholding and Form 1099?

By Robert W. Wood

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Because tax advice to plaintiffs in lawsuits is often left until the settlement is concluded, many plaintiffs' attorneys direct that all monies are paid to them to obviate withholding and Forms 1099. While some defendants go along with this, it is an inappropriate practice.

When the mechanics of even a simple settlement agreement to resolve litigation are considered, taxes inevitably come up. Many plaintiffs' lawyers know they may be called on to provide detailed computation and advice concerning tax issues. Clients want to quantify their net recoveries after attorney fees and costs. Clients also want to know their net after taxes. Even if the client fails to specifically ask about taxes, it is hard to ignore the fact that tax issues should be considered. The lawyer should bring up taxes even if the client does not.

But which lawyer? Clients expect their lawyer to guide them through their case from soup to nuts. Understandably, clients often fail to appreciate the variety of legal specialties or the degree to which the tax aspects of a settlement are outside the scope of most plaintiffs' lawyers' expertise. Thus, lawyers who do not provide any tax advice or who fail to direct their clients to competent tax advisers may be doing the client a significant disservice.

Of course, it is an even bigger disservice to the client if the plaintiff's lawyer attempts to provide tax advice and fails to do it effectively. There have been some notable legal malpractice cases on this point. However, simply *excluding* tax advice from the scope of legal representation may not always be the perfect answer.

If the lawyer settling a case for the client excludes tax advice, can the lawyer count on the client to get tax advice elsewhere? Usually not, no matter how clearly the lawyer indicates he is not providing tax advice. The lawyer can advise the client in writing to obtain tax advice, but the client may not follow through with it.

Moreover, even if the client procures tax advice elsewhere, the advice may be from an accountant thinking more about tax compliance and return filing than about any planning opportunities. The tax adviser, whether lawyer or accountant, may not ask for the right documents, or may not provide the kind of tax input that is generally necessary to complete a settlement agreement in short order. Once the plaintiff and defendant have agreed in principle to settle a long-standing dispute, there is generally a rush to complete it.

Some plaintiffs' lawyers will insist that outside tax advice be procured. Some will even front the expense of tax advice, agreeing to bear it if the client will not. Some lawyers will provide an introduction to a tax lawyer, perhaps even offering to pay for an initial consultation so the client at least has an idea of the tax issues involved, the approximate dollars at stake, and how much flexibility there may be. An initial consultation can provide an overview of the tax issues so the client can more readily assess whether it makes sense to hire someone to attempt to address tax issues in the settlement agreement. All these avenues are possible, and all have variations.

Unfortunately, in most cases, nothing is done. This may be because the plaintiff's lawyer fails to opt for one of these alternatives, the client is overwhelmed with other details and fails to focus on tax concerns, the client is simply not interested, or the client doesn't obtain the tax advice in time. This is not to say tax issues are never addressed; the plaintiff will have to get tax advice about the recovery come filing time. This is often precipitated by the arrival of forms 1099 or W-2 in January after the settlement.

Against this background, it should not be surprising that many plaintiffs' lawyers somehow end up providing their own brand of tax advice. In some cases it may be fine; some plaintiffs' lawyers have sufficient tax expertise and can adequately accomplish things a tax lawyer would do.

There might even be a case in which a plaintiff's lawyer — equipped with the right tax skills — can do a superb job of providing and implementing tax advice. The plaintiff's lawyer certainly knows the facts and the propensities of the defendant and the defense lawyer. The plaintiff's lawyer will be negotiating the settlement agreement. Even if an outside tax adviser is solicited, the plaintiff's lawyer will probably need to insert into the settlement agreement the language provided by the tax lawyer.

However, there is a built-in danger in the plaintiff's lawyer trying to achieve tax goals in addition to his other responsibilities. Even if the plaintiff's lawyer has the requisite tax knowledge, he may not be objective or may

provide the advice in a slipshod manner. For example, knowing that section 104 excludes recoveries for personal physical injuries and physical sickness, the plaintiff's lawyer may add language to the settlement agreement, insisting that the entire recovery is excludable when the recovery is actually a mixture of wages and damages for emotional distress. Although inserting wholesale tax exclusion language would be inappropriate, the defendant may agree to that language, giving the plaintiff a false sense of security that this tax treatment will prevail.

There are many other common problems. In an employment dispute, for example, the plaintiff's lawyer acting as a tax lawyer may argue for no income or employment tax withholding. This may be the lawyer's or the client's idea, and the defendant may disagree, of course. But if a defendant agrees to no — or minimal — wage treatment when much of the recovery is wholly wages, what has the plaintiff achieved?

The plaintiff may be happier receiving a larger check instead of a net check ravaged by withholdings. Of course, one-half of Social Security and Medicare taxes are borne by the employee. In that sense, the no-withholding solution may save the plaintiff something, at least in the short run.

But if a plaintiff "succeeds" in having no withholding, will the plaintiff be prepared to pay estimated taxes and to handle the burden of paying tax on the settlement in a lump sum the following April? Many are not prepared for this eventuality. This is particularly so if the plaintiff has earned solely wages in the past and is unaccustomed to budgeting for tax liabilities without payroll withholding.

The Latest Tax 'Solution'

It seems that plaintiffs' lawyers commonly tell defendants to issue one check payable to the law firm's trust account, or to the plaintiff's lawyer or law firm, without any reference to a trust account.

In either case, many plaintiffs' lawyers now assert that this obviates both withholding on any wage portion of the settlement and the issuance of any and all Forms 1099. Does it? Defendants, I am told, often agree to this practice. They do so in employment disputes, personal injury cases, and various other disputes.

In personal physical injury cases, this practice may not create any tax or reporting problems. After all, the recovery in a bona fide personal physical injury case would presumably be excludable under section 104. In turn, that means there would be no IRS Form 1099 obligation for the payment, however the check is issued.

In virtually any other type of litigation, the practice is surely wrong for plaintiffs, defendants, and plaintiffs' counsel. Let us start with the Form 1099 rules.

Form 1099 Issues

Does this way of issuing a check in a taxable (nonpersonal physical injury) case prevent the defendant from having to issue Form 1099 to the plaintiff and the plaintiff's lawyer? It is pretty clear the answer is no.[1] The Treasury regulations provide that:

> A person who, in the course of a trade or business, pays $600 of taxable damages to a claimant by paying that amount to the claimant's attorney is required to file an information return under section 6041 with respect to the claimant, as well as another information return under section 6045(f) with respect to the claimant's attorney.[2]

This rule is illustrated in the following example, which concludes that the defendant is required to issue an information return to the plaintiff even though the check was issued solely to the plaintiff's attorneys:

> *Example 5. Multiple attorneys listed as payees*. Corporation P, a defendant, settles a lost profits suit brought by C for $300,000 by issuing a check naming C's attorneys, Y, A, and Z, as payees in that order. Y, A, and Z do not belong to the same law firm. P delivers the payment to A's office. A deposits the check proceeds into a trust account and makes payments by separate checks to Y of $30,000 and to Z of $15,000, as compensation for legal services, pursuant to authorization from C to pay these amounts. A also makes a payment by check of $155,000 to C. A retains $100,000 as compensation for legal services. *P must file an information return for $300,000 with respect to A* . . . A, in turn, must file information returns with respect to Y of $30,000 and to Z of $15,000 under [section 6045(f)] because A is not required to file information returns under section 6041 with respect to A's payments to Y and Z because A's role in making the payments to Y and Z is merely ministerial. . . . *As* described in *Example 3, P must also file an information return with respect to C, pursuant to section 1.6041-1(a) and (f)*.[3]

The reference in the last sentence to Example 3 presumably means that the defendant must report the *gross* taxable amount to the plaintiff. Example 3 involved a defendant who issued separate checks of $100,000 to the plaintiff's attorney (as compensation for legal services) and the remaining $200,000 to the plaintiff. Under these facts, the regulations required the defendant to report, with respect to the plaintiff, the entire $300,000 gross amount that was includable in the plaintiff's gross income.

The answer is the same whether the check is made out to the plaintiff's attorney or to the attorney's trust account. The attorney is treated as the payee in either case.[4] (The attorney cannot be treated as the payee if the check

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[1]Note that in cases of personal physical injury, it is also clear that for reporting purposes, a payer should "not report damages (other than punitive damages) . . . received on account of personal physical injuries or physical sickness [or] damages received on account of emotional distress due to physical injuries or physical sickness." *See* instructions to Form 1099-MISC (2010), p. 4.

[2]*See* reg. section 1.6041-1(a)(1)(iii).

[3]*See* reg. section 1.6045-5(f), Example 5 (emphasis added).

[4]Reg. section 1.6045-5(d)(4).

is made out to ''client c/o attorney,'' or if the attorney otherwise does not have the right to negotiate the check.)

All these regulatory provisions apply to payments made on or after January 1, 2007.[5]

Wage Withholding Issues

What about the income and employment tax withholding aspects? Normally, a defendant would consider wage withholding issues only when the nature of the dispute raised those issues. In most garden-variety employment litigation, at least part of the damages or settlement amounts logically must be regarded as wages.

Nevertheless, to my surprise, the practice of plaintiffs' counsel asking defendants to make settlement checks payable to the plaintiff's counsel or to the counsel's trust account — without any reference to withholding issues — is fairly common in employment litigation. Even more surprising, some employers go along with the practice. Can any employer seriously believe its liability for failure to withhold is obviated by making a payment to the plaintiff's lawyer's trust account? Apparently, some do.

But if the payment represents wages, the act of paying the employee's agent hardly insulates the defendant. After all, the obligation to withhold rests with the employer.[6] Perhaps some of these employers take the position that by paying the plaintiff's lawyer rather than the plaintiff directly, the employer does not have ''control'' over the payment.

This control argument is weak, particularly since any help it provides to the defendant seems so obviously to result in liability to the plaintiff's lawyer. Section 3401(d)(1) provides that if the person for whom an individual performed services does not have control over the payment of wages for those services, the term ''employer'' means the person who has control of the payment. If the employer lacks control over the payment, presumably the plaintiff's lawyer becomes the section 3401(d) ''employer.'' That means the plaintiff's lawyer may be responsible to withhold employment taxes. Such a withholding responsibility may shock most plaintiffs' lawyers who follow this practice.

In any case, the assumption that the employer lacks the requisite control to withhold in the first place seems dubious. The authorities construing the term ''control'' make clear that ministerial functions are not enough to impart control.[7] Indeed, the regulations provide that an attorney performs a purely ministerial function if he receives a settlement amount, withholds attorney fees, and pays the remainder to the client.[8]

The short answer is that liability for an employer's failure to withhold cannot be delegated.[9] Accordingly, employers who take aggressive positions on their withholding obligations in employment litigation do so at their own peril.

Conclusion

There's no easy answer to the question of how to address taxes in settlement agreements. Litigators can't be expected to know what to say and what not to say, which suggests that outside tax advice should be obtained in every case.

Of course, not every client will pay to consider tax issues thoroughly before a settlement agreement is signed. Clearly, some cases will be too small or too cut and dried for much action. In that context it may be understandable that plaintiffs' lawyers look for a shortcut that will fix the situation, get the case settled and the money paid, and allow taxes and returns to be considered later.

Yet sometimes lawyers will outsmart themselves with language intended to fix tax issues that instead fixes little.

In sum:

- Far too many plaintiffs conclude employment and other litigation believing they will owe no taxes.
- Far too many plaintiffs in nonemployment (and nonpersonal physical injury) cases believe they won't need to include contingent legal fees in their gross income (or if they do, that they can deduct them off the top).
- Far too many defendants fail to consider their reporting obligations both during and after a settlement.
- Far too many employers do not carefully think through the ramifications of their wage withholding or lack thereof.
- Far too many plaintiffs' lawyers assume that neither they nor their tax and accounting practices will ever be attacked.

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[5]Reg. sections 1.6041-1(a)(1)(iii) and 1.6045-5(h).

[6]Section 3401(d); section 3402(a)(1).

[7]*See, e.g.*, *In re Earthmovers Inc.*, 199 B.R. 62 (Bankr. M.D. Fla. 1996); *In re Professional Security Services Inc.*, 162 B.R. 901 (Bankr. M.D. Fla. 1993); *see also* reg. section 31.3401(d)-1(g) (''if the person making such payment is acting solely as an agent for another person, the term employer shall mean such other person and not the person actually making the payment'').

[8]Reg. section 1.6045-5(f), Example 5.

[9]*See United States v. Garami*, 184 B.R. 901 (Bankr. M.D. Fla. 1995); *In re Professional Security Services Inc.*, 162 B.R. 901 (Bankr. M.D. Fla. 1993); *see also* section 3504; reg. section 31.3504-1(a).