

Do Tax Issues Impact Mediations?

By Robert W. Wood

A mediation is about resolving a dispute. The plaintiff wants as much as they can get, the defendant wants to pay as little as possible, and the mediator tries to work on both sides. Taxes may not come up until after a deal is reached, but if no one is thinking about taxes, should they be?

Some plaintiffs with tax concerns mention them early on, making it clear that any settlement must involve a particular tax treatment. But that may lead to lower defense offers, so in general, I believe tax requests should come near the end. A plaintiff might want to say, “okay to that figure, provided that you give me the tax treatment I want.”

But if you reach a deal, will a document be prepared on the spot by the mediator? Will it be a fill in the blanks form? Will it be an unsigned term sheet, a signed one that is binding, or a full-blown settlement agreement? The answer may influence how you proceed on the tax issues. Many mediators prefer a signed term sheet, but in that event, what happens if the more full-blown settlement agreement is never executed?

The term sheet may say that in the event the parties fail to execute a comprehensive settlement agreement, the term sheet is a binding settlement agreement. Skipping a term sheet has advantages and disadvantages. On the plus side, if the parties hammer out a full-blown settlement agreement the day of the mediation, by definition, the binding versus non-binding term sheet issue will not arise.

Also, when the case is concluded with a full settlement agreement, it will *really* be concluded, hopefully including the tax issues. Not only that, but because of the rush to get it signed, if you are plaintiff and are well-prepared tax-wise, you might even get a better deal on the tax issues. If the defendant wants the case resolved that day, and their tax people are not available, the defendant might agree to something they would not accept a day or two later.

Of course, it can backfire. Both parties may not be able to vet the tax or other details in a comprehensive settlement agreement. Mediations can be long and tiring, and proximity and resources can be issues. In any event, whether you are a plaintiff or defendant—but especially for plaintiffs—it is a good idea to know going into a mediation what kind of writing, if any, will be prepared if you reach a deal.

In an employment dispute, the parties will probably have considered the wage versus nonwage question, in at least a general fashion. However, in some cases, the parties may not seriously consider tax issues until a dollar figure is agreed upon by both sides. That is especially true with section 104 exclusions for physical injuries or physical sickness.

If there is an argument for excluding some amount for physical injuries or physical sickness under Section 104, the plaintiff should consider it in advance. The complaint and the mediation brief should address it. If the claims are not set out, the defendant may be surprised if it comes up only at the end. Claims can be added of course, especially in cases that are quietly negotiated without court filings, but there’s a limit. Some plaintiffs say, “we didn’t include these claims before because then you would have gotten all our medical and

psychiatric records in discovery.” But that may not always work.

In my experience, binding term sheets are the most common method for reaching a deal. Most of the time they seem to work out okay, the tax issues can often be worked out thereafter. But not always, and it is best to know going in if that is what your mediator expects if you reach a deal. You can even ask for a sample, so you and your client can consider it. From a tax viewpoint, it is less critical for defendants to do this, but they should know too.

The rub, of course, comes later. If the term sheet does not address the allocation or tax treatment of the payments, will the parties be able to iron it out when negotiating the full-blown settlement agreement? What if they can’t, the term sheet stands, and the defendant pays the money? With or without wage withholding, with Forms 1099, etc.?

One question is how much or how little about taxes to put in a binding term sheet. The tax treatment is subject to plaintiff’s approval? No less than 50% will be treated as wages, subject to withholding and reported on Forms W-2? Should the plaintiff ask for express physical injury language—and no Form 1099—in the term sheet? The answers usually depend on the circumstances, so it is tough to give a template.

But if you later discover there is problem, you may wish you had been *more* explicit. If there are big tax issues you need addressed, plan ahead if you can. And if you have a tax plan prepared, think about what you should propose in the term sheet *before* it is signed.

Can term sheets with taxes covered go too far? Some term sheets end up having comprehensive tax language that is more or less replicated later in the comprehensive settlement agreement. But at least that approach means that there will not be a donnybrook over the tax issues later.

Most term sheets do not mention tax forms such as Form 1099, but settlement agreements always should. Which IRS forms are issued can have a huge impact on the plaintiff’s tax position. If the settlement agreement is silent on tax reporting, the defendant has to use its best judgment. Every year I receive phone calls and emails around January 31 from plaintiffs who received Forms 1099 they find surprising or believe are wrong.

As just a few examples, a payment for personal physical injuries or physical sickness is not supposed to be reported to the plaintiff on a Form 1099. A payment for capital proceeds is not either—since the defendant will not know what portion if any represents a return of basis, and what part may represent capital gain. But if you don’t specify, many defendants will issue the forms in any event.

The types of Forms 1099 matter too. A Form 1099-MISC generally signals that a payment is income. But a Form 1099-NEC usually means income tax as well as self-employment taxes. Unless the payment is for services, a plaintiff will not want a Form 1099-NEC. Lawyers care about their own tax reporting forms too.

Most payments to lawyers are required to be reported on a Form 1099, even if the law firm is incorporated, and even if the payment is of settlement proceeds. With settlement proceeds, much of the payment will likely end up going to the plaintiff represented by the lawyer. But the lawyer will usually receive a Form 1099 for 100% of the funds. Lawyers should prefer receiving Form 1099-MISC, Box 10, a special box for "gross proceeds paid to an attorney." But if you don't specify, you may end up with the payment reported on Box 3 of Form 1099-MISC, which is income.

If the settlement agreement specifically prescribes (or proscribes) certain Forms 1099, it is generally easy to contact the defense and get corrected forms issued if something went awry. But if the settlement agreement is not specific, corrections are rare. Whatever reporting position the defendant has taken is likely to be within the law or a reasonable interpretation. A definitive statement in the term sheet or settlement agreement can resolve any debate about exactly what tax forms will be issued, in what amounts, and to whom.

You cannot bind the IRS or state tax authorities in a settlement agreement. Plaintiff and defendant may agree that the settlement is for personal physical injuries and therefore should not constitute income, but the IRS can always disagree. Similarly, plaintiff and defendant in an employment action might agree that fifty percent of the settlement amount constitutes wages, and the other fifty percent is non-wage income to be reported on a Form 1099. The IRS can disagree, although it is rare for the IRS to argue for more wages if there is something reasonable in that category.

Of course, the fact that one cannot *bind* the IRS does not mean you should not take a shot at the tax issues. Many tax auditors will not look behind a settlement agreement to ask questions about the tax issues if they find the settlement agreement satisfactory. So don't ignore the chance to help shape the tax result.

Besides, post-settlement disputes about taxes can occur. I have seen defendants who withhold taxes or who issue Forms 1099 get embroiled with the plaintiff again over tax reporting. That means unhappy parties and lawyers. Some defendants (say in lemon law cases) avoid mentioning Forms 1099. If the settlement agreement does not say anything, the defendant can presumably send out Forms 1099 however they want, within reason.

The plaintiff may push back hard, demand corrections, but most such requests don't go anywhere. Withholding of wages is a different matter. It is rare for that not to be addressed. No employer wants to withhold on a payment and then have the plaintiff refuse to accept the net check, or worse still, sue all over again about the tax withholding.

In *Redfield v. Insurance Company of North America*, 940 F.2d 542 (9th Cir. 1991), Mr. Redfield sued the Insurance Company of North America for age discrimination. His case went to trial, he obtained a judgment, and it was upheld on appeal. Finally ready to lick its wounds and move on, the company withheld and tendered a net payroll check, which Redfield refused.

The parties fought for several more years in district court and the Ninth Circuit as Redfield said his payments were not wages. After the *second* Ninth Circuit battle, Redfield prevailed. After several years of litigation and expense, Insurance Company of North America had to pay the full amount of the judgment. This was judgment not a settlement, but disputes nearly that bad have occasionally happened with settlements.

Plaintiffs, defendants, lawyers, and mediators all have an agenda in mediation, and taxes may be far down on that list. But taxes will matter if the mediation goes well. I am often hired after a successful mediation, and it can work out just fine. But usually, it works out much better with a little more planning. And if the tax issues are material about withholding, wording, allocations, or Forms 1099 parties should be careful what they sign.

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