

How, When To Address Taxes In Mediation

By Robert W. Wood

In mediation, you summarize your case and focus on key points. Each side tries to convince the mediator, who works on both sides. Some mediations end in full-blown settlement agreements. But in a majority of cases, the parties sign a term sheet at the conclusion of the mediation indicating that they have tentatively resolved the case for a specified payment.

The term sheet says the parties will cooperate to produce a final settlement agreement both parties will sign. However, what happens if the final settlement agreement is never executed? Is the term sheet itself binding if a more comprehensive settlement agreement is not completed?

The term sheet may say that if a settlement agreement cannot be executed, the parties agree that they have not settled the case. This seems rare. Conversely, the term sheet may say that the case will be considered settled based on the term sheet as a binding agreement. This is more common.

It is even possible for the term sheet to invoke the mediator for help in reaching a final settlement agreement. 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 term sheets and some that did not specify which they were.

Yet after 35 years of tax practice, I have witnessed only one case in which a term sheet deal was later derailed during negotiations over a more comprehensive agreement. That case ultimately settled, so even it was not really a failure of the term sheet process.

The primary issues in a term sheet are the dollars, timing, who pays, who receives, enforceability, confidentiality, etc. Plainly, these are not tax-related. No matter how the parties decide to proceed, however, they may ultimately have to address tax issues.

What if the parties will not sign a term sheet but will proceed directly to a binding settlement agreement signed before the parties leave the mediation room? This approach has 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.

With no term sheet, 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 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 consider all of the provisions and issues. If a binding settlement agreement is signed and there is no further documentation, there will be little opportunity to catch errors or reflect on a draft agreement.

Moreover, there will be little time to discuss 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.

If there are arguments for excluding some damages under Section 104 (the personal physical injury exclusion), 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.

In extreme cases, the defendant will not know whether it should withhold on some or all of the settlement. 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 are filed by the defendant. Unfortunately, in many cases, the parties do not seriously consider the tax issues until a dollar figure is agreed upon by both sides. Although I would like to think that the parties are tax savvy before the mediation begins, the reality is often otherwise.

Realistically, it is unlikely that all the appropriate tax issues will be vetted and that the tax guidance will be implemented 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 may arise.

In this mash-mash, what is the right approach? I suggest these steps:

1. Do not go to mediation without at least a basic understanding whether there are any tax issues and, if so, what they are. That could mean as little as a brief phone call with a tax adviser beforehand, or something more extensive.

2. If you have tax issues, flag them at mediation if you can. Even if there is nothing in the term sheet about taxes, do not sign a settlement agreement or term sheet without at least raising tax issues.

3. If possible, go beyond oral reference to tax issues. The term sheet could say that the parties will cooperate on tax language in the settlement agreement.

4. If possible, go beyond mere tax cooperation language. A plaintiff may want the term sheet to say that there will be tax language in the final settlement agreement that is acceptable to the plaintiff. The defendant might agree to a particular tax treatment provided that the plaintiff provides a tax opinion to the defendant.

5. Most tax issues are raised by plaintiffs. But if you represent a defendant and you know your tax position, express it. If the entire settlement will be taxed as wages subject to withholding, say so early.

Plaintiffs, defendants, counsel and mediators all have something to accomplish in mediation. Taxes may be a low priority, but not if the mediation goes well. One way or another, try to address tax issues sooner rather than later. Whether you represent plaintiffs, defendants, or act as a mediator, you will be glad you did.



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