

Is Good Tax Language In Settlement Agreements Enough?

By Robert W. Wood

Lawyers help clients to close transactions, transfer property, settle estates, pursue debt collection, prosecute and settle legal disputes, and handle numerous other matters. Lawyers handle many legal documents, including settlement agreements that resolve disputes. In many situations, money changes hands at some point, as occurs in a lawsuit settlement.

Money changing hands usually means tax issues for one or more of the parties. Lawyers often feel that they need to be aware of the tax issues, even when they are not advising on taxes. Yet sometimes, identifying tax issues can be difficult, even if you are not responsible for giving any advice on them. To begin with, the tax code is full of complex, interconnected and sometimes conflicting provisions.

On top of the tax code, there are revenue rulings, regulations, and various types of notices and other advisory items from the IRS. Some kinds of IRS releases are not even technically authority in a legal sense, but they are still important. There are also volumes and volumes of tax cases, where the taxpayer and the IRS disagree and face off in court.

The tax treatment of litigation settlements and judgments may seem to be among the more straightforward tax issues, but litigation has endless variety. Even so, settling litigation usually involves relatively few tax code provisions and regulations. The tax doctrines and case law focus on the facts and the nature of the dispute and how it was prosecuted in discerning the tax treatment.

In the end, someone is paying and probably deducting the payment on their taxes. Someone is receiving money and probably has income they need to report, depending of course on the type of case. Often, you may be able to help shape the tax treatment to the client by what you do in the litigation documents, and later when the settlement agreement is being prepared. If you are excluding any tax advice from your representation, you may want to be careful just how much tax-related commentary or suggested wording you include.

However, some lawyers may try to help steer a tax result, even if they make clear to the client that they are not giving tax advice and that the client should seek tax advice elsewhere. For example, if a payment should be tax-free physical injury damages, the lawyer may want to stress that, and to try to get the defendant to agree not to issue an IRS Form 1099 to the client. If there are wages being paid (such as severance pay in an employment case), you may want to bargain over the amount that is going to be treated that way.

After all, if an amount is paid as wages, there's no alternative but for the recipient to treat it as wages on their tax return. You might be able to adjust the amount of tax withholding if you provide in the settlement agreement that the plaintiff will supply the employer with a new IRS Form W-4. If the plaintiff was previously employed in California, but now lives out of state, you might be able to specify that the

company will not withhold California taxes. But beyond issues of this sort, wages are wages.

Defendants, of course, have their own set of tax concerns. If you represent a defendant in an employment case, what should you do if the plaintiff insists that they won't settle unless everything is put on Form 1099, with no tax withholding? Whether you agree may depend on how anxious you are to resolve the case, and the stakes. Most employment cases involve wage claims, and the IRS and the FTB are used to seeing at least some wages paid in any employment case.

An employer's liability for failing to withhold income and employment taxes can involve significant penalties. The employer can require the plaintiff to provide a tax indemnity, but the plaintiff may not agree. Even if they do, it may not be a significant comfort post-settlement. Pursuing a former employee for a significant tax indemnity can be hard to enforce and may foment more litigation.

And what about tax forms? In nearly every kind of case, there are going to be some tax forms in play. To begin with, most defendants will ask for an IRS Form W-9 from the plaintiff lawyer, the plaintiff or both. A Form W-9 verifies your taxpayer ID number, typically your Social Security Number, or if you are a company, your employer identification number. If you want to be paid, refusing to hand over a W-9 may not make sense.

The IRS says that anytime a payor *thinks* they may have to report a payment on an IRS Form 1099, they should ask for a Form W-9. If they fail to get one signed, they may have to withhold taxes on the payment, even if the payee is not an employee. This backup withholding at 24% is the usual consequence of refusing to provide a Form W-9. Forms 1099 facilitate computer matching of Social Security numbers and dollar amounts, which streamlines IRS collection efforts.

Failing to report a Form 1099 on your tax return (or to explain it) usually triggers an IRS notice asking you to pay up. Forms 1099 can result in confusion and tax worries for clients. Say that a lawyer settles a case for \$1 million, with payment to the lawyer's trust account. Assume that 60 percent is for the client, and 40 percent is for the lawyer. The lawyer is sure to receive a Form 1099 reporting the full \$1 million as gross proceeds. The lawyer can report as income the \$400,000 fee without worrying about computer matching, since gross proceeds do not count as income.

The client isn't so lucky. Unless the settlement is not taxable (say, compensatory damage for personal physical injuries), the client will probably receive a Form 1099-MISC for the full \$1 million. The client must then figure out how to deduct the \$400,000 in legal fees. Since 2018, it is harder to find a way to claim legal fee deductions in some cases.

A plaintiff in a physical injury case who has just secured the agreement of the defendant not to issue a Form 1099 will wonder why they are being asked to provide a Form W-9. Does having the form necessarily mean that the defendant will issue a Form 1099? It may just mean that this defendant won't pay anything to anyone without a signed

form. In addition to supplying a payee's Social Security number, the Form W-9 certifies that the recipient is a U.S. person (that is, a U.S. citizen or tax resident), and therefore is not subject to the onerous reporting and withholding obligations often required for outbound payments to non-U.S. persons.

Thus, some companies have a policy of requiring signed Forms W-9 for any payment. When a payer requires a Form W-9, it is usually not worth fighting about providing it, especially if there is already an understanding about which Forms 1099 will be issued. Unfortunately, disputes about Forms 1099 are common. The Form 1099 regulations are complex, which causes many businesses to err on the side of issuing the forms.

Recipients may not like this, and lawsuits for issuing Forms 1099 are filed on occasion. Most such suits don't seem to go very far, perhaps precisely because it is often possible to justify whatever forms were issued. So, while you probably will have to provide an IRS Form W-9 to get paid if that form is requested, try to head off Form 1099 issues whenever you can. Often, you may be able to agree on what forms will be issued and to whom.

Ideally, everyone should have a sense of what to expect when they sign a settlement agreement and the money changes hands. You don't want to be surprised the following January when IRS Forms 1099 arrive. But not how careful you are, are all the tax issues completely put to bed once the settlement agreement is signed, the money is paid, and the tax forms arrive? Not hardly.

The plaintiff must still file a tax return reporting the settlement and the related legal fees and costs. The settlement agreement and tax forms that are issued are part of the equation, but they are not the entire picture. Besides, even if the settlement agreement is clear what the payment is for, the IRS and the California Franchise Tax Board are not bound by it. The IRS and FTB can request other documents, including the complaint, discovery, etc., and they may reach a different tax result.

Depending on the size and complexity of the issues, the plaintiff may want a formal tax opinion that supports their desired reporting of the settlement. The plaintiff may also want a letter to their tax preparer that directs what should be reported where on their tax return, and with any advisable disclosures. After a settlement, keeping good documentation is essential. In any tax audit, the taxpayer has the burden of proof.

No matter how good the language in a settlement agreement may be, tax language in a settlement agreement does not guarantee the desired tax treatment. A tax opinion after the settlement can be invaluable. For one thing, a tax opinion generally obviates IRS penalties, and that is the classic reason many people get them. But tax opinions are worth much more than that.

There is never enough time to get your ducks in a row when an audit arrives. It is unlikely that you will give the IRS or the FTB a copy of a formal tax opinion. Opinions should be kept privileged between lawyer and client. The IRS requires tax opinions to be balanced, and to mention tax authorities that are against you, as well as those that support your position. Therefore, giving the whole tax opinion to the IRS is usually a mistake.

However, cutting and pasting from a tax opinion to create advocacy letters (and if necessary, briefs) can be invaluable. You may be able to resolve an audit early with convincing letters. Getting an opinion will also force you to be organized. Preparing an opinion on the tax issues requires

collecting the key documents and evidence that supports the opinion, and retaining them in the event of an audit. The documents might include the complaint, the settlement agreement, and mediation or other briefs that summarize claims and damages.

They might include expert reports, damage studies, or appraisals. They might include declarations or letters from lawyers, doctors, and others prepared after the conclusion of the case. And they should contain any pertinent tax reporting forms (W-2 and 1099), including any correspondence the parties had once those forms were issued. Try to collect all you can while the case is still fresh. If there are holes in the record that might weaken the tax arguments, consider whether you can fill them.

Letters or declarations from lawyers, parties, and third parties about particular claims and damages can be helpful. They may be viewed as window dressing, prepared after the case, but they can still be persuasive with the IRS or FTB. And collecting them several years after the case is resolved when a tax audit is underway is much harder and of less value. You can only get them when the case is fresh, and when it is just for the tax lawyer's file.

A plaintiffs' lawyer may be done with a case once a settlement agreement is signed and the monies have been paid. Usually, defendants are done with a case then too, although they usually have Form 1099 responsibilities in January of the following year. But remember that clients, both defendants and plaintiffs, need to face tax issues that will relate to their tax returns and payments.

Most business defendants have systems in place for this, and in most cases, the business will be able to deduct the settlement payment and all the related legal fees on their taxes. One exception applies to confidential sexual harassment or abuse settlements and related legal fees. This is the so-called Harvey Weinstein provision added to the tax law in 2018 to preclude deductions for settlements and the legal fees. Yet reports suggest that some defendants still find a way to justify writing these off.

More generally, though, nearly every plaintiff will face tax issues, and some will be surprised when Forms 1099 arrive in January. Many will not have a tax system in place, or a tax adviser who knows how to handle them.

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