LAWSUIT SETTLEMENTS: TAX ISSUES FOR CORPORATE COUNSEL[1]

By Robert W. Wood

When a lawsuit is settled and a corporation is the defendant, there are a host of tax considerations that should be taken into account. Most corporate counsel have been involved in disputed matters where the plaintiff insists on a certain tax characterization (for example, a recovery excludable as personal injury damages). How to respond to this query, as well as various other pitfalls, deserves attention. In some cases, these issues will require the special assistance of a tax counsel. However, some of the issues can be solved by corporate counsel. At a minimum, corporate counsel must be able to spot the issues. The following list should be helpful in spotting the issues when they arrive.

Deductibility

The first thing that may worry corporate counsel on payment of a settlement amount (or a judgment) is whether the payment is deductible. In the vast majority of litigation arising in a business, the payment (together with associated attorneys' fees) will be deductible. There are only a couple of exceptions, and all of these are of limited application. The first and perhaps most difficult to understand is the requirement that in some cases a settlement payment (and the associated legal fees) must be capitalized. Usually these relate to particular kinds of suits over capitalized assets. For example, a lawsuit over an acquisition, a lawsuit over title to the corporation's property. The IRS takes the position that in these cases the expense must be capitalized over the life of the asset.

Another major area in which a deduction may be questioned is where the payment is in the nature of a fine or penalty. Under Internal Revenue Code Section 162(f), the payment of a fine or penalty is nondeductible. Note that this is only payment to a governmental entity. Punitive damages paid to private parties are fully deductible. Indeed, even if a payment is to a governmental entity and looks to be a fine or penalty, a deduction may still be available.

Surprisingly, there is significant case law dealing with the topic of whether a fine or penalty is really intended to be punitive (in which case the payment is nondeductible) or is instead remedial in nature. Environmental payments and a variety of other sorts of payments to governments and quasi-governmental entities have been examined in this context. Corporate counsel should certainly be alert to anything that carries the "fine or penalty" moniker before making payment. Sometimes it is possible to enter into a settlement agreement with the government agency in question specifying that the payment is remedial rather than punitive in character.

In the "danger of nondeductibility" category, we should also list personal expenses. This doesn't come up too often in the corporate context. Yet, there have been a few cases where persons in a business setting thought they could deduct payments, but they were ruled to be nondeductible by the company. If a company pays its CEO's divorce litigation expenses (or settlement), for example, the IRS (and the courts) have not been sympathetic. These are purely personal matters, even if the corporation may see itself as protecting its assets.

There have been few (but very few) cases in which the same has occurred with sexual harassment cases. Although no company likes to see sexual harassment suits, the overwhelming majority of these suits are, without any question, deducted by the paying company, even if the conduct of the

[1] Adapted from an article originally published in BNA's Corporate Counsel Weekly, Vol. 15, No. 43, p. 8 (November 8, 2000). Copyright 2000 by The Bureau of National Affairs, Inc. (800-372-1033).

executive or worker involved is outside the course and scope of his or her employment (as it almost always will be).

Withholding Concerns

As all companies know, payments that are in the nature of wages are subject to withholding requirements for federal income tax, social security and unemployment tax, and generally state income and employment taxes as well. If a lawsuit is brought regarding some kind of employment discrimination or wrongful termination, and a settlement is reached, the question is what portion of the settlement ought to be treated as wages. There is no easy answer.

As far as the IRS is concerned, it does not matter that the worker has not been employed by the company for many years. Sometimes litigation takes five years or more to resolve. The mere duration of time does not turn something that was wages into something else. Generally, companies look to what the parties requested in their litigation documents (briefs, mediation briefs, experts reports, etc.).

Example: Suppose the plaintiff claims that the wage loss in a million dollar suit amounts to $400,000, and the defendant claims that the wage loss amounts to only $200,000. If the suit ends up settling for $800,000, then it would seem that a minimum of $200,000 should be allocated to wages. Very frequently the other side's expert testimony (or damage study) can be useful in arriving at tax characterization decisions.

A word should be said about penalties a company may face. The penalty for failure to withhold is significant, and the indemnity provisions that are typically put into settlement agreements (requiring the plaintiff to indemnify the paying company for taxes) are rarely, if ever, invoked by paying companies. Typically the employee does not have much money to chase, and the employer is generally reluctant to get involved in a subsequent legal proceeding in any event. It is important to make this withholding determination before the case is fully resolved.

At the same time, while the penalties for withholding are severe, the reporting penalties (penalties for failure to issue an IRS Form 1099) are not. That brings us to our next topic.

Reporting (Form 1099) Obligations

In settling a dispute, if an amount is subject to wage withholding, as noted above, there should be tax withholding and the employer should send a Form W-2 to the IRS and the plaintiff. If an amount is paid as general damages, punitive damages, or most other kinds of damages, it is subject to the general rule that a Form 1099 should be issued for the amount of the payment. Here is where a great deal of confusion has arisen concerning reporting obligations.

First, let's be clear on one thing that is not subject to 1099 reporting: a payment for physical injuries or physical illnesses. Thus, if your company pays someone $10,000 who slipped and fell in company headquarters and was physically injured, that $10,000 is not includable in the recipient's income and you need not issue a 1099. The IRS instructions to Form 1099 specifically so state.

What happens, though, when you have a mixed claim, say a sexual harassment claim where there was physical touching and some physical injury (such as a sexual assault and battery), but far more damages for other elements? There is no guidance yet on exactly what the physical illness/physical injury requirement of Section 104 (as amended in 1996) truly means. Most defendants try to engage in good faith bargaining over what elements of the payment should be (if any) attributed to the physical illness/physical injury element. If the defendant has a good faith basis for making this

determination (the defendant may insist on an opinion from the plaintiff's counsel), then the portion so allocated should arguably be excludable from the plaintiff's income and no IRS Form 1099 would be required. A Form 1099 should be issued for everything else (again, except for withholding amounts, which would be the subject of a W-2).

Suppose the company is wrong about its obligation to issue a Form 1099? The penalty is surprisingly small, assuming the company is wrong, but not intentionally so. The basic penalty for failure to issue a Form 1099 is $50 per failure. Thus, failing to issue one Form 1099 incurs a modest (indeed, inconsequential) penalty. There is a penalty much more severe, though if the company can be found to have willfully violated the Form 1099 reporting requirements, the penalty is generally 10% of the amount involved.

In twenty-one years of practice, I have never seen this penalty assessed, much less successfully collected. Yet, it should serve as a warning that companies should not knowingly disregard the Form 1099 rules in an effort to get a case settled. In my view, one can rebut this intentional disregard penalty by showing that one looked at the reporting question, discussed it and obtained an opinion of tax counsel that no Form 1099 was required. I can't imagine there being any penalty with this kind of evidence in your file.

Conclusion

The tax issues affecting a settlement or judgment are usually not the most important issues in a settlement. On the other hand, they are all too frequently left to the very last minute or, worse yet, ignored entirely. Since the tax swing on a settlement can make the difference whether the case is resolved or not, corporate counsel should pay more attention to these rules.