



Robert W. Wood
THE TAX LAWYER

September 27, 2025

Read Tax Indemnity Provisions In Legal Agreements Carefully



A tax indemnity provision in a legal document generally states that one party will cover specific taxes or will cover tax problems if they arise. Tax indemnity provisions appear in a wide variety of agreements, including [indemnity provisions in settlement agreements](#). The defendant is paying money and probably hoping to deduct it. The defendant may face other tax issues, such as wage withholding or the need to issue IRS Forms 1099. Some defendants figure that those tax concerns can be deferred and dealt with later.

Plaintiffs are receiving money, so they hope to position payments as best they can from a tax viewpoint. [Most lawsuit settlements are taxed by IRS](#), so the plaintiff may be worried if the money is taxable, if it is ordinary income or capital gain, about withholding, and about Forms 1099. There are usually attorney fees, which also raise tax issues.

An indemnification obligation does not prevent a tax problem, nor does it bind the IRS or state tax authorities. If you are the one the IRS identifies as the one with the tax liability, you have the problem, even if you can go after someone else to try to cover your loss.

Withholding Taxes On Wages

An indemnification obligation is a third-party arrangement between contracting parties. Thus, it is only as good as the creditworthiness of the indemnifying party. Moreover, it says nothing about the primary liability that the party to be indemnified has to the IRS or to state tax authorities. For example, consider the question of tax withholding in suits arising out of employment. Some of the settlement is usually wages in any [employment suit settlement](#). Tax withholding is required on wages and on some other payments (such as some payments to non-U.S. plaintiffs). When withholding is required, the payer is a withholding agent and fails to withhold at its peril.

Failure-to-withhold liability can be significant, involving liability for the payments themselves, interest, and potentially steep penalties. The fact that someone else (typically the settling plaintiff) has agreed to step in and repair the tax damage does not mean that the person will actually step in. Even if that person does step forward, they may not have the financial ability to repair the tax damage.

Suppose that a wrongful termination of employment case is being settled for \$1 million, with the client receiving \$600,000 and the lawyer receiving \$400,000. Assume that the plaintiff receives a Form 1099, agrees to pay any tax due, and agrees to indemnify the defendant for taxes. But what if the IRS claims that the \$600,000 was wages subject to withholding? The employer has the liability for failure to withhold, and the penalties can be large.

Will IRS Honor a Tax Indemnity?

Even if the settlement agreement says the plaintiff will indemnify the company for taxes, the IRS will not agree to go after the plaintiff. The defendant can try to get the plaintiff to step in, but how likely is that? By the time the tax issues are examined and contested, the plaintiff may be out of funds. Besides, even if the plaintiff can pay, he will probably fight the liability. It is highly unlikely that the plaintiff will agree that the indemnity obligation he signed actually covers failure-to-withhold liability of the defendant.

Many general indemnity provisions are unlikely to be read broadly enough to actually cover the employer's failure-to-withhold liability. As this withholding example suggests, there is also no guarantee that the tax damage will be small. In that sense, a tax indemnity provision may lull you into a sense of complacency. A common comment is that "we have indemnity from the other side for taxes, so we are covered." Despite a tax indemnity provision, you should

understand the risks, tax dollars, penalties, interest, and counsel fees you are trying to guard against. But aside from those cautions, are tax indemnity provisions a bad idea?

In almost every employment case, some of the settlement payment should be wages subject to withholding. If there is any failure to withhold liability, it resides squarely with the defendant employer. The IRS will pursue the defendant for all the withholding money, interest, and penalties. As a matter of contract law, the defendant can demand indemnity and then can try to go after the plaintiff for that.

But unless the indemnification agreement states that it covers failure-to-withhold liability, it may be very hard to enforce. Besides, the IRS certainly will not release its hold on the defendant employer, whatever the indemnity provision may say. There is also an enormous practical barrier. Trying to enforce an indemnity provision (at least against a former employee) can be a mistake, since the indemnity litigation can backfire.

If the defendant even thinks that some or all of the settlement money is wages, the defendant should withhold. Most often, the money in an employment case should be allocated into several categories. Reasonable minds can differ on whether 10 percent or 90 percent is wages, or something in between. But a portion is probably wages.

This is not to say that the defendant cannot take a calculated risk that withholding is required, yet still settle and not withhold, reporting the entire payment on a Form 1099. It happens, frequently in fact. Employers sometimes settle a case that (from a business perspective) must be settled, when the plaintiff insists that if there is any withholding, the plaintiff will not settle.

Avoiding Tax Indemnities

In an ideal world, perhaps the defendant should offer more money to settle. That way, the defendant can withhold if required, and the plaintiff can still collect a net payment that the plaintiff finds acceptable. And if the defendant is insisting on tax indemnity, the plaintiff should read it carefully to make sure it does not go too far.