Seven Tax Mistakes in Mediating Lawsuits

by Robert W. Wood

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In this article, Wood explores seven tax mistakes litigants make in mediating disputes and suggests how to avoid them.

Is anyone thinking about taxes in a mediation? The plaintiff wants as much as they can get, the defendant wants to pay as little as possible, and the mediator pushes and pulls on both sides. Taxes may not come up until after a deal is reached. If no one is thinking about taxes, should they be? If they are, should they say anything about the tax issues to the mediator or the other side? And just when does one raise tax issues — at the beginning, middle, or end of the mediation? Or perhaps right before signing? I will give you my answers to these questions, but not every case is the same, and flexibility is often required.

Unlike arbitration, mediation is nonbinding,[1] but its goal is a binding deal. The mediator's role is to bring the parties to the bargaining table, and once there, to get each party to compromise. Mediators vary in their approaches to this difficult task. No matter how the mediator proceeds, because so many cases are resolved at mediation, one should be prepared.

1. Don't bring up taxes too early. Some plaintiffs with tax concerns mention them early on, making it clear that any settlement must involve a particular tax treatment. If you do this, the tax issues will be used against you, a kind of tax arbitrage in which the defendant tries to pay you less but gives you the tax treatment you want (or some of it, at least). There are exceptions, of course. But in general, tax requests should come near the end. A typical time would be once a number that the plaintiff is willing to accept is on the table.

Before you say OK without conditions, you might want to say, "OK, provided that you give me the tax treatment I want." Of course, the tax request can and should be much more specific. And that leads to the difficult documentation question.

2. Don't fail to consider the conclusion. How will the mediation conclude if you reach a deal? It is useful to know this in advance, even though the mediation may be a bust. But if you reach a deal, will a document be prepared on the spot and handed to you 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 answers to these questions will influence how you proceed on the tax issues. Most mediators do not want the parties to leave the room or Zoom meeting without a binding deal in principle. Sometimes terms sheets are not signed, and there may just be an exchange of emails. But often the parties are asked to sign a term sheet indicating that they are resolving the case for money, with a few other basic terms set out, always including confidentiality.

The writing often states that the parties will cooperate to produce a final comprehensive

[1] *Black's Law Dictionary* (2004) defines mediation as "a method of nonbinding dispute resolution involving a neutral third party who tries to help the disputing parties reach a mutually agreeable solution."

settlement agreement that both parties will sign by a specific date. But what happens if the full-blown settlement agreement is never executed? Is the term sheet itself binding if a more comprehensive settlement agreement is not completed? It is rare, but the term sheet could say that in the event a settlement agreement cannot be executed, the parties agree that they have not settled the case.

More commonly, the term sheet says that in the event the parties fail to execute a comprehensive settlement agreement, the case will be considered settled based on the term sheet as a binding settlement agreement. A specific statute is sometimes quoted or cited to lock it up. In my experience, a binding term sheet is the most common way that mediations successfully conclude. Sometimes a term sheet is signed but silent about what happens if the parties fail to execute a comprehensive settlement agreement.

In the latter case, if the parties cannot reach agreement on the comprehensive settlement agreement, a court may have to decide whether the signed term sheet is binding. The primary issues in choosing between these approaches are not tax-centric. Rather, they involve dispute resolution, enforceable agreements, and the completeness of releases. Still, each of these approaches may require the parties to address tax issues.

In some cases, the parties do not sign a term sheet but proceed directly to a binding settlement agreement, negotiated and signed before the parties leave the mediation. This approach has advantages and disadvantages. On the plus side, if the parties hammer out a full-blown settlement agreement on the day of the mediation, by definition, the binding-versus-nonbinding 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 the plaintiff and are well prepared, 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. It happens more often than you might think.

Of course, it can backfire. Both parties may not be vetting the details, or they may be unable to, particularly if they have not planned ahead. The parties may be rushing to address many issues and to complete a settlement agreement. That may be after many hours (or even days) of mediation. It may be late at night, and everyone may be tired. Proximity and resources can also be an issue.

The mediation may occur in a third-party location such as a mediator's office. The plaintiffs' and defendants' lawyers may be working on a draft settlement agreement on laptops or tablets. They may not have their full resources available, much less the time to reflect on all 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 to reflect on drafts later.

3. Be careful previewing your tax issues. From a tax viewpoint, it's a good idea to know going into a mediation what kind of writing, if any, will be prepared if a deal is reached. But can it be too much? Should defendants send their standard form settlement agreement over in advance with lots of blanks? I'm not sure that hurts a defendant, but trying to negotiate the agreement back and forth before there is one may not make sense, even on the tax issues. It may be possible to have a template for what the plaintiff is requesting and for what the defendant is willing to provide on the tax points, but most parties do not want to do this.

In an employment dispute, the parties will probably have considered the question of wages versus non-wages in at least a general fashion. But in some cases, the parties might not seriously consider tax issues until both sides agree on a dollar figure. That is especially true with the section 104 exclusion, at least for defendants. The tax issues may become intractable or be ignored. If a full-blown settlement agreement must be signed that night and the parties do not have the time or expertise to consider tax issues, then the tax issues may fall where they may. Both parties may suffer, especially the plaintiff. The plaintiff may have a painstaking wait until January 31 of the next year when IRS Forms 1099 are issued. And what then?

4. Don't forget the section 104 exclusion. If there is an argument for excluding some damages for physical injuries or physical sickness under section 104, the plaintiff should — and arguably must — consider it in advance. The complaint (draft or filed) and the mediation brief should address it, even if they are not perfect, because many a defendant acts shocked when it comes up at the end.

There is no easy answer because plaintiffs generally are disadvantaged if they start asking for tax accommodations even before there is a dollar amount each side can accept.

It is especially sensitive if the case for an exclusion is weak, if the record is not well developed, and if the defendant can rightly say, "You never told us that you had ____!" Claims can be added, of course, especially in cases that are quietly negotiated without court filings, but there's a limit. Some plaintiffs can say, "We didn't include these claims before because then you would have gotten all our medical and psychiatric records in discovery." But that might not always be credible or work.

5. Beware the binding term sheet. I have a love-hate relationship with binding term sheets. In my experience, they are the most common method for reaching a deal, what most mediators want, and what most parties and lawyers seem willing to do. And most of the time, they seem to work out OK, and the tax issues can often be worked out thereafter. But not always. And make sure you know going in if that is what your mediator expects if you reach a deal. You can even ask for a sample so that you and your client can consider it. 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 that 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.? It can be a real mess. Some mediators keep their role in the case alive to work through those issues. And some parties may even try to go to court despite a binding term sheet.

Of course, the nub of the tax issue is how much or how little to put in the binding term sheet. Should it say the tax treatment is subject to the plaintiff's approval? Or no less than 50 percent will be treated as wages, subject to withholding, and reported on Form 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 a huge problem, you will wish you had been more explicit. I have seen situations in which a term sheet involving seven- and eight-figure sums does not say if the defendant employer will withhold. Months later, the parties may still be fighting about it, unable to execute the full-blown settlement agreement that everyone assumed would be done within two weeks.

So if there are big tax issues that one or both sides are going to need addressed, plan ahead. And if behind the scenes you have a whole tax plan prepared, at least think about what you really should insert in the term sheet before it is signed. In one case, the tax plan was clear (to one side) for years, but no one thought to plan ahead in the term sheet. Then a dispute arose. There could even be malpractice liability if your job was to get the deal done at a particular dollar figure with a particular tax treatment and you failed to come through.

If you are scared about this, can you go too far? Perhaps, but it is hard to see how. 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 major donnybrook over the tax issues later. If you have been through even one of these protracted and expensive post-term-sheet fights, you might be tempted to veer toward being more explicit in term sheets in the future.

6. Don't fail to consider tax forms. Maybe this isn't exactly a mediation mistake because many — probably most — term sheets don't mention tax forms. But how about settlement agreements? At least there, it is worth discussing the forms. Which IRS forms are issued can have a huge effect on the plaintiff's tax position. If the settlement agreement is silent on tax reporting, the plaintiff will have no recourse if the forms are prepared in

a manner at odds with how the plaintiff believes they should be prepared.

Every year I receive many phone calls and emails around January 31 from plaintiffs who received Forms 1099 for settlements they think should be tax free. When a plaintiff (or plaintiff's counsel) receives tax reporting forms in January or February that they think are wrong, there is often little recourse. If the settlement agreement prescribes (or proscribes) specific reporting forms, it is generally easy to contact the defense and assert that the settlement agreement has been breached and corrected forms can be issued.

If the settlement agreement is not specific, phone calls to the defense attorney or defendant when forms arrive in January will fall on deaf ears. Whatever position the defendant has taken is likely to be within the law or within a reasonable interpretation of it. The plaintiff has no bargaining power and, besides that, is usually not well liked by the defendant. It is far better to have a definitive statement in the term sheet or settlement agreement that resolves any debate about exactly what tax forms will be issued, in what amounts, and to whom.

7. Don't fail to include tax provisions. Again, this point applies to both term sheets and settlement agreements, but especially the latter. You cannot bind the IRS in a settlement document.[2] The plaintiff and defendant may agree in a settlement agreement that the settlement is for personal physical injuries and therefore should not constitute income, but the IRS can always disagree. Similarly, the plaintiff and defendant in an employment action might agree that 50 percent of the settlement amount constitutes wages and the other 50 percent is non-wage income to be reported on a Form 1099. But the IRS can disagree with the allocation or tax treatment,[3] although it seems rare for the IRS to argue for more wages if there is something reasonable in that category.

Yet the mere fact that one cannot bind the IRS does not mean you should not take a shot at addressing the tax issues. Many IRS agents and Appeals officers will not look behind a settlement agreement to ask questions about the tax issues. A settlement agreement represents an opportunity to shape and mold the tax treatment of the payments.

Even so, some settlement agreements do not say anything about taxes or tax reporting. The defendants do whatever they think best when disbursing money and later at tax reporting time. Yet there can be downsides. I have seen defendants withhold employment taxes on settlement payments only to find that the plaintiff will not accept the payment or, even worse, will refuse to sign all the appropriate forms and file them with the court.

I have seen defendants issue Forms 1099 in the year following a settlement only to find themselves in court again fighting with the plaintiff over tax reporting. Those lawsuits are rare and usually unsuccessful, but they are expensive, and the settlement agreement could have made all those matters clear. Defendants who end up litigating tax and withholding issues separately after a case is resolved will not be happy with anyone, including their own lawyers for allowing a repeated mess.[4]

Some defendants (say in lemon law cases) avoid mentioning Forms 1099. If the settlement agreement does not say anything, the defendants can presumably send out Forms 1099 however they want, within reason. The plaintiffs may push back hard, demand corrections, but most of those 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*,[5] Fremont Redfield sued his employer, 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 check, which Redfield refused.

[2] *See, e.g., Basle v. Commissioner*, T.C. Memo. 1957-169.

[3] *See Bagley v. Commissioner*, 121 F.3d 393 (8th Cir. 1997), *aff'g* 105 T.C. 396 (1995).

[4] *See Redfield v. Insurance Company of North America*, 940 F.2d 542 (9th Cir. 1991).

[5] *Redfield*, 940 F.2d 542.

The parties went back to court for many years of more fighting in the district court and the Ninth Circuit — for the second time — as Redfield said his payments were not wages after all. After the second Ninth Circuit battle, Redfield prevailed. So, after several years of litigation and countless dollars of expense, Insurance Company of North America had to pay out the full amount of the judgment.

This involved a judgment, not a settlement, but disputes nearly that bad have happened with settlements too. Ideally, plaintiff's counsel and defense counsel will agree upfront on what is appropriate in a case arising out of wage-based claims. But the answer is not always simple. And if they have to argue about it — especially in a second court case — some or all of the parties are going to be unhappy, maybe even with their lawyers.

Conclusion

Plaintiffs, defendants, lawyers, and mediators all have an agenda to accomplish in mediation. Taxes might seem far down that list, but it is important to consider them if the mediation goes well. And how do you know what will happen? I am sometimes engaged the night before or the day of a mediation, or right after one.

How many times have I heard, "We never thought we would reach a deal"? It can all work out fine in some cases, but it might not. And usually, it works out much better with a little more time. Try to plan ahead. And if the tax issues are material enough that you think there could be a dispute after a vanilla term sheet is signed — about withholding, wording, allocations, or Forms 1099 — be careful what you sign. You don't want to trade one litigated case for another. ■