TAX INDEMNITY PROVISIONS

IMPORTANT CONSIDERATIONS FOR CLIENTS

by Robert W. Wood

A tax indemnity provision in a legal document generally states that one party will cover certain taxes, or will cover tax problems if they arise. Tax indemnity provisions are common. They appear in many variations, and can show up across a wide variety of contracts and agreements.

One recurring context is in settlement agreements that resolve legal disputes. The issue and need for the provision might arise something like this: You agree in principle to settle a case for your client, and you are trying to get the deal inked. But there are potential taxes or potential tax risks.

Whether you represent plaintiffs or defendants, your client probably has tax issues, whether they know it or not. The defendant is paying money and probably hoping to deduct it. The defendant may face other tax issues, such as withholding on wages, or the need to issue IRS information returns, such as Forms 1099.

Some defendants figure that any such tax concerns can be deferred and dealt with later. Some defendants know that any deal about tax withholding or tax reporting usually should be struck then, not later. Besides, the plaintiff is likely to ask for tax provisions in the settlement agreement.

Most plaintiffs in litigation are more worried than defendants about taxes. Plaintiffs are receiving money, so hope to position payments as best they can from a tax viewpoint. The plaintiff may be worried if it is taxable, ordinary income or capital gain, and may also have concerns about withholding, Forms 1099, etc. There are usually attorney fees that also raise tax issues.

Attorney Fees

The plaintiff will hope that only his *net* recovery is taxed (after legal fees and costs). The U.S. Supreme Court in *Banks*[1] held that plaintiffs generally must report gross recoveries, even if the contingent fee lawyers are paid directly by the defendant. For tax purposes, the fees are considered first paid to the plaintiff.

Whether you represent plaintiffs or defendants, your clients probably have tax issues, whether they know it or not.

Reporting the income on a gross basis means that the plaintiff must consider whether, how, and where to deduct the legal fees. Depending on the type of case and whether it arises in the plaintiff's business, the plaintiff may not be able to deduct all of the legal fees. In short, there are often latent tax issues that make tax indemnity provisions common. But the meaning and importance of the indemnity provision is another matter.

Discussing Indemnity

The first sign of a tax issue may be a draft settlement agreement that says something about tax withholding, the issuance of IRS Forms 1099, or tax indemnity. There may be tax advisers on one or both sides, or there may be no tax advisers in sight until long after the case is resolved. Some lawyers insist that the client hire a tax professional, but many lawyers try to muddle through the tax issues themselves.

Curiously, many non-tax lawyers seem comfortable handling tax indemnity provisions. They may recognize that indemnity may be needed in case there is a tax problem, such as failure to withhold, failure to issue forms, or failure of the plaintiff to pay taxes. It might seem that a tax indemnity provision serves to obviate the tax issues. If you get a solid tax indemnity for your client, there might seem to be no need to understand the size, scope, or impact of the tax issues.

But that can be a mistake. Suppose the defendant is settling all claims and paying the plaintiff $X for a complete release. The settlement agreement may say that the defendant has given no tax advice, the plaintiff agrees to pay his own taxes, and that the defendant will issue an IRS Form 1099 reporting the payment.

The settlement agreement might also say that if the defendant incurs any tax problem on these funds, the

©ISTOCKPHOTO.COM/SKODONNELL

plaintiff will indemnify the defendant. Is this a good idea? Does the defendant even need any tax advice in this case?

The tax indemnity provision seems to put the liability on someone else. If so, the reasoning may go, there is no need to worry about the size or scope of the tax problems. Such thinking can be shortsighted for several reasons.

Pursuing Third Parties

First, an indemnification obligation does not prevent a tax problem, nor does it bind the IRS or state tax authorities. If you are the taxpayer, you have the problem, even if you can go after someone else to try to cover your loss. An indemnification obligation is a third-party arrangement between contracting parties.

Thus, it is only as good as the credit-worthiness 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 taxing authorities. For example, consider the question of tax withholding.

Tax withholding is required on wages and on some other payments (such as some payments to non-U.S. plaintiffs). Where withholding is required, the payor 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 they will actually step in. Even if they do, they may not have the financial ability to repair the tax damage. Suppose that a wrongful termination of employment case is settling 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 the $600,000 was wages subject to withholding? The employer has the liability for failure to withhold, which could amount to $300,000 or so.

The fact that someone has agreed to step in and repair the tax damage does not mean they will actually step in.

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 could pay, he or she will probably fight it. It is highly unlikely that the plaintiff will agree that the indemnity obligation he or she 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 these cautions, are tax indemnity provisions a bad idea?

Types of Indemnity

Some lawyers worry that a tax indemnity provision is a red flag to the IRS. Some suggest that a tax indemnity provision is an admission to the IRS that there is a tax game afoot. It is hard to see how. Tax indemnity provisions are common in numerous types of agreements, and are unlikely to be viewed as red flags by the IRS.

In that sense, a tax indemnity provision probably cannot hurt. Nevertheless, it may not help either. Such provisions are of limited utility in many types of legal settlement agreements, especially in settling employment litigation.

For example, if the defendant is a business and the plaintiff is an injured person or former employee, the prospect that the defendant will actually pursue the plaintiff on the tax indemni-

We're proud to be represented in the 2016 Oregon Super Lawyers®

Super:

adjective

(1) of the highest degree, power, etc.

(2) of a superior quality.

(3) exceptional SYK lawyers who help our clients protect their families and businesses, for success and happiness in the years to come.

Super Lawyers 2016

Partnering with businesses, entrepreneurs & families to ensure success since 1927.

111 S.W. 5th Avenue | Suite 3800 | Portland, OR 97204 | 503.226.2966

116 3rd Street | Suite 211 | Hood River, OR 97031 | 541.436.0777

SamuelsLaw.com | WealthLawBlog.com

Super Lawyers is a registered trademark of Thomson Reuters

ty provision is remote. There is usually little for the defendant to benefit, and there are usually reasons not to try. It is also clear that the indemnity provision may not accomplish what the defendant thinks it will.

Again, what if some or all of the settlement payment to the plaintiff is really wages? Suppose that the defendant issues a gross check and reports the settlement figure on a Form 1099. Later, the IRS claims that some (or all) of the settlement is wages subject to withholding.

In virtually every employment case, at least some of the settlement payment should be wages subject to withholding. Not all of the money may be wages, but failing to consider wage exposure would be a mistake.[2] And plainly, 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 is explicit 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) is almost always a mistake. Most lawyers will advise the defendant not to even try to pursue the plaintiff, since the indemnity litigation can backfire. If the defendant 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. An indemnity provision does not hurt anything, but it probably does not help much either.

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, where the plaintiff insists that if there is any withholding, the plaintiff will not settle.

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. But in the

No one should suffer in an abusive environment.

PRODUCT LIABILITY SERIOUS INJURY SEXUAL ASSAULT NURSING HOME ABUSE sgb-law.com

real world, the defendant may agree to run the tax risk.

The defendant's general counsel may say to the tax adviser, "we are managing risks, and the litigation risk with this case is vastly greater than the tax risk." Businesses must weigh these risks. What seems silly, though, is if the defendant is convinced that there is no tax risk because there is an indemnity provision.

Non-Employee Litigation

What about tax indemnities outside of employment litigation? Tax indemnity provisions can often be more helpful in other contexts. For example, suppose the defendant agrees not to issue an IRS Form 1099, because the plaintiff claims the payment is for personal physical injuries or sickness that is tax-free under Section 104 of the tax code?[3]

The defendant may believe that the settlement payment is really a payment for emotional distress, and therefore taxable. The defendant might say that in order not to issue a Form 1099, the defendant requires a tax opinion from the plaintiff, and a tax indemnity. Here, the indemnity would presumably cover penalties for failure to issue a Form 1099.

The main penalty for failure to issue a Form 1099 is only $260, unless the defendant is found to have been willful. In that case, the penalty could be much more serious—10 percent of the settlement payment. In practice, though, such 10 percent penalty assertions are rare.

The penalty for intentional failure to issue a Form 1099 seems to be reserved for situations where it was clear the payor knew there was a reporting obligation, and ignored it. In any event, indemnity provisions in such situations may make more sense than where wages and withholding are involved.

Tax Indemnities in Acquisitions

Tax indemnity provisions are also common in acquisition agreements. A purchase of one company by another can be handled in many different ways. Often, there are tax issues that will remain debatable even post-closing.

There may be income tax, sales and use tax, property tax, and foreign tax issues. Whatever the issues, it is appropriate to allocate the risks. And unlike in the context of litigation settlements, enforcement may be a factor.

For example, unlike litigation settlements, escrows or hold-backs are common in such transactions. Often, they may not extend for the entire statute of limitations period that could bracket the time of potential tax risks. Nevertheless, an escrow or holdback may materially help and can put real teeth in the indemnity provision.

Lawyer Risks

Lawyers are trained to ask for indemnity and to cover as many risks for their clients as they can. Tax indemnity provisions are often written and debated by non-tax lawyers. That is to be expected. Everyone is a little afraid of taxes and tax liabilities.

And like confidentiality provisions, indemnity provisions—even about taxes—may seem pretty straightforward. After all, a tax indemnity may seem to reduce or even obviate the tax risks. However, whenever possible, get some tax advice even if you have a strong indemnity provision.

There is a big difference between: (1) feeling comfortable that a small penalty will be covered by the plaintiff if it materializes; and (2) believing that a tax bill for 40 percent of the settlement for failure to withhold taxes will be adequately addressed via an indemnity that may never be collectible. One can still ask for indemnity. But understanding the type, scope, and amount of the potential tax problems is a good idea.

Tax indemnity provisions are not one-size-fits-all. No matter how tightly you write a tax indemnity provision, there may be ambiguities. Even if the scope and meaning of the indemnity provision is clear, there may be big questions (then or later) on whether the indemnifying plaintiff will have any assets to pursue.

If you tell your clients the indemnity provision protects them, it can be upsetting to have your client complain several years later that an indemnity provision you wrote or recommended did not protect them. And that may mean the lawyer who said, "Don't worry, we've got indemnity" might end up being asked to pay.

Indemnity Payments as Income

What happens if you get hit with a tax bill from the IRS, and the other party indemnifies you for it? Is the indemnity payment income? If so, can you require the indemnifying party to "gross up" any payment for taxes?

There is often confusion surrounding the taxation of indemnity payments, but the IRS usually views them as income.[4] The IRS has frequently asserted the payment of another person's income tax (directly or indirectly) is gross income to that person.[5] Taxpayers often argue otherwise, citing *Clark v. Commissioner* for the proposition that tax indemnity payments are excludable from gross income.[6]

APPEARANCE MATTERS

Clients Notice
Judges Notice
Colleagues Notice

AACD
American Academy of Cosmetic Dentistry
One of Only 330 Accredited Members Nationwide

Give your appearance a professional edge.

Rhys Spoor DDS
Aesthetic, Implant & Restorative Dentistry
206-682-8200
www.rhysspoor.com

As to whether a gross up for taxes is required, that is a drafting issue. Many parties will not even think of it, and if they do, they may not want to explicitly raise it. A provision that says the plaintiff will indemnity the defendant for all tax consequences of a settlement may be inartful and not specific. But it may be more likely to be signed than one that is long, and that says the plaintiff must even gross up any required taxes on the indemnity payment itself.

Conclusion

As with many other common and useful clauses in legal documents, tax indemnity provisions are a drafting staple. They are often a good idea, and they can be adapted for a variety of purposes. Even so, one should not assume that they fix all tax problems. **NWL**

Robert W. Wood practices law with Wood LLP in San Francisco. He is the author of numerous tax books including *Taxation of Damage Awards and Settlement Payments* (www.TaxInstitute.com). He is a member of many state bars, a certified tax specialist, and a frequent expert witness. He is a tax columnist for *Forbes* and for *Tax Notes*. He can be reached at wood@woodllp.com.

This discussion is not intended as legal advice.

Notes

1. C.I.R. vs. Banks, 543 U.S. 426 (2005).
2. *See* Wood, "When Defendant Employers Are Sued (Again) for Withholding Taxes," Vol. 148, No. 10, *Tax Notes* (September 7, 2015), p. 1151.
3. *See* Wood, "Tax-Free Physical Sickness Recoveries in 2010 and Beyond," Vol. 128, No. 8, *Tax Notes* (August 23, 2010), p. 883; Wood, "Is Physical Sickness the New Emotional Distress?" Vol. 126, No. 8, *Tax Notes* (February 22, 2010), p. 977.
4. *See e.g.*, Priv. Ltr. Rul. 9833007 (Aug. 14,

1998); Priv. Ltr. Rul. 9743035(July 28, 1997); Priv. Ltr. Rul. 9743034 (July 28, 1997); Priv. Ltr. Rul. 9728052 (Apr. 16, 1997); Priv. Ltr. Rul. 9226033 (June 26, 1992).

5. *See e.g.*, Priv. Ltr. Rul. 9833007 (Aug. 14, 1998); Priv. Ltr. Rul. 9743035 (July 28, 1997); Priv. Ltr. Rul. 9743034 (July 28, 1997); Priv. Ltr. Rul. 9728052 (Apr. 16, 1997); Priv. Ltr. Rul. 9226033 (June 26, 1992); *see also* Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929).
6. 40 B.T.A. 33 (1939), *nonacq. sub nom.*, 1939-2 C.B. 45; acq. 1957-2 C.B. 4.