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BY ROBERT W. WOOD

Tax Issues in Mediation

The time, expense, publicity and unpredictability of the courts have made mediation of disputes common. Mediations can occur before a complaint is filed, anytime during litigation, or even after a verdict when a case is on appeal. Sometimes there are multiple unsuccessful mediations before one that settles the case. I have spent much of my career advising litigants and their attorneys about taxes on settlements, and mediation can present unique opportunities.

Plaintiffs should anticipate how tax issues will be handled if the mediation is successful. Defendants should consider whether they have tax issues, and whether they can agree to tax accommodations for the plaintiff in settling the case. Sometimes tax is used as a kind of arbitrage, offering tax benefits to reduce settlement amounts. Sometimes tax is a condition of a figure, as in "We'll agree to \$___ if it is \$___ for tax purposes."

Lawyers (especially on the plaintiff's side) should consider whether there will be time to address tax issues during or following mediation. Mediators should consider what should be signed if the mediation is successful, and whether that document should include tax language.

Non-binding Mediation, Binding Deal

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, probe for weaknesses with each side, getting each to compromise. Mediators vary in their approaches. Some have a joint session and then separate sessions with each side.

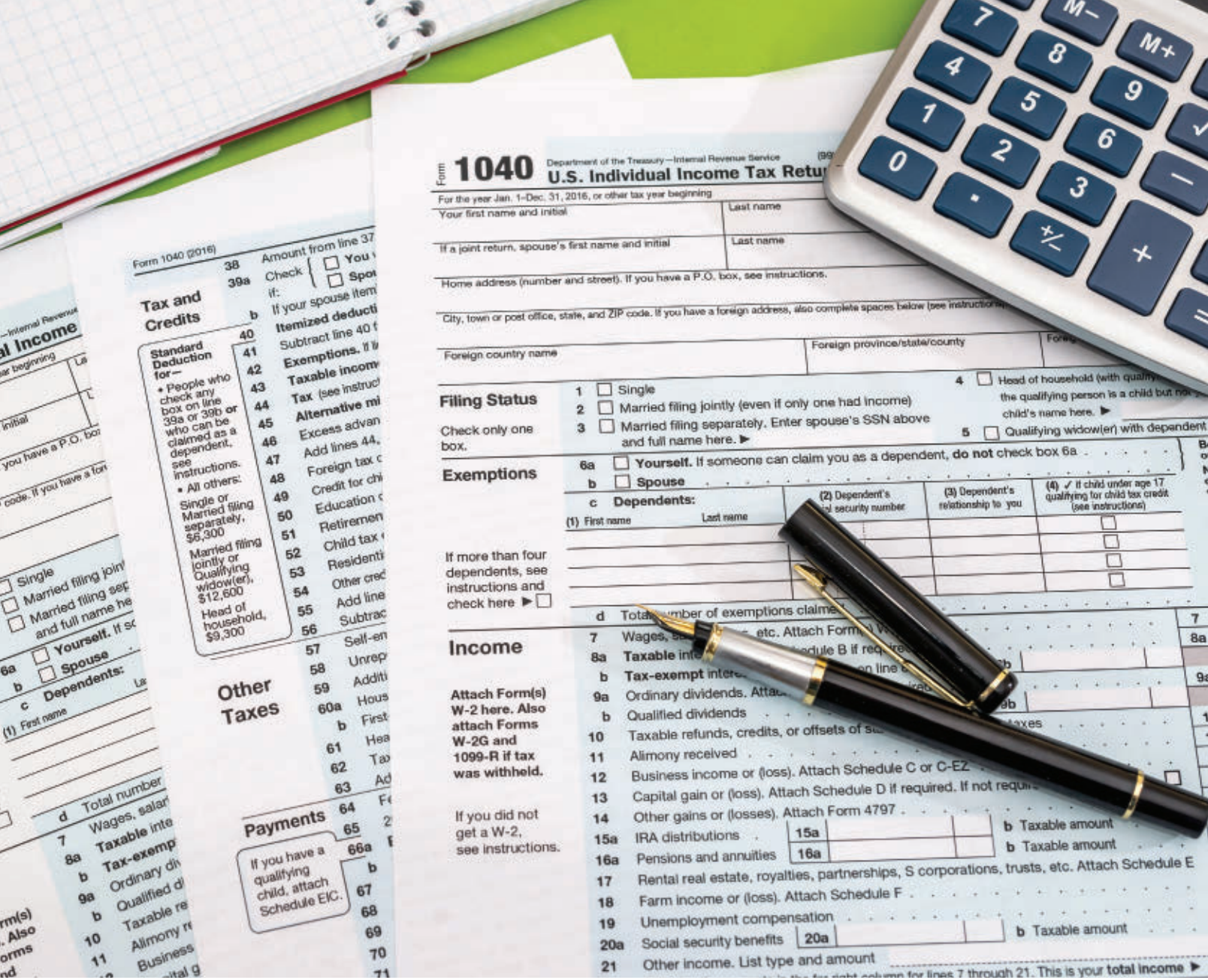
Increasingly, though, joint sessions seem out of favor, so the entire mediation is conducted with the mediator shuttling between rooms. If a case resolves in mediation, some kind of document is prepared. Whether it is an unsigned term sheet, a signed one, or a full-blown settlement agreement, taxes should be considered.

- In an employment dispute, are all payments of wages subject to withholding, or is there an appropriate allocation between wage and nonwage damages on a Form 1099? Can anything be excluded from income for physical injuries or physical sickness? Is any equity or stock option compensation to be paid, and can anything be taxed as capital gain? How will Forms W-2, 1099, and legal

fees be handled?

- In a personal physical injury case, will wording help the plaintiff's case for tax-free treatment? Will the defendant agree not to issue a Form 1099? If punitive damages were awarded and the case is on appeal, will the plaintiff be stuck with taxable treatment on the punitive damages, or can that be finessed somehow? What about interest, which like punitive damages, is also taxable?
- If a homeowner sues an insurer for not covering mold damage, relocation expenses, and sickness from mold inhalation, what will the parties request and what should the settlement agreement say about tax treatment? In an intellectual property dispute, is there a case for





capital gain to the plaintiff, and will particular wording help? The list of possible examples is almost infinite.

In each case, if a settlement is reached, monies will be paid and documents need to be prepared. But how much should taxes be addressed at the mediation, how much later, and precisely what is binding?

Term Sheet

Most mediators do not want the parties to leave without a binding deal in principle. Sometimes these terms sheets are not signed. But often, the parties may be asked to sign a term sheet indicating that they are resolving the case for \$___, with a few other basic terms. The writing often states that the par-

ties will cooperate to produce a final longer settlement agreement that both parties will sign.

But what happens if the more full-blown settlement agreement is never executed? Is the term sheet *itself* binding if a more comprehensive settlement agreement is not completed? The term sheet may say that in the event a settlement agreement *cannot* be executed, the parties agree that they have *not* settled the case.

Conversely, the term sheet may say that in the event the parties fail to execute a full settlement agreement, the case will be considered settled based on the term sheet as a binding settlement agreement. If the term sheet is silent about what happens if the parties fail to execute a comprehensive settlement agreement, a court may have to de-

cide. The primary issues in choosing between these approaches are not tax issues.

Rather, they involve issues of dispute resolution, enforceable agreements and the completeness of releases. Nevertheless, each of these approaches may require the parties to address tax issues.

Binding Settlement Agreement

In some cases, the parties do not sign a term sheet but use an unsigned term sheet, or even 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 the day



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of the mediation, by definition, the binding versus non-binding 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. On the minus side, the parties will 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 will 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 upon 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 over time.

Moreover, there may be little time to discuss the tax points or to solicit and implement tax advice. In some cases, there will be tax input by one or both sides prior to the mediation. 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. For example, in an employment dispute, the parties will probably have considered the wage versus nonwage question in at least a general fashion.

In addition, if there is an argument for excluding some damages for physical injuries/sickness under Section 104, the parties should consider it in advance. Any insurance coverage restrictions should be considered too. However, in some cases, the parties may not seriously consider tax issues until a dollar figure is agreed upon by both sides.

Even if there has been some tax discussion, some tax issues may become intractable or be ignored if the settlement agreement

must be signed that night. 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 those issues may fall where they may. Both

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.

If the settlement agreement is not specific,
phone calls to the defense attorney or
defendent when forms arrive in January
will fall on deaf ears.

It is difficult to convince a defendant to undo a tax form when they have no legal obligation. The plaintiff has no bargaining power, and besides, may not be well liked by the defendant. It is far better to have a definitive statement in the term sheet or settlement agree-

ment that resolves any debate about exactly what tax forms will be issued, in what amounts, and to whom.

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Forms 1099 and W-2

What IRS forms are issued can have a huge impact on the plaintiff's tax position. If the settlement agreement is silent on tax-reporting issues, 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 numerous 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 they think are wrong, there is often little recourse. If the settlement agreement specifically prescribes (or proscribes) certain reporting forms, it is generally easy to contact the defense and assert that the settlement agreement has been breached. If the forms have already been sent to the IRS, there is a procedure for correcting erroneous Forms 1099 via corrected forms.

Tax-reporting forms may or may not be addressed in a binding term sheet. If the term sheet is not binding, or if the term sheet leaves the tax-reporting details for the settlement agreement, these reporting issues need to be addressed. If the settlement agreement is not specific, phone calls to the

Why Include Tax Provisions?

You cannot bind the IRS in a settlement document.² Plaintiff and defendant may agree in an agreement that the settlement is for personal physical injuries and therefore should not constitute income—but the IRS can always disagree. Similarly, 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.

Once again, the IRS can always disagree with the allocation or tax treatment.³ Yet it can be foolish not to *try* to address taxes in settlement agreements. 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.

With a general release, I have even heard IRS personnel say, "If this payment was for personal physical injuries and therefore tax-free, why doesn't the settlement agreement say so?" A settlement agreement represents an opportunity to shape and mold the tax treatment of the payments. Tax disputes about these issues are not easy to resolve—in audit, IRS Appeals or litigation.

Former longtime Taxpayer Advocate

Nina Olson has said that legal settlement recoveries have jammed the Tax Court's docket.⁴ One reason is the unclear scope and varying interpretations of Section 104. Another is the lack of agreement on tax issues in settlement agreements.

Defendant Issues

Some defendants may argue that it is only in the *plaintiff's* interest to put tax provisions in a settlement agreement, never a defendant's. However, defendants may need to address their own tax issues, such as the rule preventing tax deductions for confidential sexual harassment settlements and legal fees. There are various techniques that might get around some or all of the pain.

Even more fundamentally, defendants need to know what they can or should do concerning tax withholding and IRS forms like Form 1099. Should you issue them to lawyer, client, or both? 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 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. Such lawsuits are rare, and most such lawsuits may be regarded as spurious. But they are expensive and maddening fights, particularly when the settlement agreement *should* have made all such matters clear.

A defendant who ends up litigating tax and withholding issues separately *after* a case is resolved will not be happy with anyone, including the defendant's own lawyers for allowing a repeated mess.⁵ For both plaintiff and defendant, only *before* the settlement agreement is finalized and executed does there remain bargaining power over such issues. Do not fail to take advantage of this opportunity.

Are Taxes Essential?

Some courts may even view taxes as an essential element of a settlement agreement. This topic could come up in a term sheet signed at the conclusion of a mediation that is never followed by a more full-blown settlement agreement, or in a settlement agree-

ment that simply fails to address taxes. *Sheng v. Starkey Laboratories, Inc.*⁶ had its beginning in a simple employment dispute.

The underlying claim was made by Beihua Sheng, a former employee of Starkey who sued for sexual harassment and retaliation. The parties met for a settlement conference before a magistrate. After discussion, the attorneys for Sheng and Starkey shook hands on a \$73,500 figure.

Unfortunately, the attorneys could not agree on the tax treatment of the settlement. Sheng's attorney asked for an assurance that Starkey would not withhold taxes. Starkey asked for indemnity in the event the IRS thought withholding was required. According to Sheng's lawyer, the parties agreed to meet again to iron out this tax question.

Later that day, the parties learned that the judge (not the magistrate judge) had granted summary judgment to Starkey three days before the settlement conference before the magistrate judge. When the judge became aware of the settlement, he withdrew his grant of summary judgment. He then issued a new order endorsing the settlement and dismissing the plaintiff's case without prejudice. The plaintiff tried to enforce the \$73,500 settlement.

Conversely, Starkey sought to reinstate the prior summary judgment ruling. Starkey argued there could not have been an enforceable settlement because: (1) the parties were negotiating without the knowledge summary judgment had already been granted; or (2) they had failed to reach a complete agreement because the tax treatment of the settlement proceeds had not been addressed. The District Court determined that the summary judgment ruling had not matured into a court order before the settlement was reached, and that the failure to agree on tax consequences did not preclude a settlement.

Taxes are Material

Starkey appealed, arguing that no settlement was ever reached because they had not agreed on tax consequences. A mutual mistake of fact existed, argued Starkey. The Eighth Circuit reversed, agreeing there was no contract unless the parties agreed to all material terms.

What is material had to be evaluated

when the contract is formed, and subsequent events cannot make terms nonmaterial that were material at the time a deal was being considered. The tax and indemnity issues were material, and that vitiated the settlement.⁷ The final chapter in *Sheng v. Starkey Laboratories* came on remand, where the court found the parties *had* reached agreement on all essential terms. The court rescinded the dismissal order and reinstated summary judgment in Starkey's favor.

Still not done, Sheng appealed! Considering the case for a second time, the Eighth Circuit said the settlement did not hinge on tax issues, and the summary judgment motion did not give rise to a mistake of fact vitiating the settlement.⁸ Of course, *Sheng* is an unusual and protracted tale of woe. Yet it illustrates how much time and money can be spent on relatively small tax issues that can often be dealt with in advance.

Conclusion

Plaintiffs, defendants, lawyers and mediators all have an agenda to accomplish in mediation. Taxes might seem to be far down on that list, but it is important to consider taxes if the mediation goes well. When you can, try to address the tax issues sooner rather than later. Regardless of your role in the dispute, you'll be glad you did. **AZ**

endnotes

1. *Black's Law Dictionary* (8th ed. 2004) which 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."
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'd* 105 T.C. 396 (1995).
4. Nina Olson, National Taxpayer Advocate 2009 Annual Report to Congress, p. 446, Doc 2010-174, 2010 TNT 4-19.
5. *See Redfield v. Insurance Co. of North America*, 940 F.2d 542 (9th Cir. 1991).
6. 53 F.3d 192 (8th Cir. 1995), *after remand, rev'd in part and aff'd in part*, 117 F.3d 1081 (8th Cir. 1997).
7. *Id.*
8. *See Sheng v. Starkey Labs.*, 117 F.3d 1081 (8th Cir. 1997).