Tax Aspects of Settling Corporate Lawsuits

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 physical injury damages). How to respond to this query, as well as various other pitfalls, deserves attention.

Deductibility

The first thing that should concern corporate counsel on payment of a settlement amount (or a judgment) is whether the payment is deductible. Of course, in the vast majority of litigation arising in a business, everyone will assume that the payment (together with associated attorneys' fees) will be deductible. However, this can be a dangerous assumption. There are only a couple of exceptions to the normal rule of deductibility, but they are important.

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, legal fees in merger and acquisition deals, *etc.* The IRS takes the position that in these cases the expense must be capitalized over the life of the asset.

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Another major area in which a deduction may be questioned is where the payment is in the nature of a fine or penalty. Under Code Sec. 162(f), the payment of a fine or penalty is nondeductible. In contrast to the general rule that payments made in the course of a trade or business are deductible (either by settlement or judgment), the Internal Revenue Code expressly states that no deduction is allowed for "any fine or similar penalty paid to a government for the violation of any law." This provision denies a deduction for both criminal and civil penalties, as well as for sums paid in settlement of a potential liability for a fine or penalty.[1] It is the latter element of the provision that often causes great controversy. It may (or may not) be clear that it is likely that a fine will be imposed when a potential liability is satisfied by way of a negotiated settlement with a governmental entity.

Whether a fine or penalty may be imposed may, in some cases, depend upon the intent of the perpetrator. If the fine or penalty is in fact imposed, the denial of the deduction is unwavering in its resolution. It does not matter whether the violation of law was intentional or unintentional. In either case, no deduction will be permitted for the payment of a fine or penalty even if the violation is inadvertent, or if the taxpayer must violate the law in order to operate profitably.[2]

These rules seem to be bubbling to the surface a lot lately. One can hardly pick up a newspaper or listen to the news without hearing about another corporate wrongdoer being forced to

pay a fine or penalty. For example, in 2003, MCI was fined a record $500 million by the SEC for accounting fraud.[3] Consider too the roughly $1.5 billion shelled out by the securities industry in 2003 for its indiscretions. Interestingly, of this amount, only about $450 million was characterized as fines or penalties.[4] The bulk of the settlement, more than $1 billion, went toward investor restitution, education and the dissemination of independent research (which are tax-deductible business expenses). That indicates a key point about all of this from a payor's perspective. Often there is wiggle room.

Indeed, Exxon was almost as fortunate as the securities industry players when paying for its Exxon Valdez oil spill. The U.S. government's $1.1 billion Alaska oil spill settlement with Exxon actually cost Exxon a mere $524 million on an after-tax basis. The Congressional Research Service determined that more than half of the civil damages totaling $900 million could be deducted on Exxon's federal income tax returns.[5]

Frequently, the line drawing exercises that take place here are not terribly precise. While a fine or penalty (nondeductible under Code Sec. 162(f)) and a punitive damages payment may both relate to "bad" conduct, they employ different tax rules.

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 any payments. Sometimes it is possible to enter into a settlement agreement with the governmental agency in question specifying that the payment is remedial rather than punitive in character.

Also, in the antitrust context, there is a statutory rule denying a deduction for two-thirds of the damages paid pursuant to a treble-damage antitrust suit, if certain conditions are met.[6] The deduction for two-thirds of the payment (in effect, the trebled portion), is disallowed only where there is a conviction in a related criminal proceeding, or a plea of guilty or *nolo contendere*. The Senate Finance Committee Report[7] to this provision (enacted in 1969), is crystal clear as to what Congress then meant:

> This means that the deduction (of the penalty portion) is to be denied only in the case of 'hardcore violations' where intent has been clearly proved in a criminal proceeding. The denial of the deduction is limited to two-thirds of the amount paid or incurred since this represents the "penal" portion of the payment. The remaining one-third is to continue to be deductible on the grounds that it represents a restoration of the amount already owing to the other party.

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 later found 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 terribly sympathetic (big shocker!). These are purely personal matters, even if the corporation may see itself as protecting its assets.

There have been 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 deducted by the paying company, even if the conduct of the executive or employee involved is outside the course and scope of his or her employment.

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 employee has not been employed by the company for many years. Sometimes litigation takes five years or more to resolve. The mere passing 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 $1 million 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.

If an employer fails to deduct and withhold the requisite amounts from an employee's (or former employee's) wages, the employer is liable for the amount of the tax that should have been deducted and withheld.[8] But, if the employer fails to deduct and withhold income tax from wages, it may be relieved of liability for the tax if the employer can show that the tax has been otherwise paid, such as when the employee filed his tax return and paid the tax. This does not relieve the employer of liability for other penalties or additions to tax imposed because of the failure to withhold.[9] Moreover, if an employer fails to pay any tax which should have been shown on Form 940 (FUTA) or Form 941 (FICA and income tax withholding), but which was not, the employer must pay the tax within 10 days after the IRS serves a notice and

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demands for payment. If the employer does not pay within the allotted period, an addition to the tax equal to 0.5 percent of the amount of the tax for each month the tax remains unpaid, up to 25 percent, will be assessed.[10]

An additional penalty of up to 10 percent may be imposed by Code Sec. 6656(a) for failure to deposit employment taxes (employee's withholding and FICA), unless it is shown that such failure is due to reasonable cause and not due to willful neglect. Moreover, if any amount of tax required to be paid is not paid by its due date, interest will accrue on the amount owing.[11] Interest will also accrue on any penalties or additions to tax assessed as a result of a failure to collect and pay employment taxes or to report employment taxes as required.[12]

If the failure to pay any tax due, including employment taxes, is on account of negligence or fraud, additional penalties may be asserted under Code Sec. 6662 or 6663. If any part of any underpayment of tax is due to negligence or disregard of the rules, there will be added to the tax the sum of 20 percent of the total underpayment (even any part not attributable to negligence) and 50 percent of the interest under Code Sec. 6601 on that part of the underpayment attributable to the negligence.[13] The definition of negligence includes the failure to make reasonable attempts to comply with the law.[14]

If any part of the underpayment is due to fraud, the addition to tax is the sum of 75 percent of the underpayment due to fraud and 50 percent of the Code Sec. 6601 interest on the part of the underpayment due to fraud.[15] If fraud is established, all of the underpayment will be presumed to be due to fraud, except for any part the taxpayer can show is not attributable to fraud.[16] The elements of fraud include an actual, intentional wrongdoing with an intent to evade a tax believed owing; fraud may not be presumed, especially not from a failure to report income alone.

At the same time, while the penalties for failing to withhold are severe (you might even say punitive), 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 a company pays someone $10,000 who fell at its corporate headquarters and was physically injured, that $10,000 is not includible in the recipient's income, and you need not issue a 1099. The IRS instructions to Form 1099-MISC 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 almost no guidance yet on exactly what the physical injury/physical sickness requirement of Code Sec. 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 injury/physical sickness 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 not be the subject of an IRS Form 1099. 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.[17]

A second penalty applies to failures to file Form 1099 only in cases of willful or intentional failures to file Forms 1099.[18] This penalty is equal to the greater of $100 or 10 percent of the aggregate amount of items required to be reported.[19] Our experience may be atypical, but we have *never* seen the IRS successfully assert this penalty. Of course, there is a threshold question in this circumstance whether the choice to not issue the plaintiffs Forms 1099-MISC for their share of the attorneys' fees could possibly be considered a willful or intentional "failure" to file such form. There is a separate penalty for failure to include correct information on an information return, or the inclusion of incorrect information.[20] This penalty is also $50 per failure.

Finally, Code Sec. 6722(c) imposes an intentional disregard penalty for information returns which are incorrect and where the reporting person has intentionally disregarded the information return rules. As in the case of the penalty for willful failures to file Forms 1099, this penalty is equal to the greater of $100 or 10 percent of the aggregate amount of items required to be reported.[21] Again, as we noted with respect to the Code Sec. 6721(e) penalty (discussed above), we have never seen the IRS successfully assert this penalty.

It is clear from the regulations that inconsequential errors and omissions will not trigger even the basic $50 penalty for failures to furnish correct payee information.[22] It follows that the willfulness penalty also applies only where there has been a failure that is beyond this inconsequential error or omission standard. Merely reporting the payments to the attorneys as gross income to them (rather than both the attorneys and the plaintiffs) would probably not be considered a failure to furnish correct information.[23]

Indeed, the Internal Revenue Code itself provides specific reasonable cause abatement provisions. The above-discussed penalties for information reporting failures may be waived if the filer (in this case, the defendants), can establish that the failure is due to reasonable cause and not to willful neglect.[24] The regulations provide that a penalty will be waived for reasonable cause if the filer can establish that either (1) there are significant mitigating factors with respect to the failure; or (2) the failure arose from events beyond the filer's control.[25]

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The "significant mitigating factors" which can result in a penalty being waived include (among other factors), the established history

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