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TAX PROVISIONS IN SETTLEMENT AGREEMENTS: BREACHES AND NEEDLESS LITIGATION

by Robert W. Wood

Once a case has been settled (or has actually proceeded to judgment), a dispute may develop as checks are being prepared and send to the plaintiff. The most common tax dispute in this context is whether withholding is appropriate. Quite a number of famous cases have dealt with this often unanticipated question. One of the first was Redfield v. Insurance Company of North America, which went on appeal twice (imagine the cost!). The first appeal was on the substantive legal question of liability for age discrimination and wrongful termination, and the second time on appeal (to the Ninth Circuit) solely on the question whether withholding was required. See Redfield v. Insurance Company of North America, 940 F.2d 542 (9th Cir. 1991).

The second most common dispute to arise is over the issuance of IRS Forms 1099, even if it is clear that withholding would not be required. A plaintiff who receives a Form 1099 (but who is claiming that the recovery is excludable from income as a personal physical injury or physical illness under Section 104 of the Internal Revenue Code) will argue that no Form 1099 should issue. If the recovery is truly excludable from income, the plaintiff is absolutely right. Even the IRS agrees that a Form 1099 should not be issued in this circumstance. See IRS' own Instruction to Form 1099-MISC. The problem is that sometimes settlement agreements are not explicit on this point, and it is often unclear whether all or a part of a recovery is excludable.

Unfortunately, this Form 1099 issue is even more of a hidden and surprising problem than withholding, since Forms 1099 are generally not issued until the year after the year of the payment. 1099s (and Forms W-2) are required to be sent to the taxpayer no later than the end of January of the year following the year of the payment. Then, these forms are required to be sent to the IRS no later than the end of February of the year following the payment. Thus, there is a built-in one-month lag between the time when the taxpayer must get the form (1099 or W-2) and the time the IRS must get it. This built-in one-month lag, as will be seen below, can offer a time for correction — assuming you act quickly — when there has been a mistake.

Let's look at the question of withholding first, particularly since there is recent authority. The court of appeals for the Federal Circuit has now decided Crosby v. Postal Service, Fed. Cir. No. 00-3155 (Sept. 14, 2000), dealing with a settlement agreement. The settlement agreement between the former employee and the Postal Service included language saying that the Postal Service would make "standard" deductions from the settlement award. The appeals court affirmed the Merit Systems Protection Board decision that the Postal Service reasonably interpreted this language that it should deduct taxes.

Surprise Withholding

The underlying claims involved Equal Employment Opportunity Commissioner charges against the Postal Service. The Postal Service agreed to pay Crosby $400,000 minus standard deductions. Subsequently, when it came time to exchange the release for the check, Crosby was handed a check only for $261,015 instead of $400,000. Surprise! Crosby petitioned the Merit Systems Protection Board alleging, among other things, that the Postal Service erred in deducting the FICA and income from the settlement amount.

The court, however, held that the Postal Service did not violate the settlement agreement by deducting the tax. Although the Postal Service did not dispute that the settlement was an award for pain and suffering and not for lost income and benefits (or any other form of wages), the explicit reference in the settlement agreement to "standard deductions," along with other evidence, including — believe it or not — a declaration submitted by Crosby's attorney, supported the conclusion that the parties to the contract understood that taxes were to be withheld.

Crosby is not the first case to consider such questions. In 1995, the Eighth Circuit decided in Sheng v. Starkey Laboratories, Inc., 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). There, the failure of the parties to agree on the tax treatment of a settlement in a sex discrimination case was considered a material issue that prevented the finding of an enforceable contract between the parties. The federal District Court ordered enforcement of a settlement between the parties after one of the parties balked at the deal. The Eighth Circuit reversed. See 53 F.2d 192 (8th Cir. 1995).

Sheng had its beginning in a simple employment dispute. The underlying claim was made by Beihua Sheng, a former employee of Starkey Laboratories who sued for sexual harassment and retaliation. Although a settlement was reached at the $73,500 figure, there was confusion about just what happened in the settlement conference. The respective parties met for a settlement conference in front of a Magistrate in the U.S. District Court for the District of Minnesota. The parties were referred to the settlement conference by a judge who had presided over the litigation of Sheng's discrimination claims.

After some discussion, the attorneys for Sheng and Starkey Laboratories shook hands on the $73,500 figure. Unfortunately, the attorneys could not agree on the tax treatment of the settlement. Not surprisingly, Sheng's attorney asked for an assurance that Starkey Laboratories would not withhold taxes from the proceeds. Starkey Laboratories, on the other hand, asked for an indemnification clause that would protect the company in the event the Internal Revenue Service thought that withholding was required. According to Sheng's lawyer, the parties had agreed to meet again to iron out this nettlesome tax question.

When is a Settlement a Settlement?

Later that day, the parties learned that the judge presiding over the substantive discrimination suit had granted summary judgment to Starkey Laboratories on December 17, 1993 (three days before the settlement conference before the magistrate had even begun!). When this judge became aware of the settlement on December 20, he withdrew his December 17 order which had granted summary judgment. On December 21, he issued a new order endorsing the settlement and dismissing the plaintiff's case without prejudice.

The plaintiff tried to enforce the alleged settlement for $73,500. Starkey Laboratories, on the other hand, sought to reinstate the December 17 summary judgment ruling so that it could escape payment altogether. Starkey Laboratories argued that there could not have been an enforceable settlement either because: (1) the parties were negotiating without the knowledge that summary judgment had already been granted; or (2) they had failed to reach a complete agreement on material terms—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. The court also determined that the failure to agree on tax consequences did not preclude a finding that the settlement had been reached. Indeed, the court noted that on December 20, 1993, the IRS had issued a Revenue Ruling (No. 93-88) ostensibly settling the question that settlement proceeds in a post-1991 Title VII claim are not taxable. Regardless of what the parties thought, then, the court acknowledged that the IRS would not attempt to tax the proceeds. Revenue Ruling 93-88 was since suspended by Notice 95-45.

Taxes Are Material

Starkey Laboratories did not give up here. On appeal to the Eighth Circuit Court of Appeals, the defendant argued that no settlement was ever reached because they had not agreed on the tax consequences of the settlement payment when they became aware of the summary judgment ruling. A "mutual mistake of fact" on the part of the parties existed, argued Starkey. The Eighth Circuit Court of Appeals listened intently to these arguments, and reversed the district court because the settlement was inchoate.

Applying basic contract law, the Eighth Circuit Court of Appeals concluded that no contract exists unless the parties agree to all material terms. What is a "material" term has to be evaluated when the contract is being formed. Events occurring subsequent to the settlement agreement (here, the later IRS Revenue Ruling about Title VII recoveries) could not make terms that were material at the time a deal was being considered into nonmaterial terms. The tax and indemnity issues, reasoned the court, were material terms on which no agreement had been reached between the parties. That vitiated the settlement. See 53 F.2d 192 (8th Cir. 1995).

The final chapter in Sheng v. Starkey Laboratories came on remand of the case to District Court. There, the

District Court found the parties had reached agreement on all essential terms of settlement. Consequently, the court rescinded the dismissal order and reinstated the summary judgment order in Starkey's favor. Sheng appealed!

In the Circuit Court for the second time, the Eighth Circuit agreed with the District Court (on remand) that the settlement did not hinge on the tax issues. Plus, the Eighth Circuit found that summary judgment motion and the judge acting on it did not give rise to a mistake of fact that vitiated the settlement. See Sheng v. Starkey Laboratories, 117 F.3d 1081 (8th Cir. 1997).

Conclusion

Both of these cases graphically demonstrate that it is vital for the parties to understand whether withholding will be taken. Crosby was apparently surprised, and obviously not too happy that withholding would be taken. So was Sheng. It is best if a settlement agreement not only says whether withholding will be taken (and, if so, exactly on what amounts), but also deals specifically with what types of forms will be issued (W-2, 1099, etc.).

In Sheng, imagine all the legal fees generated by these two District Court decisions and two appeals? All of this was after the execution of a settlement agreement, making a rather dramatic case for considering these issues before a settlement agreement is finally negotiated.

***Tax Provisions in Settlement Agreements: Breaches and Needless Litigation*, Vol. 29, No. 11, TaxPractice (March 12, 2001), p. 324; also published in Vol. 16, No. 11, BNA's Employment Discrimination Report (March 14, 2001), p. 382.**