Breaching Tax Treatment Contracts

by Jasper L. Cummings, Jr.

Jasper L. Cummings, Jr.

Jasper L. "Jack" Cummings, Jr., is of counsel with Alston & Bird LLP in Raleigh, North Carolina.

In this report, Cummings discusses lawsuits against parties that breach (or allegedly breach) tax treatment agreements by reporting to the IRS. He points out some little-known code sections that regularly arise in this rapidly growing area of litigation, and he identifies some traps to avoid.

Table of Contents

I.	**Wishin' and Hopin'**	535
II.	**The Corporate Cases**	536
	A. Acquisition Agreements	536
	B. Unhappy Marriage	536
	C. Purchase Price Allocation Problems	537
	D. Other Corporate Issues	538
	E. Lessons to Be Learned	539
III.	**The Employment Cases**	540
	A. The Problem	540
	B. Withholding Cases	540
	C. Reporting Cases	540
	D. Independent Contractor Cases	542
IV.	**Debt Discharge Cases**	542
V.	**Partnership Cases**	543
VI.	**Practical Advice**	543

I. Wishin' and Hopin'

Parties to contracts with tax implications — from employment contracts to settlement agreements to merger contracts — sometimes have the presence of mind to add an agreement on how they both will report the transaction or relationship. And sometimes one party breaches, or the other party thinks it has breached, by reporting to the IRS. Litigation in this area has skyrocketed in the last 15 years, with some unusual results.

This report addresses those breaches of agreements to report or not report a transaction in a specific way. When these agreements go wrong, the disputes can be particularly acrimonious because the breach is often intentional and sometimes meant to retaliate against the other party, which usually doesn't want to pay income tax. Sometimes a contract does not mention taxes but one party thinks a nondisclosure clause means nondisclosure to the IRS.

The headline is that you can't be bound to report incorrectly or not file a form you're required to file, but that doesn't seem to stop plaintiffs. A second headline is that any of the following code sections or forms will likely come up in this type of dispute:

- The sections requiring reporting by payers (starting with section 6041, the most broadly applicable reporting rule) plus many other more particularized requirements for reporting both payments and transactions, such as reorganizations, and reporting business sale price allocations under section 1060.
- Section 7206(1), which requires taxpayers to report in the way they believe to be truthful (that is, not fraud). Defendants can claim this requirement made them report as they did. Plaintiffs can claim the defendant violated the statute.
- The surprising section 7434: "If any person willfully files a fraudulent information return with respect to payments purported to be made to any other person, such other person may bring a civil action for damages against the person so filing such return."[1]
- Form 8082, "Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)," which allows taxpayers to report that they are taking an inconsistent position from that taken by a partnership, S corporation, estate, or trust. Unfortunately, there appears to be no such form for disagreeing with a Form 1099 filed by a payer or disagreeing with other types of information reporting.[2]

---

[1] *See also* section 6724(d)(1)(A) for a long list of information returns to which this damages section can apply. As discussed below, however, Form 1099-C is not included in that list.

[2] Form 8275, "Disclosure Statement," is for the disclosure of positions to avoid accuracy-related penalties. It does not specifically cover reporting that is inconsistent with a Form 1099 or other information return received by the IRS, and it likely doesn't cover that reporting, although there is no harm in trying

(Footnote continued on next page.)

This report does not discuss the many other types of breach of tax contracts, including disputes over tax-sharing agreements, which are addressed in an earlier article.[3] This report also does not discuss the many cases in which one party reports to the IRS that it has paid income and the payee disputes the taxability of the income with the IRS but not with the payer.[4] Nor does it discuss suits to enforce a promise to deliver a specific tax benefit, usually made in tax shelters.[5] The many ways contracts can produce tax disputes should warm the hearts of all litigators.

II. The Corporate Cases

A. Acquisition Agreements

Agreements for the purchase of stock or the merger of corporations generally follow forms that are the result of a century of refinement and have been the subject of many continuing legal education programs. They invariably include standard tax provisions addressing the target's tax liabilities already reported (or not) on filed returns; the target's pre-closing tax liabilities on unfiled returns; and future returns, tax assessments, and refunds.

Sometimes they include an agreement on how to characterize the acquisition for tax purposes if there is any uncertainty. That can occur, for example, when an acquisition does not fit within an IRS ruling guideline or involves an issue on which the IRS will not rule. An example of the latter is tracking stock. An example of the former is mergers with contingent stock that exceed the bounds of Rev. Proc. 84-42,[6] which often happens with high-tech start-ups that can't be valued. Agreements to report a good reorganization are also common. But parties don't always report as they promised.

B. Unhappy Marriage

An acquisitive corporate reorganization that leads to the firing of the target's principal shareholder-employee, dissolution of the target, and almost 20 years of litigation is an unhappy marriage, indeed. That's what happened with the acquisition of Mayer Corp., a New Jersey land development corporation, by Development Corp. of America (DCA), a conglomerate, Florida-based land developer. The unhappy acquirer was held liable for breaching the contract to report the transaction as a reorganization.[7]

DCA acquired Mayer Corp. solely for stock in 1969. Part of the stock was contingent on Mayer Corp.'s performance over a three-year period. By early 1973, all the contingent stock had been delivered to the shareholders. The parties were aware of the IRS ruling requirements (under the predecessor of Rev. Proc. 84-42) for not treating contingent stock as boot in reorganizations, and they attempted to comply with them. The parties were also aware that the stock had to be voting stock to qualify for B reorganization treatment. Plus, they knew that even qualifying but delayed consideration in a reorganization could be treated in part as imputed interest under section 483, and the shareholders did not want to pay tax on any imputed interest.

Therefore, the acquisition agreement provided that the contingent stock to be issued to the shareholders would be put in escrow. The shareholders could vote it and receive dividends and would be treated as owning the stock from the date of closing. The agreement also provided that the parties intended the transaction to be a B reorganization and that they would take no action inconsistent with that agreement.

DCA became unhappy with its acquisition in late 1973, and the shareholders became unhappy with DCA when it refused to register their stock. They sued DCA in April 1974.[8] In September 1974 DCA filed its 1973 return and claimed a large deduction for imputed interest on the contingent stock released from escrow in 1973. In 1975 DCA liquidated Mayer Corp. and claimed a loss based on treating the original acquisition as a purchase and not a reorganization.

The IRS denied DCA the interest deduction and the loss. DCA petitioned the Tax Court and eventually lost that case.[9] The company's theory was that a voting agreement among the DCA shareholders

---

if the taxpayer really wants to bring the inconsistency to the IRS's attention before information matching does that.

[3]Jasper L. Cummings, Jr., "Tax Sharing Agreements and Related Contracts," *Tax Notes*, Sept. 22, 2014, p. 1411. *E.g.*, *Marvel Entertainment Group Inc. v. Mafco Holdings Inc.* (*In re Marvel*), 273 B.R. 58 (D. Del. 2002).

[4]*E.g.*, *Burns v. United States*, 76 F.3d 384 (9th Cir. 1996). Robert W. Wood has written on many of these cases and related issues arising in connection with dispute settlements. *See* Wood, "Tax Provisions in Settlement Agreements: Breaches and Needless Litigation," 29 *Tax Prac*. 324 (2001); and Wood, *Tax Aspects of Settlements and Judgments*, BNA Portfolio 522-4th.

[5]*E.g.*, *Lasker v. Bear, Stearns & Co.*, 757 F.2d 15 (2d Cir. 1985) (containing the remarkable fact that virtually all oil futures trades when oil futures first began to be traded in the 1970s were fraudulent, made on a rigged market). *See* Cummings, "Are Judges Just English Teachers?" *Tax Notes*, June 13, 2016, p. 1553.

[6]1984-1 C.B. 521. *See* Cummings, "How to Stop Worrying About Contingent Stock Rights," *Tax Notes*, Sept. 26, 2016, p. 1827.

[7]*Mayer v. Development Corp. of America*, 541 F. Supp. 828 (D.N.J. 1981), *aff'd without opinion*, 688 F.2d 822 (3d Cir. 1982).

[8]*Mayer v. Development Corp. of America*, 396 F. Supp. 917 (D. Del. 1975).

[9]*Development Corp. of America v. Commissioner*, T.C. Memo. 1988-127.

ensuring that Henry Mayer would have a seat on the board was boot and prevented the B reorganization, which would presumably result in allowing the imputed interest. The Tax Court held against DCA on all counts.[10] Meanwhile, the IRS determined that Mayer Corp. was not entitled to B reorganization treatment and that Mr. Mayer received imputed interest under section 483. The objection to the reorganization treatment was dropped, and the interest adjustment was settled after Mr. Mayer filed a Tax Court petition.[11]

But before he won his argument with the IRS, Mr. Mayer sued DCA for breaching the agreement to treat the transaction as a B reorganization and implicitly agreeing not to deduct imputed interest. After an extensive bench trial and opinion, the federal district court granted judgment to Mayer. It held that DCA breached the contract because it not only agreed to treat the transaction as a B reorganization but also implicitly agreed not to claim there was imputed interest. However, the executives of DCA did not tortuously interfere with Mayer's contract rights because they did not cause the interest deduction to be claimed for the purpose of harming Mayer and his wife (a debatable finding, based on believing the officers' self-serving testimony). The Mayer Corp. shareholders were entitled to damages for taxes caused by the breach, but at that point it was unknown whether the Mayers would owe taxes.

Mayer had to overcome many objections including (1) that the tax representation was not just a closing condition, (2) that the settlement of the prior suit barred the current claim, and (3) that section 7206(1) prevented an agreement precluding truthful reporting. The court rejected the third objection basically because the transaction could reasonably be treated as a B reorganization without imputed interest.

A more recent unhappy corporate marriage case involves the combination of Energy Transfer Equity LP and the Williams Companies Inc., which failed because Energy Transfer could not obtain the required pre-closing tax opinion.[12] Although the court decided against Williams on the basis of how reasonable the lawyer's analysis was, Williams wanted to focus on the reasonableness of Energy Transfer's efforts to obtain the tax opinion.

Mayer (which appears to be the earliest and one of the few reported decisions on a reorganization agreement tax provision of this type) and *Williams* illustrate several problems that can arise in this type of deal:

- Post-closing unhappiness between the parties about business matters can lead to unwillingness to cooperate in tax matters, particularly when the tax interests of the parties are not aligned, as is common.
- Great care must be taken to keep this type of tax representation out of the "condition of closing" category and thus not grounds for later indemnity claims. The same goes for limiting the scope of settlement agreements.
- It will be difficult to hold any individual officer on the other side personally liable for interfering with the contract.
- A party that has breached a contract to report will almost always claim that it was compelled to do so by some provision of the code, which will be a good defense if true.
- The long lead time between contracting and closing, which is common in major combinations, can produce buyer's remorse for which a tax reason may be found to get out of the contract.

C. Purchase Price Allocation Problems

1. *Stern.* Although section 1060 requires both parties to the purchase and sale of a business, as broadly defined, to report on Form 8594, "Asset Acquisition Statement," an allocation of the purchase price to the various items of property sold, it does not require them to agree on an allocation — and rightly so. In most cases parties do not agree, except to the extent that the terms of the agreement itself state some allocation, as in *Stern*,[13] discussed below. If they do agree to an allocation and one party reports to the IRS an allocation that is "illegal" in the sense of being clearly incorrect under the rules of sections 1060 and 338, the party benefiting from the improper allocation generally cannot have a remedy against the party that wants to report correctly.[14] This can happen when one party lets the

[10]It found that DCA was never entitled to an interest deduction because the acquisition was a B reorganization and the stock issued in escrow was owned from closing by the Mayer Corp. shareholders. In part because DCA was not a party to any voting agreement with the shareholders, any such agreement could not constitute boot (there was no argument that the stock was not voting stock). Also, DCA took a carryover basis in the stock.

[11]*See Development Corp. of America*, T.C. Memo. 1988-127.

[12]*Williams Cos. Inc. v. Energy Transfer Equity LP*, Nos. 12168-VCG, 12337-VCG (Del. Ch. 2016).

[13]*Stern & Co. v. State Loan & Finance Corp.*, 238 F. Supp. 901 (D. Del. 1962).

[14]*See* Michael L. Schler, "Sales of Assets After Tax Reform: Section 1060, Section 338(h)(10), and More," 43 *Tax L. Rev.* 605, 632-634 (1988).

other party make an allocation for both of them because the first party doesn't think it cares but the other does care.[15]

Stern & Co., a retailer, needed cash and determined to sell its affiliated finance subsidiaries to a finance company. The sale agreement stated that the $2.5 million purchase price was paid in equal parts for the stock of the two corporations. However, on its returns, the buyer claimed that it had paid for a covenant not to compete and other intangibles that could be quickly written off. Back in those gentler days (the 1950s), IRS agents had time to put two and two together and follow leads from one taxpayer to another without the aid of computers. So they reopened the audit of Stern's return for the year of sale, which had previously been audited without change. The IRS asserted additional tax. Also, back in those pre-1986 days, corporations enjoyed a capital gains preference by way of a cap on the rate on capital gains. But if Stern sold goodwill or a covenant not to compete, it would earn ordinary income, which would be taxed at a higher rate. That was the basis for the audit adjustment.

Stern filed a Tax Court petition, and the case was settled favorably. Stern then successfully sued the buyer in district court for a $20,000 attorney fee in the Tax Court proceedings. The district court held that the buyer had implicitly agreed that it would treat the transaction as a stock purchase for $2.5 million and do nothing to jeopardize the tax results to Stern, even though that agreement was not specifically negotiated.

2. Other allocation litigation. When the contract does not allocate the purchase price and one party files its own allocation with the IRS, that allocation can turn out to have surprising ancillary consequences. In *Holston*,[16] for example, a plaintiff sued for breach of a right of first refusal because the defendant had sold the property subject to the right as part of a larger business sale. The plaintiff asserted that the measure of damages was the value of the business in excess of what the actual buyer paid. Although the court recognized the possibility that the allocation might not reflect business reality, it ultimately based the damages on the actual buyer's tax allocation of the price to the particular asset.

The court expressed doubts about relying on tax allocation agreements in applying a right of first refusal, citing the Fourth Circuit's opinion in *Pantry Pride*,[17] which reflected skepticism about the economic reality of purchase price allocation agreements for tax purposes. The Fourth Circuit said that those artificial allocations "may bear no relation to its worth." It turns out that "package deals" and rights of first refusal create recurring problems to which the tax allocation may be relevant.[18]

However, for some purposes the tax allocation may be held against a party in a contract dispute. When the buyer in *T.H. Engineering and Manufacturing* complained that the goodwill was not what was expected, the absence of goodwill from the contract allocation weighed against the buyer's claim.[19]

An entirely different type of allocation problem concerns the allocation of damages to various claims of a plaintiff, usually in settlement but sometimes in a judgment. The courts in one high-profile case, *Polone*,[20] held the taxpayer to the negotiated allocation. They found the allocation binding because of arm's-length negotiations. Robert W. Wood has useful advice in this area.[21]

D. Other Corporate Issues

There are many other ways in which promises about taxes can result in contract breaches and lawsuits.

1. Assumed liability for taxes. The plaintiffs in *Flores* sold some assets to the defendants, and the defendants agreed to pay a tax owed to Mexico by the plaintiffs but failed to pay it.[22] The plaintiffs sued for damages, and the defendants asserted that recovery was barred because the plaintiffs' failure to pay the tax had been a Mexican crime. The court rejected the defense. It recognized the Texas rule that a plaintiff cannot recover for his own wrongdoing but said that the rule did not extend to this case. The contract, in effect, was designed to make the sole victim of the crime (Mexico) whole.

2. Post-closing refund claim. The plaintiff in *LASMO* sold subsidiaries to the defendant, and the agreement required the defendant to prosecute a sales tax refund claim and pay the net recovery over

[15]*E.g.*, *Western Insulation LP v. Moore*, No. 06-2028 (4th Cir. 2007).

[16]*Holston Investments Inc. BVI v. LanLogistics Corp.*, 664 F. Supp.2d 1258 (S.D. Fla. 2009); later opinion at No. 08-21569 (S.D. Fla. 2010).

[17]*Pantry Pride Enterprises Inc. v. Stop & Shop Cos. Inc.*, 806 F.2d 1227 (4th Cir. 1986).

[18]*See* Rick Strange and Thomas Fahring, "Rights of First Refusal and Package Oil and Gas Transactions," 53 *S. Tex. L. Rev.* 29 (2011).

[19]*T.H. Engineering & Manufacturing Inc. v. Mussard*, No. E2001-02406-COA-R3 (Tenn. App. 2002).

[20]*Polone v. Commissioner*, T.C. Memo. 2003-339, *aff'd*, 505 F.3d 966 (9th Cir. 2007).

[21]*See* Wood, "Who Said Settlement Agreement Tax Language Was Binding?" *Tax Notes*, Nov. 21, 2011, p. 1031.

[22]*Flores v. ASI Computer Technologies Inc.*, No. L-06-135 (D. Tex. 2010).

to the plaintiff.[23] In the audit, the state uncovered some sales taxes due, and the defendant netted those tax liabilities against the recovery. The plaintiff asserted that that was not what the netting language in the agreement meant. The court found the contract ambiguous and declined to grant summary judgment to either party.

3. The reason you don't buy stock. KDI Corp. acquired a corporation from the defendants in a 1969 reorganization. The next year the target did poorly, and the assets were sold back to the prior shareholders. Meanwhile, KDI had become liable for the target's tax liabilities as a transferee. An IRS assessment for an earlier year arrived in 1973. The prior owners refused to defend the assessment. KDI petitioned the Tax Court and lost,[24] paying about $44,000 in tax, $22,000 in interest, and $3,500(!) in attorney fees, for which it sued the shareholders in district court.[25]

The 1969 agreement appeared to warrant the correctness only of a balance sheet from earlier in the year, but a year-end balance sheet was supplied to KDI. The court was able to construe the contract to also warrant the correctness of that year-end balance sheet, which failed to reflect the tax liability. Therefore, a breach occurred, and the only defense was whether a release in the 1970 sale-back agreement waived it.

The district court held for the defendants on this release, even though the existence of the tax liability was unknown by KDI when the release was executed in 1970. But the defendants had also agreed to assume all liabilities related to the business they reacquired in 1970, and the court held that this included the tax liability. KDI was not barred from recovery by a representation it made that there were no undisclosed liabilities. The court granted judgment for KDI for the full amounts sought.

4. Agreement to arbitrate taxes. Tyco International Ltd. spun off CIT Group Inc., which later went into bankruptcy. The two corporations were parties to a tax agreement entered into in connection with the spinoff. Tyco wanted to collect some taxes from CIT and to arbitrate the liability dispute with CIT under the arbitration rules of the agreement. The court held that that was permissible, even though the agreement had been rejected in the bankruptcy proceedings.[26]

5. What a continuation of business enterprise representation really means. The plaintiffs in *Metcoff* were shareholders of a corporation acquired by a larger corporation in a reverse triangular merger.[27] They became unhappy because the acquirer terminated the business of their prior corporation, and so the former shareholders sued for that and other reasons. The district court struck the count that was based on a representation that the acquirer had no intent to terminate the business, which had been inserted to qualify the reorganization. The court said this did not bind the acquirer to continue the business indefinitely.

6. Implied contract to properly compute earnings and profits. In *Estate of Mikulski*, the plaintiff shareholders obtained a class certification and defeated removal to federal court for their claim that the corporation breached the implied terms of the stock certificate by overstating its earnings and profits and treating more of their distributions as dividends and less as return of capital.[28] This calls into question the common disregard of the earnings and profits account of domestic corporations.

7. Contractual protection. In the unlikely event that "contractual protection" has been provided for a tax outcome, a transaction may be reportable, according to the regulations.[29]

E. Lessons to Be Learned

This potpourri of acquisition- and corporate-related litigation about tax suggests the following:

- General releases for tax liabilities are treacherous. Be sure whether a release is limited to known or to both known and unknown liabilities and whether the counterparty hid the liability.
- Tax stuff can happen in three months. If a balance sheet is not "brought down" to closing, you're stuck with a prior balance sheet, which may have become inaccurate by closing.
- When tax-sharing or tax allocation agreements are used in spinoffs, they are always negotiated to favor the interests of the distributing corporation, except in the odd case in which the historic management goes with SpinCo. Beware of those agreements.
- Don't count on zealous assistance from the prior owners. Offloading a tax fight with a tax collector onto the acquirer of a business is asking for trouble unless the business in the buyer's hands is liable to the collector for the tax.

---

[23] *LASMO PLC v. Ultramar Corp.*, No. 3-95-CV-00371 (D. Conn. 1997).

[24] *KDI Navcor Inc. v. Commissioner*, T.C. Memo. 1976-77.

[25] *KDI Corp. v. Vollstedt*, No. 76-594 (D. Ore. 1978).

[26] *CIT Group Inc. v. Tyco International Ltd.* (*In re CIT Group Inc.*), No. 09-16565 (Bankr. N.Y. 2012), *aff'd*, No. 12-1692 (2d Cir. 2012).

[27] *Metcoff v. NCT Group Inc.*, No. X04CV040184701S (Conn. Super. 2006).

[28] *Estate of Mikulski v. Centerior Energy Corp.*, No. 94536 (Ohio App. 2011).

[29] Reg. section 1.6011-4(b)(4).

- The term ''net'' is almost never self-defining. If it means net of tax, say so.
- Mixing target shareholder status and interests with target employee status and interests is both a necessary and dangerous complication in most acquisitions of private corporations. The practitioner at the most risk here is the one trying to represent the shareholder-employee and her target corporation.
- Bankruptcy happens. Always evaluate the wisdom of a contract term against the possibility that the counterparty may become a debtor in bankruptcy and that persons you don't even know about, such as creditors, could be enforcing that contract.
- For reorganization representations, consider the possibility that someone might look at a ''tax representation'' in a merger agreement and treat it as a real business representation.

III. The Employment Cases

A. The Problem

A payer's filing of Form 1099 with the IRS showing that it paid income to a person theoretically doesn't prove that the person received taxable income. In practice, however, the Form 1099 filing will put the payee in a world of trouble with the IRS if he doesn't also report the income on Form 1040. Payers are highly likely to file the Form 1099 for any and all involuntary payments because they didn't want to pay in the first place and surely won't forgo a deduction, which may be linked to the taxability of the income. If the payee or his lawyer thinks about the problem in advance, he may try to obtain an agreement not to report, or at least an agreement not to reveal the payment, which in hindsight may look like an agreement not to report or even an agreement not to claim a deduction.

In some of these cases, the includability of the payment in income actually may be uncertain, as it was for damages for personal injury until the Supreme Court cleared up most of the uncertainties and the statute was amended.[30] In other cases, the treatment may be uncertain because the parties' business agreement is unclear.

B. Withholding Cases

When the relevant form is the Form W-2, the stakes are even higher because the payer has withheld and the payee has to seek a refund from the IRS (or not; sometimes the payee just sues the payer). From the employer's viewpoint, if it's going to report the payment of income, it may as well withhold employment taxes. Experienced counsel will see this issue coming when the payment arises out of litigation, but it is not always anticipated.

For example, the postal service settled a claim with an employee and agreed to pay an amount for pain and suffering, stating that ''the Postal Service agrees to pay the sum of $400,000 minus standard deductions to Harley D. Crosby. The matter of tax liability is understood to be exclusively between Crosby and the Internal Revenue Service.'' The postal service withheld income tax and FICA tax, and the employee filed another petition to enforce the settlement to require payment in full. The court held that the agreement contemplated the tax withholding.[31]

In another case, settlement was reached and the parties asked the court to determine whether withholding was required, which it did require. The opinion stated that the parties' failure to agree on withholding did not void the settlement agreement because ''terms relating to the tax treatment of a settlement agreement are not considered essential, but rather are part of the implementation of the settlement agreement.''[32] This is an important principle.

Withholding issues sometimes arise when negotiating the settlement of tort actions. When a settlement figure is reached, the defendant always wants it to be gross, but the plaintiff may want it to be net (or be grossed up for taxes) if there is any ground for uncertainty about the taxability. One case had to go to a court of appeals just to find out that a factual hearing was required to determine what had been agreed to.[33]

In an analogous case (not involving withholding, however), a utility company settled a class action by agreeing to provide $390 million in rate reductions, which it did.[34] The class plaintiffs then claimed that because the utility had paid less gross receipts tax as a result of the decline in its gross receipts, the tax savings should be added to the judgment. The trial court agreed, but the Second Circuit did not.

C. Reporting Cases

''Miscellaneous income'' is the most common category for reporting income to a former employee when the employer decides not to withhold. The arrival of the Form 1099 in the payee's mailbox maybe a year later comes as a surprise and has triggered a lot of second lawsuits.

[30]*See Commissioner v. Schleier*, 515 U.S. 323 (1995).

[31]*Crosby v. U.S. Postal Service*, No. 00-3155 (Fed. Cir. 2000).

[32]*Josifovich v. Secure Computing Corp.*, No. 07-5469 (D.N.J. 2009) (citing other cases).

[33]*Beihua Sheng v. Starkey Laboratories Inc.*, 53 F.3d 192 (8th Cir. 1995).

[34]*County of Suffolk v. Long Island Lighting Co.*, 266 F.3d 131 (2d Cir. 2001).

1. Confidentiality agreements — 'law and business necessity.' *Duse* seems to be the most widely cited opinion in this area.[35] Bernard Duse sued his former employer, IBM, for reporting to the IRS that the amount it had paid him in settlement of a race discrimination suit was miscellaneous income.[36] The settlement agreement required IBM not to disclose the settlement except as required by law or business necessity (this is a standard term). The court held that the amount was not excludable from Duse's income, and it dismissed the complaint. IBM was required to file the report because most of Duse's claims were for economic damages that arose out of the employment relationship and were not clearly excludable compensation for personal injury. The court did not determine the taxability of all of the payment because it was unclear, but the facts at least created a business necessity for IBM to file the report. For the same reason, the court found that IBM did not intentionally inflict emotional distress.

In another case, Casey Haugland sued his former employer, a brokerage firm, for breaching a confidentiality agreement by reporting a settlement to the IRS.[37] The firm filed a Form 1099 showing that it had paid Haugland about $25,000, which was an amount owed on a note to the firm that was forgiven in the settlement of Haugland's employment termination dispute. Haugland did not report the amount and notified the IRS that the Form 1099 was erroneous, but the IRS assessed additional tax and Haugland paid it. The district court denied Haugland's claim against the firm for reimbursement of the tax based on breach of the agreement, because it found that Haugland failed to prove he didn't owe the tax. The court did not decide whether the contract contemplated the filing of the Form 1099, but it dismissed on the ground that Haugland failed to prove any loss.

Another court found that it was a business necessity for a former employer to report to the IRS a settlement of an employment discrimination suit.[38] Thus, the Form 1099 could not have been filed in retaliation for the plaintiff's claim and could not be the basis for a second employment discrimination action.

2. Check sent to lawyer. Another case involved a mediated wrongful termination claim by Luanne Nierenhausen against the May Department Stores Inc.[39] May agreed to pay $27,500 by check to Nierenhausen's attorneys, and it agreed to pay Nierenhausen's share of the mediation fee by check directly to her. The agreement stated that May would send Nierenhausen's attorneys a Form 1099 for the amount paid to it. May sent that Form 1099 but also sent a second Form 1099 to Nierenhausen for the combined amount paid to both her and her attorneys. She sued May for liquidated damages and won. The court found that May had agreed to send only the one form to the lawyer and that the law did not require it to do otherwise. Also, the contract was not against public policy.

This is a somewhat unusual holding because the income did not belong to the attorney. The Supreme Court held in a different case in 2005 that all of the recovery was income to the plaintiff and that the plaintiff owed a fee to the attorney.[40]

3. Correct the Form 1099. Robert Ward sued the defendant insurance company to correct a Form 1099 it had filed showing that it had paid him income for the amount of a settled claim that exceeded policy limits.[41] The settlement agreement did not say how the amount would be treated for tax purposes or say that the insurer would or would not report it. The agreement described the settlement as for damages that both might and might not be taxable. Therefore, the insurer did not breach the contract by filing the form and did not have to amend it.

4. Confidentiality. Brian Kelly won a settlement against a debt collection agency, which paid him the settlement amount and reported the payment to the IRS.[42] The settlement agreement included a nondisclosure agreement. Because of the IRS filing, Kelly moved to renege the settlement and proceed to trial. The magistrate recommended against this because the agreement did not address tax treatment, the payment could reasonably be viewed as taxable, and Kelly should have known that reporting could occur.

In *Elwood*, a bank customer sued the bank alleging that a bank employee stole his identity.[43] The

---

[35]*Duse v. International Business Machines Corp.*, 252 F.3d 151 (2d Cir. 2001).

[36]The plaintiff sued again claiming that IBM had defrauded the court by failing to reveal that it was treating Duse as an independent contractor, but the court found that the earlier court and Duse had been so informed. *Duse v. IBM Corp.*, No. 3:02cv707 (D. Conn. 2002). *See* Helen M. Kemp, ''Taxability of Settlements in Employment Cases,'' 12 *Conn. Law*. 12, 17 (2001-2002).

[37]*Prudential Securities Inc. v. Haugland*, 973 S.W.2d 394 (Tex. App. 1998).

[38]*Ezra v. State*, No. B216144 (Cal. App. 2010).

[39]*Nierenhausen v. May Department Stores Co.*, No. B191105 (Cal. App. 2007).

[40]*Commissioner v. Banks*, 543 U.S. 426 (2005).

[41]*Ward v. American Family Life Assurance Co.*, 444 F. Supp.2d 540 (D.S.C. 2006).

[42]*Kelly v. Wright*, No. 08-5991 (D. Minn. 2010).

[43]*Elwood v. Bank of Am. Corp.*, No. 408CV123 (D. Ga. 2009).

case was settled with a confidentiality agreement, and the bank filed Form 1099. The customer sued the bank in state court for filing the Form 1099, and the bank removed the case to federal court. The federal court sent the case back to state court, finding that no federal issue was involved. The bank asserted that it might rely on section 6041(a) as compelling it to report the payment, but the federal court said it had not made that defense an issue of the case and it was not an issue at that point.

5. Anyone can file a Form 1099. In *Sticks*, a corporation and a shareholder sued the corporation's CFO for breach of various duties and settled for $150,000.[44] The CFO sent a Form 1099 to both the corporation and the shareholder reflecting $150,000 of income. They unsuccessfully sued the CFO for doing so, and the CFO claimed that their attorney should pay his legal expenses. The court refused to grant that order because there was some ground for the plaintiffs' second complaint against the CFO.

6. 'Free stuff.' Cable users had been receiving free service from Bright House Networks LLC for years under a contract promising perpetual free service. Bright House terminated the free service, and the users sued and won a recovery. Bright House filed Form 1099 for the year it paid the judgment. The plaintiffs claimed the judgment amount was supposed to be a net amount, that Bright House had never previously filed Forms 1099 for free service, and that it did so for the plaintiffs because they sued. The court allowed some discovery of Bright House's practices.[45]

D. Independent Contractor Cases

An employee does not normally sign a contract providing that he is an employee, but if the employer plans to treat him as an independent contractor, the employer likely will propose a contract, largely for tax purposes. A fraudulent (or desperate) employer can be tempted to breach the contract and withhold, particularly if the employer fails to pay the withheld taxes over to the IRS.[46]

An Ohio employee found his employment status involuntarily converted to independent contractor status, and he sued the employer for breach of contract to withhold.[47] The court dismissed the claim on the grounds that the employer had not helped itself and that the employee was better off because he got a larger take-home check. So whether or not there was a contract to withhold, the employee was not damaged.

[44]*Sticks Inc. v. Hefner*, 829 N.W.2d 191 (Iowa 2013).

[45]*Bright House Networks LLC v. Cassidy*, 129 So.3d 501 (Fla. App. 2014).

[46]*E.g.*, *Poche v. Texas Air Corps*, 549 F.3d 999 (5th Cir. 2008).

[47]*Jaberg v. Kayline Co.*, Nos. 73169, 73392 (Ohio App. 1998).

IV. Debt Discharge Cases

The Great Recession produced a lot of bad debts, which banks eventually wrote off. Many of the debtors were former homeowners and other individuals who are unlikely to feel they have earned income in those situations. Hence, they don't like being told they received income, regardless of whether they can figure out it's excludable under section 108.

In one case, the court held that the bank did not breach its contract by reporting the forgiveness of the plaintiff's debt.[48] The settlement agreement said nothing about tax reporting, so there was no contract to be breached.

In another case, a credit card debtor sued a bank for reporting discharge of indebtedness income, and other breaches of contract.[49] She relied in part on section 7434, which creates a right for civil damages against anyone who "willfully files a fraudulent information return." The court dismissed the section 7434 claim because Form 1099-C is one of the few information reporting forms not listed in the definition of information return under section 6724(d)(1)(A). In another case, the district court missed that exception, although the circuit court found it.[50] In any event, the debt was owed and discharged, so the filing of Form 1099-C could not have been improper. But a later opinion noted that the exception for the Form 1099-C applied only to banks and that if a non-bank creditor forgave a debt, it could file a Form 1099-MISC and be held liable if the filing was fraudulent.[51]

In an Arizona case, the bank issued a Form 1099-C but continued collection efforts and sued the debtor for the debt. The court found that the filing of the form was evidence of the fact of discharge, even though the bank had "corrected" the filing.[52]

Banks report all sorts of income in addition to discharge of indebtedness, interest being foremost. A huge dispute arose over the name in which interest on Series EE bonds was reported, and it went to Ohio appellate courts multiple times on the pro se plaintiff's claims that the Form 1099 was incorrect.[53]

[48]*McClusky v. Century Bank FSB*, No. 14-3419 (6th Cir. 2015).

[49]*Watson v. Citi Corp.*, No. 2:07-cv-0777 (S.D. Ohio 2008).

[50]*Cavoto v. Hayes*, 634 F.3d 921 (7th Cir. 2011).

[51]*Angelopoulos v. Keystone Orthopedic Specialists*, No. 12-cv-05836 (N.D. Ill. 2014).

[52]*CoBiz Financial v. CF Homes LLC*, No. 1 CA-CV 09-0711 (Ariz. App. 2010).

[53]*Lewis v. J.E. Wiggins & Co.*, Nos. 04AP-469, 04AP-544, 04AP-668 (Ohio App. 2004).

V. Partnership Cases

Partnerships are fertile fields for breach of contract and bad-faith reporting because of the greater uncertainty of partnership tax law and the unusual relationships formed. For example, most partnerships provide for distributions of amounts the partners will need to pay for their taxes on the partnership income, and partners may have to sue to get the cash.[54]

An accounting partnership broke up, and the departing partners took some receivables and other accounts. The remaining partner reported the events to the IRS in a way that would increase the taxable income of the departing members and decrease his taxable income. The court held him liable under section 7434 for filing fraudulent information returns.[55]

VI. Practical Advice

Situations in which a payee may be at odds with the payer or in which counterparties become at odds are precisely the situations in which the problems of reporting and withholding described above occur. For that reason, mutually agreeable solutions by contract are unlikely, misunderstandings are likely, and breach of contract is likely.

The best practical advice is obvious: Don't ignore the tax implications in any contract negotiations, and try for a binding resolution of tax treatment and future actions regarding tax reporting. When that is not possible and the parties agree to disagree, the payee should ask for the next best thing: a gross-up for taxes. Courts have found such an agreement for parachute payments does not violate public policy.[56]

When gross-up is impossible, the party that knows its reporting will be inconsistent with the other party's should try to at least avoid penalties by making some sort of disclosure. Unfortunately, Form 8082, which is used to give notice that the taxpayer is taking an inconsistent position, applies only to partners, S corporation shareholders, and trust beneficiaries.

Finally, suing the other party for breach of contact regarding tax reporting probably isn't worth it for anyone but pro se plaintiffs. ■

[54] *E.g.*, *Interactivecorp v. Vivendi Universal*, No. 20260 (Del. Ch. 2004).

[55] *Pitcher v. Waldman*, Nos. 14-3369, 14-3392 (6th Cir. 2015).

[56] *See Campbell v. Potash Corp. of Saskatchewan Inc.*, 238 F.3d 792 (6th Cir. 2001).