

Did You Discuss Tax Indemnity In Settlement Talks?

By Robert W. Wood

You just agreed in principle to settle a big case for your client, and you are trying to get the deal inked. Whether you represent the plaintiff or the defendant, your client will almost certainly face tax issues. Depending on your role in the case, you may be drawn into them too. The first sign there is a tax issue may be a draft settlement agreement that says something about tax withholding, Forms 1099, or tax indemnity.

But somehow, tax issues may come up. If you are lucky, there will be tax advisers involved on one or both sides of the case to explicitly address the tax issues. However the tax issues are raised, you should have someone on your team address them. Ignoring the issues, or assuming they can be dealt with after the money is paid, may not be wise.

Some lawyers insist that their client hire a tax adviser. Some lawyers try to muddle through themselves. One common issue that lawyers seem used to handling is a tax indemnity provision that may seem to obviate the tax issues. It might go something like this.

The defendant is settling all claims and paying the plaintiff \$X for a complete release. The settlement agreement recites the fact that the defendant has given no tax advice to the plaintiff. It says that the plaintiff agrees to pay his or her own taxes, and that the defendant will issue an IRS Form 1099. The settlement agreement goes on to say that if the defendant incurs any tax problem on these funds, the plaintiff will indemnify the defendant.

Is this a good idea? Is there any tax impact? Does it hurt anything? Does the defendant even need any tax advice in this case? After all, the tax indemnity provision seems to put the issue back on the plaintiff, correct?

Let's leave aside the question whether the plaintiff might need tax advice too, though that is usually also a good question. The tax indemnity provision may not be all that it seems to be. First, some lawyers worry that a tax indemnity provision is an admission to the IRS that there is a tax game afoot.

Let's dispense with that canard first. Tax indemnity provisions are very common in all types of agreements, and they are unlikely to be viewed as a red flag by the IRS. Nevertheless, such provisions are unlikely to be very useful either in many legal settlement agreements. This is especially true 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 indemnity 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 does.

For example, what if some or all of the settlement payment to the plaintiff is really wages? In our example, the defendant issues a gross check and reports the settlement figure on a Form 1099. Of course, in virtually every employment case, at least some of the settlement payment should be wages subject to withholding.

That does not mean that 100 percent of the settlement payment is wages, but failing to consider wage exposure would be a mistake. And plainly, if there is any liability for failure to withhold income and employment taxes, it resides squarely with the defendant employer. The IRS will pursue the defendant for all the withholding money 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.

And then there is the 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 litigation is likely to backfire. If the defendant *thinks* that some or all of the settlement money is wages, the defendant should withhold.

Most often, the money should be allocated into several categories. To be sure, reasonable minds may differ on whether 10 percent or 90 percent is wages, or something in between those extremes. But a *portion* of the settlement is probably wages. The 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 and yet still settle and still not withhold, reporting the entire payment on a Form 1099. It happens. Employers sometimes settle a case that they feel from a business viewpoint *must* be settled. The plaintiff might insist that if there is any withholding, the plaintiff will not settle.

In an ideal world, perhaps the defendant should offer more money to settle, so that it can withhold and the plaintiff can still get a net payment that the plaintiff finds acceptable. But in the real world, the defendant may agree to run the 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 withholding tax risk." What seems silly, though, is if the defendant convinces itself that there is *no* risk because there is an indemnity provision.

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

The defendant may believe that the settlement payment it is really a payment for emotional distress, and therefore is 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 cover penalties for failure to issue a Form 1099.

The main IRS penalty for failure to issue a Form 1099 is only \$100, unless the defendant is found to have been *willful*. In that case the penalty would be much more serious, 10 percent of the settlement payment. (In practice, such 10 percent penalty assertions are quite rare.) In any event, indemnity provisions in such situations may make more sense than where wages and withholding are involved.

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

Indeed, a tax indemnity provision often may seem to offer the promise that the tax risk is obviated. However, whenever possible, get some tax advice too. And try not to rely too heavily on a tax indemnity provision as a substitute for analysis. It can be pretty upsetting to have your client complain several years later that the indemnity provision you recommended did not protect them after all.



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