

Don't Forget About Tax Issues When Mediating

An effective settlement depends upon closure, and to fully conclude a matter, counsel need to be aware of the tax implications of their agreement.

Mediation is by definition nonbinding. The mediator's role is to bring the parties to the bargaining table, and once there, help them discuss their respective interests, analyze the strengths and weaknesses of their positions, and assist them in reaching a mutually acceptable resolution of the problem. Mediators vary in their approaches to this herculean task.

Many spend time in a joint session, and then in separate sessions with each side. Sometimes the entire mediation is conducted with the mediator shuttling between rooms, never holding a joint session. We may think of mediation as involving only two parties, but many multi-party disputes are also resolved in this way.

The nonbinding nature of mediation can be considered a weakness, but is arguably more of a strength. Frequently, the parties would not be willing to meet to discuss their case in anything but a nonbinding context. If the mediation is unsuccessful, they simply walk away and everything that has been said is confidential and cannot be used as evidence later on. And,



if the mediation yields a settlement, the terms of the deal will need to be reduced to writing.

As part of that documentation, tax details should be considered. Arbitration, as distinguished from mediation, may be binding or nonbinding depending on the nature of the matter, prevailing contracts, and governing law. Even in binding arbitration, though, certain aspects of a decision can be overturned by the courts.

Tax Issues Lurk Beneath the Surface
Focusing just on mediation, though,

the question is how to handle the inevitable tax consequences that will flow from resolving a non-tax dispute. Examples include:

- **Employment Disputes.** Suppose a fired employee sues the company for wrongful termination, age discrimination, etc. There are no tax issues in the dispute, but there will invariably be tax consequences when the dispute is resolved. The tax issues may include: (a) whether all the payments are wages subject to withholding; (b) the appropriate allocation

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between wage and nonwage damages; (c) whether any equity or stock option compensation is to be paid; (d) if any equity feature can be taxed as equity rather than ordinary income; and (e) how withholding, Forms 1099, etc., will be handled.

• **Intellectual Property Claims.**

Suppose one party uses the intellectual property of a competitor and the dispute is mediated. If the defendant agrees to pay the plaintiff \$5 million, how will the parties characterize it for tax purposes? Will the plaintiff insist on it being treated as capital gain and reported as such? Will the defendant agree?

• **Personal Physical Injury Case.**

Suppose a plaintiff is injured in a serious automobile accident in which the defendant manufacturer's vehicle malfunctions. Such a dispute may be mediated pre-trial or post-verdict while the case is on appeal. Assume there was an award at trial for compensatory damages (\$5 million), punitive damages (\$20 million), and interest (\$1 million). The case is mediated on appeal and the parties agree to resolve the dispute for \$10 million. How will the payment be treated for tax purposes? Will it all be tax-free as compensatory damages, or is some of it punitive damages or interest? What will the plaintiff and defendant agree to in the settlement agreement?

• **Property Damage Claim.**

Suppose the plaintiff homeowner has insurance issued by the defendant. Plaintiff suffers a significant loss due to mold at plaintiff's home. Plaintiff sues for property damage, relocation expenses, and personal physical injury (or sickness) damages from mold inhalation. If the dispute is mediated, what will the parties request and what should the settlement agreement say about tax treatment?

These are merely a few examples. A complete list would be virtually endless. None of these cases is a tax dispute, yet a payment to resolve the matter inevitably raises tax issues. If a settlement is reached, monies will be paid and documents must be prepared. Plaintiff and defendant will need to

consider tax issues before tax reporting and return filing time the following year.

What Should You Document?

How much in the way of tax-related documentation should be prepared at the conclusion of the mediation? How much should be prepared later, and precisely what is binding?

In mediation, you summarize your case and focus on key points. Each side tries to convince the mediator, who works on both sides.

Some mediations end in full-blown settlement agreements. But in many cases, the parties sign a term sheet at the conclusion of a successful mediation, indicating that they have tentatively resolved the case for a specified payment. The term sheet usually says the parties will cooperate to produce a final settlement agreement that both parties will sign.

However, what happens if the final settlement agreement is never executed? Is the term sheet itself binding if a more comprehensive settlement agreement has not been completed?

For clarity, it may be better for a term sheet to come down one way or another on this point. It 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 formal settlement agreement, the case will still be considered settled based on the term sheet as a binding document. It is even possible for the term sheet to invoke the mediator's role to try to help the parties to reach a final settlement agreement.

The primary issues in a term sheet are the dollars, timing, who pays, who receives, when the money is due, enforceability and confidentiality. Plainly, these are not tax-related. But no matter how the parties decide to proceed, they may ultimately have to address tax issues.

Is an Immediate Agreement Best?

What if the parties do not sign a term sheet but instead proceed directly to a binding settlement agreement signed before the parties leave the mediation room? This approach has advantages and disadvantages. On the plus side, the parties walk away with a complete

settlement agreement. Done deal. Case closed. On the minus side, the parties will almost certainly be rushing to complete their agreement, perhaps after a long mediation. It may be late at night, and everyone may be tired. Proximity and resources can also play a part. Often, the mediation will take place in a third-party location such as a mediator's office.

The lawyers may be drafting a settlement agreement on their laptops and may not have their full resources available. There may not be time to reflect on all of the provisions and issues. If a binding settlement agreement is signed and there is no further documentation, there may be little opportunity to catch errors or reflect on problems created by a hastily created draft.

Almost inevitably, there are post-mediation tax issues. The real issue is when and how will they be addressed? There may be little time to discuss tax points or to solicit and implement tax advice in the hasty, closing moments of a mediated matter.

Prepare Wisely

A better approach is to receive tax input before the mediation takes place.

For example, in an employment dispute, the parties will probably have considered the "wage v. nonwage" question, at least in a general fashion. If there are arguments for excluding some damages under Internal Revenue Code Section 104 (the personal physical injury exclusion), the parties should think about this in advance. The plaintiff should be prepared to assert how much of an exclusion seems reasonable and how it can be documented. The defendant should be prepared to develop a position about what it is willing to do.

In extreme cases, the defendant will not know whether it should withhold on some or all of the settlement. The defendant may be unclear whether it can or should issue a Form 1099 for some or all of the payments, and if so, to whom they should be issued. The plaintiff may be equally uninformed.

As a result, the plaintiff may be upset the following January, when Forms 1099 and W-2 are filed by the defendant. In many cases, the parties do not seriously consider the tax issues until after—sometimes long after—a dollar figure has been agreed upon. It is un-

likely that all the appropriate tax issues will be vetted and that the tax guidance will be implemented by the end of the mediation.

Moreover, even if there has been some level of tax discussion, it is almost inevitable that some tax issues will be mishandled if the settlement agreement is signed in haste. The defendant may agree to things it may later regret. The plaintiff may not even request the right concessions. Tax misinformation is often rampant at bargaining sessions.

Helpful Tips

If a complete settlement agreement must be signed before the parties have the time or expertise to consider tax issues, problems may arise. In this mash-mash, what's the right approach? Here are several key steps to follow:

- 1. Pre-Plan.** Do not go to mediation without at least a basic understanding whether there are any tax issues and, if so, what they are. That could mean as little as a brief phone call with a tax adviser beforehand, or something more extensive.
- 2. Flag the Issues.** If you have tax issues, flag them at mediation if you can. Even if there is nothing in the term sheet about taxes, do not sign a settlement agreement or term sheet without at least raising tax issues you think are important.
- 3. Commitment to Cooperate.** If possible, go beyond oral reference to tax issues. The term sheet could say that the parties will cooperate on tax language in the

settlement agreement.

- 4. Protect the Client's Interest.** If possible, go beyond such mere tax cooperation language. A plaintiff may want the term sheet to say that there will be tax language in the final settlement agreement that is "acceptable to the plaintiff." That may put the plaintiff in the driver's seat. Later, the defendant might agree to a particular tax treatment. Perhaps the defendant will ask the plaintiff to provide a tax opinion to the defendant. Hopefully, the issues can be worked out.
- 5. Be Specific.** If the tax issues are pivotal—such as a plaintiff not wanting to settle a case unless the money will all be tax-free—get even more explicit in the term sheet, and the settlement agreement.

6. Regardless of who raises the tax issues, know your client's position what it is based on, and be prepared to express it. For example, if the entire settlement will be taxed as wages subject to withholding, say so early. Having a settlement fall apart over tax issues that have been pushed under the table can be a real mess.

IRS Information Returns

Don't forget about IRS Form 1099!

What IRS reporting forms are prepared can have a huge impact on the plaintiff's tax position. If the term sheet and comprehensive settlement agreement are silent on the tax reporting, the plaintiff will have no recourse if the forms are prepared in conflict with how the plaintiff believes they *should* be prepared.

Every year I receive phone calls and emails from plaintiffs who have received a Form 1099 for a settlement they thought was tax-free. Many *assumed* their settlement would involve no Form 1099. 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, it is generally easy to contact the defense lawyer and assert that the settlement agreement has been breached. Usually, the error can be straightened out with no tax damage. In contrast, if the settlement agreement is not specific, contacting the defense attorney or defendant at Form 1099 time—usually the following January—is unlikely to work.

If the point comes down to debating the legal requirements for issuing such tax forms, it is likely that the position the defendant has taken is within the law or within a reasonable interpretation of it. The rules are complex. Besides, it is difficult to convince someone to undo something when they have no legal obligation to do so, especially in the aftermath of litigation.

Conclusion

Plaintiffs, defendants, counsel, and mediators each have something to accomplish in mediation. Taxes may be a low priority, but not if the mediation goes well. One way or another, try to address tax issues sooner rather than later. Whether you represent plaintiffs, defendants, or are acting as a mediator, you will be glad you did.