PERSPECTIVE

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Lawyers, Clients Dance The 'Taxes Two-Step'

By Robert W. Wood

Lawyers and their clients often face tax issues. Lawyers help their clients to close deals, transfer property, settle estates, pursue debt collection, prosecute and settle legal disputes, and handle thousands of other matters. In just about every situation, money changes hands somewhere.

That usually means there are tax issues for one or both parties. For the lawyers, too.

Even *identifying* the tax issues can be tough, much less addressing them. So, deciding when you or your client need tax advice isn't always easy. Ask if you aren't sure.

The tax code has vast interconnected and conflicting provisions. Then there are revenue rulings, regulations and all manner of advisory items from the IRS. Some are not even technically authority in a legal sense, but they are still important. Then, there is the tax case law, where by definition, the taxpayer and the IRS disagree and go to court.

In contrast to many types of transactions, the tax treatment of litigation payments and recoveries is actually among the more straightforward tax issues. Settling litigation usually involves few code provisions and regulations. Even the case law focuses on the facts and the nature of the dispute and how it was prosecuted.

Someone is paying, and probably deducting it. Someone is receiving money, and probably has income. The tax disputes are usually connected to the underlying facts and the emphasis of the litigation. That does not mean there are no disputes. It also does not mean that everything is what you call it.

And that is where the taxes two step comes in. You may need tax advice to be able to take the first step. You certainly will for the second. But you may be able to handle the first step yourself, and it is worth considering it. Just what is the taxes two step?

The first step is about considering taxes before you or your client sign a settlement agreement. The plaintiff is receiving money, the defendant is paying it. That usually means a deduction to the defendant (business defendants, anyway). And it usually means income to the plaintiff. But can you avoid or shape that result? Often, yes.

Try to put your best foot forward, and say what the payment is. If the payment should be tax-free physical injury damages, say that, and try to get the defendant not to issue an IRS Form 1099. If there are wages being paid (such as severance pay), say that. And consider the tax reporting too.

If you represent a defendant and are paying severance, consider tax withholding. Defendants, tell the plaintiff you are going to withhold taxes and issue an IRS Form W-2. Defendants do not want to tender a settlement check with taxes deducted and have the plaintiff refuse to accept it.

Plaintiffs should try to argue for their position (it shouldn't be taxable at all, it shouldn't be subject to withholding, etc.). Be sure to consider tax reporting and tax payments. Everyone should have a sense of what to expect when they sign the settlement agreement and the money changes hands. You don't want to be surprised the following January when IRS Forms 1099 arrive.

So, the first step is trying to do your best with tax language in a settlement agreement. What is the second step in the taxes two step? Documentation. Even if you have a settlement agreement that is pretty clear what all the payments are, the IRS is not bound by it. Neither is the California Franchise Tax Board.

The IRS and FTB can and do look behind a settlement agreement, and may find something very different. There have been many tax cases in which taxpayers have prevailed when faced with an IRS query on the tax aspects of their settlements. There is some luck involved, but good documentation is essential.

After all, it is the taxpayer that has the burden of proof. No matter how good the language in a settlement agreement may be, tax language in a settlement agreement is not the be-all and end-all of the desired tax treatment. Get a tax opinion after the settlement to support your allocation. Don't wait for an audit.

There is never enough time to get your ducks in a row when an audit arrives. It is unlikely that you will give the IRS or the FTB a copy of your opinion. Opinions should be kept privileged between lawyer and client.

Cutting and pasting from the opinion to create advocacy letters (and if necessary briefs) is the best use of a tax opinion. You may be able to make an audit go away by early and convincing letters. Besides, getting an opinion will force you to be organized.

Preparing an opinion on the tax issues requires collecting the key documents and evidence that supports the opinion. Make a binder of the documents you collected. It might include the complaint, the settlement agreement, and mediation or other briefs that summarize claims and damages.

It might include expert reports, damage studies, or appraisals. It might include declarations letters from lawyers, doctors and others prepared after the conclusion of the case. And it should contain any pertinent tax reporting forms (W-2 and 1099), including any correspondence the parties had once those forms were issued.

Try to collect all you can while the case is still fresh. If there are holes in the record that might weaken the tax arguments, consider whether you can fill them. Letters or declarations from lawyers, parties, and third parties about particular claims, and particular evidence can be very helpful. It is true that they may be viewed as window dressing, prepared after the case.

But they can still be persuasive with the IRS or FTB. And you can almost never get them several years after the case is resolved when a tax audit is under way. You can only get them when the case is fresh, and when it is just a declaration for the tax lawyer's file.

So, try the taxes two-step if you can. You may want to do the second step even if you can't do the first. Sometimes, lawyers and clients don't think about the first step. And sometimes, they try to raise tax issues at settlement, but end up with a general release that says nothing about taxes.

Similarly, sometimes — too frequently — people do the first step and then *assume* it is all done. Be careful with this. The settlement agreement might be quite clear what the tax treatment will be. Then, when the tax reporting forms (W-2 and 1099) it may be less so. The tax preparer may get it all wrong. And even if all of this goes well, if an audit notice comes, you may wish you'd done the second step too.

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