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Legal Settlements With Tax Indemnities Are on the Rise

by Robert W. Wood

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In this article, Wood discusses tax indemnity provisions in litigation settlement agreements, and he explains why they are increasingly important since passage of the Tax Cuts and Jobs Act.

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Tax indemnity provisions generally state that one party will cover taxes if they are due. Such clauses are common in many types of agreements, and often appear in settlement agreements resolving litigation. Now after the passage of the Tax Cuts and Jobs Act (P.L. 115-97) at the end of 2017, they are taking on new importance.

For example, in sexual harassment litigation, or almost any employment case in which sexual harassment is an element, some plaintiffs now request indemnity for the possibility that they may not be able to deduct their attorney fees. In other types of litigation, some plaintiffs can no longer deduct legal fees at all and are also asking for tax indemnity, a kind of tax gross-up.

Plaintiffs in litigation are receiving money, so in general, they are understandably more worried about taxes than most defendants. This has always been true. However, the TCJA has added some new worries that can complicate already difficult tax considerations.

Taxing Attorney Fees

The Supreme Court in *Banks*[1] held that plaintiffs generally must report gross recoveries, even if their contingent fee lawyers are paid directly by the defendant. For tax purposes, the fees are considered first paid to the plaintiff. Reporting the income on a gross basis means that the plaintiff must consider whether, how, and where to deduct the legal fees.

A defendant's legal fees and settlement payments in sexual harassment cases were traditionally deductible business expenses. But under the new "Harvey Weinstein" rule of section 162(q), damages and attorney fees paid for sexual harassment in a confidential agreement are nondeductible. Defendants can avoid this rule if they forgo confidentiality, but many defendants seem willing to give up the tax deductions instead.

The no-deduction rule applies to the legal fees as well as the settlement payments. It is unclear if this rule applies to the plaintiff's legal fees as well. The target of the law is the alleged harasser and the defendant company. Yet the wording seems to prevent any deduction for legal fees in this context. There is already a bill pending, the Repeal the Trump Tax Hike on Victims of Sexual Harassment Act of 2018 (S. 2820), that would change this result for plaintiffs.

It might not pass, however, so plaintiffs worry that they will pay tax on 100 percent of any settlement payment, even if their lawyer takes 40 percent. Notably, the stakes are not just about above-the-line or below-the-line deductions. The

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

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TCJA eliminated miscellaneous itemized deductions until 2026, meaning plaintiffs have no fallback if their above-the-line deduction for legal fees is disallowed under the Weinstein rule.

Some plaintiffs are requesting tax indemnity from defendants if they are unable to deduct legal fees. Here are two examples, the first short and simple, and the second more comprehensive:

1. Defendant concedes that Plaintiff alleges sexual harassment, and that recent changes in the tax law may affect the settlement of the claims. The parties acknowledge that Plaintiff may be unable to deduct her legal fees and costs from her recovery for purposes of federal or state income taxes. In this case, Defendant agrees that it will promptly reimburse and indemnify Plaintiff for all taxes, penalties, and interest attributable to such legal fees and costs.
2. Defendant concedes that Plaintiff alleges sexual harassment, and that recent changes in the tax law may affect the settlement of the claims. Because of those recent tax law changes, the Parties acknowledge that Plaintiff may be unable to deduct her legal fees and costs from her recovery for purposes of federal or state income taxes. If Plaintiff is unable to deduct her legal fees and costs, or if she claims them as tax deductions but her deductions are denied by the IRS or California Franchise Tax Board, Defendant agrees that it will promptly reimburse and indemnify Plaintiff for all taxes, penalties, and interest attributable to such legal fees and costs. To avoid doubt, the parties intend that this indemnity will put Plaintiff in the same position she would have been in if she had received and been taxed on only her net settlement under the settlement agreement, after all her legal fees and costs. If Defendant is required to indemnify Plaintiff under this provision, Defendant will promptly reimburse and indemnify Plaintiff for all taxes, penalties, and interest attributable to such legal fees and costs, and will also gross up the amount of the indemnity payment to fully cover all federal and state income taxes on the indemnity payment itself.

Above-the-Line Deduction

Enacted in 2004, the above-the-line deduction for legal fees in section 62(a)(20) has blunted the effect of the *Banks* decision for employment plaintiffs. It has done the same for some types of whistleblower claims, notably including federal False Claims Act cases and IRS whistleblower claims. Paradoxically, though, the presence of the above-the-line deduction has stilled much of the debate and media coverage about the tax treatment of legal fees.

Some people are surprised, even shocked, to learn that they do not qualify for the above-the-line deduction. Some advisers are also worried that the above-the-line deduction is in jeopardy. At least the above-the-line deduction was left intact by the TCJA, right? Yes, but there is one unsettling issue about the above-the-line deduction.

Section 62 allows an above-the-line deduction for a "deduction allowable under this chapter." Technically, it does not create a new deduction. Instead, it promotes an existing below-the-line deduction to make it a (better) above-the-line deduction — but the below-the-line deduction has been suspended between 2018 and 2025.

Arguably, this is a problem Congress or the IRS should clarify, but it is hopefully a glitch that will either be ignored or corrected. Congress surely did not mean to affect the above-the-line deduction.

Moreover, after the TCJA, Congress later extended the above-the-line deduction to SEC whistleblower claims. That was a long-awaited change. And finally, in the pending Repeal the Trump Tax Hike on Victims of Sexual Harassment Act of 2018, Congress would clarify that plaintiffs in sexual harassment cases (which are nearly all employment claims) can still deduct their fees.

In the meantime, some plaintiffs are asking for indemnity on this issue too, and the indemnity clauses can be adapted to this general deduction issue. Many defendants may say no to such requests, but if resolving the case is important and if the plaintiff is adamant about indemnity, the result may be different. Besides, the likelihood that the indemnity language will turn into a payment someday may be remote.

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Discussing Indemnity

Rightly or wrongly, many nontax lawyers seem comfortable handling tax indemnity provisions. They may recognize that indemnity could be needed in case of a tax problem, such as failure to withhold, failure to issue forms, or failure of the plaintiff to pay taxes. It might seem that a solid tax indemnity agreement would handle the taxes.

Of course, an indemnification obligation does not prevent a tax problem, nor does it bind the IRS or state tax authorities. If you are the taxpayer, you have the problem, even if you can go after someone else to try to cover your loss. An indemnification obligation is only as good as the creditworthiness of the indemnifying party.

Moreover, it says nothing about the primary liability to the IRS or to state taxing authorities of the party to be indemnified. The fact that someone else has agreed to cover the tax damage does not mean they will. They may not have the financial ability to repair the tax damage or they may fight the indemnity obligation, whatever the language says.

A tax indemnity provision may lull you into a sense of complacency. Although practitioners often think, "We have indemnity from the other side for taxes, so we are covered," there may be a new round of litigation.

Types of Indemnity

Tax indemnity provisions are common in many types of agreements and are unlikely to be viewed as red flags by the IRS. A tax indemnity agreement probably cannot hurt, but it may not help either. For example, if the defendant is a business and the plaintiff is an injured person or former employee, an indemnity from employee to company may be hollow. The defendant may also take a calculated risk that withholding is required, yet still settle and not withhold, reporting the entire payment on a Form 1099. Employers sometimes settle a case that (from a business perspective) must be settled, even when the plaintiff insists that if there is any withholding, the plaintiff will not settle.

The prospect that a defendant will pursue a plaintiff on a tax indemnity provision may be remote. There is usually little benefit for the defendant, and there can be reasons not to try. Suppose the defendant issues a check for the gross recovery and reports the settlement figure on a Form 1099. Later, the IRS claims that some (or all) of the settlement is wages subject to withholding.

In virtually every employment case, at least some of the settlement payment might be wages subject to withholding. Failing to consider wage exposure is a common mistake.[2] If there is any failure to withhold liability, it resides squarely with the employer. The IRS will pursue the defendant for all the withholding money, interest, and penalties.

As a matter of contract law, the defendant can demand indemnity and try to go after the plaintiff, but unless the indemnification agreement explicitly states 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.

There is also an enormous practical barrier. Many lawyers will advise the defendant not to even try to pursue the plaintiff, since the indemnity litigation can backfire. If the defendant thinks that all or some of the settlement money is wages, the defendant should withhold.

In an ideal world, perhaps the defendant should offer more money to settle. That way, the defendant can withhold if required, and the plaintiff can still collect a net payment that the plaintiff finds acceptable. It may be imprudent, however, for the defendant to convince itself that there is no tax risk because there is an indemnity provision.

Non-Employee Litigation

Tax indemnity provisions can often be more helpful in other contexts. For example, suppose the defendant agrees not to issue a Form 1099 because the plaintiff claims the payment is for personal physical injuries or physical sickness that is tax free under section 104.[3] The defendant

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[2]For further discussion, see Robert W. Wood, "When Defendant Employers Are Sued (Again) for Withholding Taxes," *Tax Notes*, Sept. 7, 2015, p. 1151.

[3]*See* Wood, "Tax-Free Physical Sickness Recoveries in 2010 and Beyond," *Tax Notes*, Aug. 23, 2010, p. 883; Wood, "Is Physical Sickness the New Emotional Distress?" *Tax Notes*, Feb. 22, 2010, p. 977.

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may believe that the settlement payment is really a payment for emotional distress, and therefore taxable. The defendant might say that it will not issue a Form 1099 if it receives a tax opinion from the plaintiff and a tax indemnity agreement. In this case, the indemnity would presumably cover penalties for failure to issue a Form 1099.

The general penalty for failure to issue a Form 1099 is only $250, unless the failure is found to have been willful, in which case the penalty could be much more serious — as much as 10 percent of the settlement payment. In practice, however, 10 percent penalties are rare.

The penalty for intentional failure to issue a Form 1099 seems to be reserved for situations in which it was clear that the payer knew there was a reporting obligation and ignored it. In any event, indemnity provisions in these situations may make more sense than when wages and withholding are involved.

Lawyer Risks

Lawyers are trained to ask for indemnity and to cover as many risks for their clients as they can. Tax indemnity provisions are often written and debated by nontax lawyers, and like confidentiality provisions, indemnity provisions — even about taxes — may seem straightforward.

After all, a tax indemnity agreement may seem to reduce or even obviate the tax risks. However, whenever possible, get some tax advice even if you have a strong indemnity provision. There is a big difference between: (1) feeling comfortable that a small penalty will be covered by the plaintiff if it materializes; and (2) believing that a tax bill for 40 percent of the settlement for failure to withhold taxes will be adequately addressed by an indemnity that may never be collectible.

Understanding the type, scope, and amount of the potential tax problems is a good idea. Tax indemnity provisions are not one-size-fits-all. Even if the scope and meaning of the indemnity provision is clear, there may be significant questions (then or later) regarding whether the indemnifying plaintiff will have any assets to pursue.

If you tell your clients that the indemnity provision protects them, they may believe it. It can be upsetting to have your client complain several years later that an indemnity provision you wrote or recommended did not protect them. That may mean that the lawyer who said, "Don't worry, we've got indemnity," might end up being asked to pay.

Indemnity Payments as Income

Are indemnity payments income? If so, can you require the indemnifying party to gross up any payment for taxes? There is often confusion surrounding the taxation of indemnity payments, but the IRS usually views them as income.[4]

The IRS has frequently asserted that the payment of another person's income tax (directly or indirectly) is gross income to that person.[5] Taxpayers often argue otherwise, citing *Clark* for the proposition that tax indemnity payments are excludable from gross income.[6] Whether a gross-up for taxes is required, that is a drafting issue.

Many parties will not even think of it, and if they do, they may not want to explicitly raise it. A provision that says the plaintiff will indemnify the defendant for all tax consequences of a settlement may be inartful and not specific. However, it may be more likely to be signed than one that is long and says the plaintiff must even gross up any required taxes on the indemnity payment itself.

Conclusion

Tax indemnity provisions are inserted into many types of legal documents in a wide variety of circumstances. Perhaps they are never a bad idea, since trying to get someone else to cover some possible problem generally seems to be a good idea. With taxes, however, the details matter, as does the context and the potential scope of the indemnity. ■

[4] *See, e.g.*, LTR 9833007; LTR 9743035; LTR 9743034; LTR 9728052; LTR 9226033.

[5] *See, e.g.*, LTR 9833007; LTR 9743035; LTR 9743034; LTR 9728052; LTR 9226033; *see also Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929).

[6] *Clark v. Commissioner*, 40 B.T.A. 333 (1939), *nonacq. sub nom.*, 1939-2 C.B. 45; *acq.* 1957-2 C.B. 4.

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