Tax Dangers In Preparing Legal Settlement Checks

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When the mechanics of a settlement agreement to resolve litigation are considered, taxes inevitably come up. Clients want to quantify their net recoveries after attorney's fees and costs. Clients also want to know their net after taxes. Even if the client fails to specifically ask about taxes, it is hard to ignore the fact that tax issues should be considered.

And inevitably, checks must be drawn, something that itself raises tax reporting issues. For example, even if the settlement agreement does not attempt to explicitly deal with tax issues, the manner in which the checks are prepared will influence tax reporting (most notably IRS Form 1099). Inevitably, that means exactly how the checks are cut will influence the manner in which the parties report and pay taxes.

Even more fundamentally, in employment cases, at least some of the payments are likely to be subject to wage withholding. Generally the parties will anticipate this and explicitly provide for the withholding and issuance of IRS Form W–2 for a portion of the monies. But sometimes even this is ignored. Regardless of your role in a settlement, these can be unpleasant surprises if you do not anticipate them.

There are many common problems. In an employment dispute, the plaintiff's lawyer may argue for no wage treatment and therefore no withholding. This may be the lawyer's or the client's idea. The defendant may disagree. But if a defendant agrees to no (or minimal) wage treatment when much of the recovery is really wages, what has the plaintiff achieved?

If there is no wage withholding but the IRS later claims there should have been, the defendant is significantly at risk, since failure to withhold penalties are severe. The plaintiff may agree to indemnify the defendant, and that means the plaintiff is at risk too. Even if there is a good argument that wages are only say 10% of a settlement, what has the plaintiff achieved if there is no withholding on the balance?

The plaintiff may be happier to get a larger check rather than a net check ravaged by withholdings. Since one half of Social Security and Medicare taxes are borne by the employee, the no–withholding solution may save the plaintiff (and the employer) something, at least in the short run.

But if a plaintiff "succeeds" in having no withholding, will the plaintiff be prepared to pay estimated taxes and to handle the burden of paying tax on the settlement in a lump sum the following April? Many are not prepared for this eventuality. This is particularly so if the plaintiff has earned solely wages in the past and is unaccustomed to budgeting for tax liabilities without payroll withholding.

The Latest "Tax Solution"

One current practice that has evidently become common is for the plaintiff's lawyer to tell the defendant that there should be one check for a settlement and it should be payable to the law firm's trust account. Thus, pay to the order of "Smith & Jones Trust Account." A variation involves having the defendant make the payment solely to the plaintiff's lawyer or law firm, without any reference to a trust account. Thus, pay to "Smith & Jones."

In either case, many plaintiffs' lawyers now assert that this obviates withholding on any wage portion of the settlement, and obviates the issuance of any and all Forms 1099. Does it? Defendants, I am told, often agree to this practice. They do so in employment disputes, in personal injury cases, and in various other types of disputes.

In personal physical injury cases, this practice may not create any tax or reporting problems. After all, the recovery in a *bona fide* personal physical injury case would presumably be excludable under Section 104. In turn, that means there would be no IRS Form 1099 obligation for the payment, however the check is issued.

In virtually any other type of litigation, however, the practice is surely wrong for plaintiffs, defendants and plaintiff's counsel. Let us start with the Form 1099 rules.

Form 1099 Issues

Does this way of issuing a check in a taxable (non–personal physical injury) case prevent the defendant from having to issue Forms 1099 to the plaintiff and the plaintiff's lawyer? It is pretty clear the answer is no.[1] The Treasury Regulations provide that: "A person who, in the course of a trade or business, pays $600 of taxable damages to a claimant by paying that amount to the claimant's attorney is required to file an information return under section 6041 with respect to the claimant, as well as another information return under section 6045(f) with respect to the claimant's attorney."[2]

This rule is illustrated in the following example which concludes that the defendant is required to issue a Form 1099 to the plaintiff even though the check was issued solely to the plaintiff's attorneys:

Example: Multiple attorneys listed as payees. Corporation P, a defendant, settles a lost profits suit brought by C for $300,000 by issuing a check naming C's attorneys, Y, A, and Z, as payees in that order. Y, A, and Z do not belong to the same law firm. P delivers the payment to A's office. A deposits the check proceeds into a trust account and makes payments by separate checks to Y of $30,000 and to Z of $15,000, as compensation for legal services, pursuant to authorization from C to pay these amounts. A also makes a payment by check of $155,000 to C. A retains $100,000 as compensation for legal services. P must file an information return for $300,000 with respect to A. A, in turn, must file information returns with respect to Y of $30,000 and to Z of $15,000 [under section 6045(f)] because A is not required to file information returns under section 6041 with respect to A's payments to Y and Z because A's role in making the payments to Y and Z is merely ministerial.... P must also file an information return with respect to C, pursuant to §1.6041-1(a) and (f).[3]

The answer is the same whether the check is made out to the plaintiff's attorney or to the attorney's trust account. The attorney is treated as the payee in either case.[4] (The attorney would not be treated as the payee if the check is made out to "client c/o attorney," or if the attorney otherwise does not have the right to negotiate the check.)

All of these regulatory provisions apply to payments made on or after January 1, 2007.[5]

Wage Withholding Issues

What about the income and employment tax withholding aspects? Normally, a defendant would consider wage withholding issues only where the nature of the dispute raised such issues. In much garden–variety employment litigation, at least part of the damages or settlement amounts must logically be regarded as wages.

Nevertheless, to my surprise, the practice of plaintiff's counsel asking defendants to make settlement checks payable to the plaintiff's counsel or that counsel's trust account—without any reference to withholding issues—is fairly common in employment litigation. Even more surprising, some employers evidently agree. Can any employer seriously believe its liability for failure to withhold is obviated by making a payment to the plaintiff's lawyer's trust account? Apparently some do.

Yet if the payment represents wages, then the act of paying the employee's agent hardly insulates the defendant. After all, the obligation to withhold rests with the employer.[6] Perhaps some of these employers take the position that by paying the plaintiff's lawyer rather than the plaintiff directly, the employer does not have "control" over the payment.

This control argument is weak, particularly since any help it provides to the defendant seems so obviously to result in liability to the plaintiff's lawyer. Section 3401(d)(1) provides that if the person for whom an individual performed services does not have control over the payment of wages for those services, then the term "employer" means the person who does have control of the payment. If the employer lacks control over the payment, presumably the plaintiff's lawyer becomes the Section 3401(d) "employer." That means the plaintiff's lawyer may be responsible to withhold employment taxes. Such a withholding responsibility may shock most plaintiff's lawyers who follow this practice.

In any case, the assumption that the employer lacks the requisite control to withhold in the first place seems dubious. The authorities construing the term "control" make clear that ministerial functions are not enough to impart control.[7] Indeed, the regulations provide that an attorney performs a purely ministerial function if he receives a settlement amount, withholds attorney's fees, and pays the remainder to the client.[8]

The short answer is that liability for an employer's failure to withhold cannot be delegated.[10] Accordingly, employers who take aggressive positions on their withholding obligations in employment litigation do so at their own peril.

Conclusion

There's no easy answer to the question of how to address taxes in settlement agreements. Litigators can't be expected to know what to say and what not to say. That suggests outside tax advice should be obtained in every case.

Of course, not every client will pay to consider tax issues thoroughly before a settlement agreement is signed. Clearly, some cases will be too small or too cut and dried for much action. In such a context, it may be understandable that plaintiff's lawyers crave a shortcut, a band–aid that will fix the situation, get the case settled and the money paid, so taxes and returns can be considered later.

Yet sometimes lawyers will outsmart themselves with language intended to fix tax issues that actually fixes little. Due to these and other problems:

- Far too many plaintiffs conclude employment and other litigation believing they will owe no taxes.
- Far too many plaintiffs in non–employment (and non–personal physical injury) cases believe they won't need to include contingent legal fees in their gross income (or if they do, that they can deduct them off the top).
- Far too many defendants fail to consider their reporting obligations both during and after the conclusion of a settlement.
- Far too many employers do not carefully think through the ramifications of their wage withholding or lack thereof.
- Far too many plaintiffs' lawyers assume that neither they nor their tax and accounting practices will ever be attacked. ▪

End Notes

[1]*Note that in cases of personal physical injury, it is also clear that for reporting purposes a payor should "not report damages (other than punitive damages).... Received on account of personal physical injuries or physical sickness [or] damages received on account of emotional distress due to physical injuries or physical sickness." See Instructions for Form 1099–MISC (2010), p. 4.*

[2]*See Reg. §1.6041–1(a)(1)(iii).*

[3]*See Reg. §1.6045–5(f), Ex. S.*

[4]*Reg. §1.6045-5(d)(4).*

[5]*Reg. §§1.6041-1(a)(1)(iii), 1.6045–5(h).*

[6]*§3401(d); § 3402(a)(1).*

[7]*See, e.g., In re Earthmovers, Inc., 199 B.R. 62 (Bankr. M.D. Fla. 1996); In re Professional Security Services, Inc., 162 B.R. 901 (Bankr. M.D. Fla. 1993); see also Reg. §31.3401(d)–1(g) ("if the person making such payment is acting solely as an agent for another person, the term employer shall mean such other person and not the person actually making the payment").*

[8]*Reg. § 1.6045–5(f), Ex. 5.*

[9]*See United States v. Garami, 184 B.R. 901 (Bankr. M.D.Fla. 1995); In re Professional Services, Inc., 162 B.R. 901 (Bankr. M.D.Fla. 1993); see also §3504; Reg. § 31.3504–1(a).*

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