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Tax Indemnity Clauses in Settlement Agreements

Making another party provide indemnity sounds like a great idea, but it can get complicated.

BY ROBERT W. WOOD | OCTOBER 3, 2016

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A tax indemnity provision in a legal document generally states that one party will cover certain taxes, or will be responsible to protect the other party should tax problems arise. Such provisions are common: they appear in many variations, and show up across a wide variety of contracts and agreements.

THE SETTLEMENT CONTEXT

One recurring context where we see tax indemnity clauses is in settlement agreements that resolve legal disputes. The scenario is simple. The parties agree in principle to settle a case and are trying to get the deal inked. One side—sometimes all sides—can see the prospect of potential taxes or potential tax risks associated with the settlement.

Whether you represent a plaintiff or defendant, your client probably has tax issues, whether they know it or not. The defendant is paying money and usually is hoping to deduct it. The defendant may face other tax issues, such as withholding on wages, or the need to issue IRS information returns (such as Forms 1099).

Some defendants figure that any such tax concerns can be deferred and dealt with later. Other defendants reason that any deal about tax withholding or tax reporting should be struck at the time the parties put their John Hancock on the settlement agreement, and not at some undefined later time.

Against this backdrop, consider the plaintiff's perspective. In many cases, the plaintiff is also likely to ask for tax provisions to be included in the settlement agreement. Indeed, a significant number of plaintiffs—particularly the savvy ones—are more worried about taxes than most defendants. Why? Because the plaintiff is the party receiving money, and a smart plaintiff hopes to position payments as best he or she can from a tax viewpoint. The plaintiff may be worried about whether funds paid are taxable; if they constitute ordinary income or a capital gain; whether taxes should be withheld; whether Forms 1099 will be issued, among other issues. In addition, the question of attorney fees may pose significant tax questions.

ATTORNEY'S FEES

The plaintiff will hope that only his *net* recovery is taxed—that is, that he will pay taxes, if at all, on the net sum after first deducting legal fees and costs. The Supreme Court has held that plaintiffs generally must report gross recoveries, even if the contingent fee lawyers are paid directly by the defendant. See *Commissioner v. Banks*, 543 U.S. 426 (2005). 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 and costs. Depending on the type of case and whether it arises in the plaintiff's business, the plaintiff may not be able to deduct all of the legal fees and expenses associated with the case.

In short, there are often latent tax issues that prompt parties to consider including a tax indemnity provision in their settlement agreement before money is paid. However, the meaning and importance of a tax indemnity provision is another matter.

DISCUSSING INDEMNITY

The first sign there is a tax issue may be a draft settlement agreement that says something about withholding, issuance of a Form 1099, or the inclusion of a suggested tax indemnity clause. Not only are there various reasons the issue arises; there are also myriad scenarios around the settlement table. For instance, there may be tax advisers on one or both sides; or there may be no tax advisers in sight until long after the case is resolved. And in some cases, one or more counsel insist that the parties hire a tax professional. Even so, there are many lawyers who try to muddle through the tax issues themselves.

Curiously, many non-tax lawyers seem comfortable handling tax indemnity provisions. They may recognize that indemnity may be needed in case there is a tax problem, such as failure to withhold, failure to issue forms, or (heaven forbid) the failure of the plaintiff to pay taxes. It might seem that a tax indemnity provision obviates all of these difficulties, the thinking being that if you get a solid tax indemnity clause that seemingly protects your client, there is no need to understand the size, scope or impact of the tax issues themselves.

But that can be a serious mistake. Suppose the defendant is settling all claims and paying the plaintiff $X for a complete release. The settlement agreement may say that the defendant has given no tax advice, that the plaintiff agrees to pay his own taxes, and that the defendant will issue an IRS Form 1099 reporting the payment.

The settlement agreement might also say that if the defendant incurs any tax problem or liability with respect to the settlement, the plaintiff will provide indemnity. Is this a good idea? Does the defendant even *need* any tax advice if there is the overarching "protection" of an indemnity clause?

Rest assured of one thing: Sitting back and smugly relying on that indemnity provision may be extremely shortsighted. Several key considerations underscore this premise.

PURSUING THIRD PARTIES

The first chink in the "protective armor" of an indemnity clause is the stark reality that the clause 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 have the right to go after someone else to cover your loss. An indemnification obligation is a third party arrangement between contracting parties only.

For this reason, that "bullet proof" provision is only as good as the credit-worthiness of the party providing indemnity. Moreover, the clause says nothing about the primary liability that the indemnitee owes to the IRS or to state taxing authorities.

For example, consider the question of tax withholding, which is required on wages and on some other payments (such as some payments to non-U.S. plaintiffs). Where withholding is required, the payor is a withholding agent and fails to withhold at its peril. Exposure for failure to withhold can be significant, including liability for the payments themselves, interest, and potentially steep penalties.

The fact that someone else (typically the settling plaintiff) has agreed to step in and repair the tax damage does not mean they *will* step in. Even if they do, they may not have the financial ability to repair the tax damage.

Here's a common example of the problem. Assume a wrongful termination case is settled for $1 million, with the client receiving $600,000, the lawyer $400,000.

Assume further that the plaintiff receives a Form 1099, has agreed to pay any tax due, and has also agreed to indemnify the defendant for any tax liability associated with the settlement.

Now, enter the IRS. Suppose the IRS claims the $600,000 constitutes wages subject to withholding? If that claim is sustained, the employer has the liability for failing to withhold—and that liability could reach or exceed $300,000 in a given case.

The IRS will not agree to go after the plaintiff. The defendant can *try* to get the plaintiff to step in, but how likely is that? By the time the tax issues are examined and contested, the plaintiff may be out of funds.

Besides, even if the plaintiff *could* pay, he or she will probably contest the liability. It is highly unlikely that the plaintiff will simply agree that the indemnity obligation he or she signed actually covers failure to withhold liability *of the defendant*. Many general indemnity provisions are unlikely to be read broadly enough to actually cover the employer's failure to withhold liability.

As this withholding example suggests, there is also no guarantee that the tax damage will be small. And there is no guarantee the indemnity provision will even apply. In this situation, a tax indemnity provision may lull you into a sense of complacency. How often have we heard the refrain: "we have indemnity from the other side for taxes, so we're covered."

Despite a tax indemnity provision, you should understand the risks, tax dollars, penalties, interest, and counsel fees you are trying to guard against.

But aside from these cautions, are tax indemnity provisions a bad idea?

NOTE THE CONTEXT

Some lawyers worry that a tax indemnity provision is a red flag to the IRS—an admission of sorts that there is a tax game afoot. However, that is not a realistic sentiment: Tax indemnity provisions are common in numerous types of agreements, and are unlikely to be viewed as red flags by the IRS. Consequently, in that sense a tax indemnity provision probably cannot hurt.

However, it may not help much, either. Such provisions are of limited utility in many types of legal settlement agreements, especially in the employment context.

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 provision 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.

Again, what if some or all of the settlement payment to the plaintiff really does constitute wages? Suppose that the defendant issues a gross check and reports the total settlement figure on a Form 1099. Later, the IRS claims that some (or all) of the settlement is wages that should have been subject to withholding.

What does this mean? It means you have a problem if you didn't properly handle the tax issues at the time the money changed hands.

In virtually every employment case, at least *some* of the settlement payment should be wages subject to withholding. Not all of the money may be wages, but failing to consider any wage exposure would be a mistake. For further discussion, see Wood, "When Defendant Employers Are Sued (Again) for Withholding Taxes," Vol. 148, No. 10, Tax Notes (September 7, 2015) at p. 1151.

And plainly, if there is any failure to withhold liability, it resides squarely with the defendant 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 then can *try* to go after the plaintiff. 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.

There is also an 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 indemnity litigation can backfire. If the defendant *thinks* that some or all of the settlement money is wages, the defendant should withhold.

MAKE AN ALLOCATION

Most often, the money in an employment case should be allocated into several categories. Reasonable minds can differ on whether 10 percent or 90 percent is wages, or something in between. But a *portion* is probably wages.

This is not to say that the defendant cannot take a calculated risk that withholding is required, yet still settle and not withhold, reporting the entire payment on a Form 1099. It happens, frequently in fact. Employers sometimes settle a case that (from a business perspective) *must* be settled, where the plaintiff insists that if there is any withholding, the plaintiff will *not* settle.

GROSSING UP THE PAYMENT TO ALLOW FOR WITHHOLDING

In an ideal world, perhaps the defendant should offer more money to settle so there can be withholding and the plaintiff can still collect an acceptable net payment. But in the real world, the defendant may scoff at that approach and agree to run the tax 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 tax risk." Businesses always weigh these risks and a tax risk is just one among many. What seems silly, though, is if the defendant convinces itself that there is no tax risk because there is an indemnity provision.

OTHER CONTEXTS

What about tax indemnities in a non-employment case? Tax indemnity provisions can often be more helpful in those situations. For example, suppose the defendant agrees not to issue an IRS Form 1099, because the plaintiff claims the payment is for personal physical injuries or physical sickness that is tax-free under section 104 of the tax code? S*ee* Wood, "Tax-Free Physical Sickness Recoveries in 2010 and Beyond," Vol. 128, No. 8, Tax Notes (August 23, 2010), p. 883; Wood, "Is Physical Sickness the New Emotional Distress?," Vol. 126, No. 8, Tax Notes (February 22, 2010), p. 977.

Even if there is a strong desire to resolve the case, the defendant may believe that the settlement payment is really money paid for emotional distress, and therefore taxable. The defendant might say that in order not to issue a Form 1099, there must be a tax opinion from the plaintiff, and a tax indemnity provision. Here, the indemnity would presumably cover penalties for failure to issue a Form 1099.

The main penalty for failure to issue a Form 1099 is only $260, unless the defendant is found to have been willful, in which case the penalty—which is rare—could be much more serious (10 percent of the settlement payment).

Fortunately, the penalty for an intentional failure to issue a Form 1099 seems to be reserved for situations where it was clear that the payor *knew* there was a reporting obligation, and ignored it. In any event, indemnity provisions in such situations may make more sense than where wages and withholding are involved.

TAX INDEMNITIES IN ACQUISITIONS

Tax indemnity provisions are also common in acquisition agreements. A purchase of one company by another can be handled in many different ways. Often, there are tax issues that will remain debatable even post-closing.

There may be income tax, sales and use tax, property tax, and foreign tax considerations. Whatever the issues, though, it is appropriate to allocate the risks. And unlike in the context of litigation settlements, there is often thought given to enforcement.

For example, unlike litigation settlements, escrows or hold-backs are common in acquisition transactions. Often, they may not extend for the entire statute of limitations period that could bracket the time of potential tax risks. Nevertheless, an escrow or holdback may materially help, and can make the indemnity provision have real teeth.

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 non-tax lawyers. That is to be expected. Everyone is a little afraid of taxes and tax liabilities.

And like confidentiality provisions, indemnity provisions–even about taxes—may seem pretty straightforward. After all, a tax indemnity may seem to reduce or even obviate the underlying tax risks. However, whenever possible, get some tax advice from an experienced tax practitioner—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 via an indemnity that may never be collectible.

One can always ask for indemnity. But it is even more important to understand and appreciate the type, scope and amount of the potential tax problems associated with the transaction at hand.

Tax indemnity provisions are not one-size-fits-all. No matter how tightly you write one, there are bound to be ambiguities. Even if the scope and meaning of the indemnity provision is clear, there may be big questions (then or later) 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 the "air tight" indemnity provision you wrote did not really protect them. And that could mean that the lawyer who said, "don't worry we've got indemnity" might end up being asked to pay in the end.

INDEMNITY PAYMENTS AS INCOME

What happens if you get hit with a tax bill from the IRS, and the other party actually *does* indemnify you for it? Is the indemnity payment income to you? If so, can you require the indemnifying party to "gross-up" any payment to cover your taxes?

There is often confusion surrounding the taxation of indemnity payments, but the IRS usually views them as income. *See, e.g.,* Priv. Ltr. Rul. 9833007 (Aug. 14, 1998); Priv. Ltr. Rul. 9743035(July 28, 1997); Priv. Ltr. Rul. 9743034 (July 28, 1997); Priv. Ltr. Rul. 9728052 (Apr. 16, 1997); Priv. Ltr. Rul. 9226033 (June 26, 1992). The IRS has frequently asserted that the payment of another person's income tax (directly or indirectly) is gross income to that person. *See, e.g.,* Priv. Ltr. Rul. 9833007 (Aug. 14, 1998); Priv. Ltr. Rul. 9743035 (July 28, 1997); Priv. Ltr. Rul. 9743034 (July 28, 1997); Priv. Ltr. Rul. 9728052 (Apr. 16, 1997); Priv. Ltr. Rul. 9226033 (June 26, 1992); *see also Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929).

Taxpayers often argue otherwise, citing *Clark v. Commissioner,* 40 B.T.A. 33 (1939), *nonacq. sub nom.*, 1939-2 C.B. 45; *acq.* 1957-2 C.B. 4, for the proposition that tax indemnity payments are excludible from gross income.

As to 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 indemnity the defendant for all tax consequences of a settlement may be inartful and not specific. But it may be more likely to be signed than one that is long, and that says the plaintiff must even gross up any required taxes on the indemnity payment itself.

CONCLUSION

As with many other common and useful clauses in legal documents, tax indemnity provisions are a drafting staple. They can be a good idea, and they can be adapted for a variety of purposes. Even so, one should not assume that they fix all tax problems. The best advice is that old proverb: an ounce of prevention is worth a pound of cure. Get the tax issues right at the outset and you won't have to worry about that indemnity clause.

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