Tax Language in Settlement Agreements: Binding or Not?

By Robert W. Wood

It is common today for litigants to attempt to include tax characterization and reporting language in settlement agreements. Indeed, this almost always is a good idea. Language incorporating tax reporting and characterization helps avoid misunderstandings, and, sometimes, further litigation. Plus, the settlement agreement represents the last defining moment of the litigation and is likely to have a significant impact on the tax treatment of the items involved.

Now, the question becomes whether the tax treatment outlined in the settlement agreement is binding. Specifically, is it binding on the parties and their treatment of the items? Is it binding on the Internal Revenue Service and state tax authorities? Is it binding on the courts?

The Parties

Properly crafted tax language will be binding on the parties. If the defendant agrees to make payment in a certain fashion — for example, to withhold income and employment taxes on only 50 percent of a settlement — and then that person fails to live up to this bargain, the settlement agreement has been breached. Although such conduct is rare, in situations where I have seen it, a breach of the settlement agreement is often remedied quickly. Where this does occur, the error is usually unintentional.

Still, it is exceedingly helpful to be able to point to specific provisions in an agreement and to demand that the mistakes be corrected. This is especially so with the issuance of Forms 1099, which often are not prepared until up to a year after the settlement is struck. While Forms 1099 are sometimes prepared simultaneously with the settlement amounts to be disbursed, they are more commonly prepared the following January. This is to meet the deadline of January 31 following the year of payment for issuance to the taxpayer and February 28 for issuance to the government.

It is unclear what should occur if the settlement agreement calls for tax treatment or reporting that conflicts with the law. For example, suppose that a settlement agreement specifies that a $1 million settlement payment is to be divided between the plaintiff and his or her contingent fee attorney. The agreement specifies that $500,000 and a Form 1099 is to be issued to the plaintiff, and that the other $500,000 is to be paid directly to the plaintiff's attorney with a Form 1099 to the attorney. Despite the controversy about attorney fees in the case law, I believe this kind of payment language is permissible.

However, once the IRS issues regulations under section 6045(f), which doubtless will specify that even in such direct payment situations, the plaintiff must also be issued a Form 1099 for the money paid to the contingent fee attorney, an express settlement agreement of the nature I've described would be in conflict with the law. Whether a defendant who chooses to follow

the new regulations would then be at risk of a contractual argument from the plaintiff is debatable. The plaintiff would presumably argue the defendant breached the settlement agreement. I have not yet seen this occur, but expect it will in the future.

Binding on IRS and the Courts?

Whether express tax language in the settlement agreement is binding on the IRS or the courts seems a simple question. I would have thought that virtually everyone — whether a tax specialist or not — would instinctively answer both of these questions with a resounding "no." The IRS and the courts have long stated that settlement language bearing on tax issues is not binding. That does not mean it is worthless. It is worth something.

How much it is worth may depend on the amount of bargaining that occurred and the extent to which the parties are truly at arm's length. Parties in litigation are usually at arm's length, and even downright hostile. But the question is whether they are at arm's length over the tax issues in particular. It is not "arm's length" when a defendant states "structure the $500,000 any way you want for tax purposes."

Taxpayers have long attempted to make the tax provisions of a settlement agreement as strong as possible. One of the ways of doing this is to attempt to include in the agreement reasonable allocation and payment language. The next step is to actually negotiate over such language. A recent IRS announcement, however, suggests that perhaps this is more important than was previously thought. Moreover, this announcement states the obvious — that the language does not bind the IRS in the agreement — at least where there is no evidence that the parties negotiated the proposed language in an arm's length, bona fide, and adversarial manner.

FSA 200146008, *Doc 2001-28708 (8 original pages), 2001 TNT 223-13,* released after very heavy redacting, deals with precisely this topic. This document reviews the common factual background — a settlement agreement had been issued and included express tax language. According to the FSA, the issue submitted to the IRS's associate chief counsel (income tax and accounting) was whether the IRS was bound to follow the tax characterization included in this settlement agreement. In its extensive analysis, the FSA determines that the origin of the claim is the deciding factor in the tax treatment of litigation recoveries.

Significantly, in the FSA, the IRS recognizes that the courts have tended to uphold the allocations in a settlement agreement where the record indicates there was a negotiated and bona fide settlement arrived at in an adversarial proceeding at arm's length and in good faith. See *Bill E. McKay, et ux. v. Commissioner,* 102 T.C. 465 (1994), *94 TNT 60-9, vacated on other grounds* 84 F.3d 433 (5th Cir. 1996), *Doc 96-13888 (3 pages), 96 TNT 92-7,* and *James E. Threlkeld v. Commissioner,* 87 T.C. 1294 (1986), *86 TNT 243-70, aff'd* 848 F.2d 81 (6th Cir. 1988), *88 TNT 119-7.* Not only did the IRS note these and other cases, but the IRS also acknowledged that where express tax allocations are made in the settlement agreement, the courts will carefully consider them. The IRS cited *Christine A. Byrne v. Commissioner,* 90 T.C. 1000 (1988), *88 TNT 105-16, rev'd and remanded* 883 F.2d 211 (3d Cir. 1989), *89 TNT 179-5.*

In the FSA, the IRS observes that in *McKay,* the parties were hostile adversaries, with both economic and other interests being affected by how the payments were characterized. In *McKay,* the IRS noted, the taxpayer was not given freedom to structure the settlement on his own. The Tax Court ended up accepting the express allocations in the agreement. In so doing, the Tax Court noted that the express language in the settlement agreement was the most important factor to the purpose of the payment (in this specific instance, under section 104). Despite this conclusion, the IRS in the FSA quoted the Tax Court in *McKay* that:

> [w]e are not bound, however, by any factor or factors that are inconsistent with the true substance of the taxpayer's claim, nor are we bound by express allocations in a written settlement agreement if the parties did not engage in bona fide, arms'-length adversarial negotiations. 102 T.C. at 482.

The FSA compares and contrasts the *McKay* case — which was certainly an important taxpayer victory — with *Edward E. Robinson, et ux. v. Commissioner,* 102 T.C. 116 (1994), *94 TNT 23-18, aff'd in part and rev'd in part on another issue* 70 F.3d 34 (5th Cir. 1995), *95 TNT 238-7, cert. denied* 519 U.S. 824 (1996). *Robinson* involved a jury verdict against a defendant bank awarding damages, lost profits, and punitive damages. The trial court entered a final judgment allocating 95 percent of the proceeds to tort-like personal injuries. Later, the IRS determined that this allocation should be disregarded. Before the Tax Court, the central issue in *Robinson* was what portion of the proceeds was excludable from gross income under section 104. The Tax Court found the parties to be adversarial regarding the dollars paid, but not adversarial on the tax allocation. The Tax Court also found that the taxpayer's preparation of the settlement agreement was uncontested, and not the product of bona fide adversarial negotiations. Although the state court in Texas had approved this settlement, the Tax Court noted that with no personal income tax in Texas, no state interest would be adversely affected by the tax allocation. This gave the Commissioner yet another reason to disregard the 95 percent/5 percent allocation.

Ultimately, the FSA provides that the IRS should treat settlement language as one factor in determining the treatment of the payments. But, this factor alone is not determinative. It advises that the examining agent should examine the facts and circumstances of the payment, and the IRS can make a reallocation of the settlement amounts among the various claims resolved by the settlement. According to the FSA, the IRS should first look to the terms of the agreement and determine whether express allocations — if any — were negotiated by the parties in a bona fide, arm's length, and adversarial manner. In the absence of bona fide and adversarial negotiations, or if the settlement terms are inconsistent with the claims made by the plaintiff, or are entirely tax motivated, the FSA says the settlement allocation can be disregarded.

All this may not sound terribly helpful. However, the FSA then proceeds to advise IRS agents to perform the following series of steps. Before recharacterizing or reallocating the payments made pursuant to a settlement agreement, the IRS should first look to determine if:

- it was a bona fide and adversarial settlement as to the allocation of payments between claims;
- its terms are consistent with the true substance of the plaintiff's claims; or
- the allocation was not entirely tax motivated.

If the IRS concludes that any of these criteria are not satisfied, then the FSA indicates it is appropriate to examine all facts and circumstances surrounding the settlement. This would include the details surrounding the litigation in the underlying proceeding, the allegations contained in the payee's complaint and amended complaint in the underlying proceeding, and the arguments made in the underlying proceeding by each party. The object, of course, is to determine in lieu of what the damages were paid. See *Robinson v. Commissioner.*

Conclusion

Apart from this recent FSA — which is the latest IRS pronouncement on the topic — there have been many cases over the years dealing with the import of express tax allocations. Long ago, in Rev. Rul. 85-98, 1985-2 C.B. 51, the IRS ruled that an allocation in the pleadings between compensatory and punitive damages would be followed in determining the taxability of a lump-sum award. Nevertheless, the IRS has generally argued that settlement language should be disregarded. Courts have sometimes agreed, and sometimes not. The *McKay* case, discussed above, is a prime example. Other excellent examples that were not cited in the FSA include *John E. Galligan v. Commissioner,* T.C. Memo. 1993-605, *93 TNT 259-19,* and *George Knevelbaard, et ux. v. Commissioner,* T.C. Memo. 1997-330, *Doc 97-21376 (29 pages), 97 TNT 140-4.*

Knevelbaard involved a suit by 1,000 dairy farmers against several banks, alleging that the banks made a bad business deal that ultimately drove many of the dairy farmers out of business. The complaint contained 12 causes of action sounding in tort, and sought damages for mental suffering and emotional distress. A written settlement agreement awarding the dairy farmers $20 million allocated $19.3 million to the tort action, which was excludable from the dairy farmers' income under the then-applicable law, and $700,000 to negligent interference with contractual relationships. Ignoring the IRS's arguments, the Tax Court upheld this allocation! This result would never have been possible without an express allocation in the settlement agreement.

Today, more than ever, express consideration of tax issues ought to be a feature of every single settlement agreement.

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