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Why Every Settlement Agreement Should Address Tax Consequences

By Robert W. Wood

As a tax practitioner, I always advise plaintiffs and defendants to consider tax aspects of settlements and judgments before it is too late. Yet one can't help but feel that enormous resources — lawyers' fees and use of the judicial system, not to mention the time and energy of the litigants themselves — are being wasted when tax issues are not addressed in either a settlement or a judgment. Although agreements on these issues certainly do not bind the IRS or state taxing authorities, they do help. The alternatives are not pretty.

Consider the long and tortured case of *Daniel Greer v. United States*, 82 AFTR2d Par. 98-5443, *Doc 98-31496 (14 pages), 98 TNT 208-7, rev'd* 207 F.3d 322 (6th Cir. 2000), *Doc 2000-15424 (21 original pages), 2000 TNT 106-2*, which arose out of Daniel Greer's termination from Ashland Oil, Inc. in 1993. Greer identified various potential environmental violations that Ashland was allegedly committing and was terminated for that reason. There was a dispute between the company and the disgruntled employee about the reason for his termination.

Ultimately, the taxpayer never actually threatened the company with a wrongful discharge suit. Instead, he appealed his dismissal all the way to the chairman of the board without mentioning his wrongful discharge suspicions. In fact, Greer never sued Ashland Oil. They negotiated what was referred to as a "termination settlement" (as denominated by the taxpayer) and what was referred to by the company as a "severance agreement." Of course, the title given to something can be vitally important to its ultimate characterization by the taxing authorities.

The agreement between Greer and Ashland Oil required the taxpayer to relinquish all claims against the company in return for $331,968. A normal severance package for Greer (given his rank and years of service) would have been only $51,000. He argued that the difference was specifically in exchange for his release of all claims against Ashland Oil.

The IRS argued that this extra payment was both for the release of all potential claims and consideration for past services. The settlement agreement did not segregate the amounts paid between different categories. Ashland Oil treated the amount as wages and withheld taxes in the amount of $108,873 from the settlement payment. The taxpayer, thinking withholding was improper, sued for a refund of the taxes paid.

Unnecessary Case

The parties then proceeded to district court, which would probably have been wholly unnecessary had the parties done a better job in the original settlement agreement. In that regard, the district court examined the requirements of section 104 as in effect during the years in question. It then proceeded to find that tort-type rights were involved, and that the taxpayer had suffered personal injuries to which the settlement could be attributed. Based on what it found to be undisputed evidence, the court found that there was no other logical explanation but that Ashland Oil was "buying peace" from a potential wrongful discharge

HIGHLIGHTS

Settlements. Robert Wood examines recent cases involving the taxation of settlement proceeds and highlights difficulties that arise when the proceeds are unallocated between taxable and nontaxable in these agreements. 405

FASB. The Financial Accounting Standards Board attended a conference given by the Financial Executives Institute on June 14 and discussed a wide range of subjects. 409

GASB. The Government Accounting Standards Board met on June 28 with representatives of Public Financial Management, a financial and advisory firm to the public sector, in an effort to learn more about certain issues related to public investing. 410

GASAC. The Government Accounting Standards Advisory Council met on June 25 to review the activities of the Government Accounting Standards Board and to discuss, among other things, technical agenda priorities. 410

suit in which its alleged environmental liabilities would surface. The court found no evidence that Ashland Oil intended to compensate any other type of claim.

Turning to the portion of the settlement that the district court found was undeniably severance pay, it found that Ashland Oil's standard severance program would have paid the taxpayer $51,000. Finding no evidence to suggest anything more than the customary severance, the court concluded only that $51,000 was severance pay includable in gross income (and subject to withholding). The remaining $280,968 was held to constitute an excludable personal injury tort settlement under pre-1996 Act law. The court found that the IRS would have to refund any taxes withheld from such proceeds.

There has been a steady stream of cases such as *Greer*, which may cause consternation among tax practitioners and among successful plaintiffs. Why are some claims viewed as taxable and some are not? The district court in *Greer* went through a number of the classic cases involving what constitutes a personal injury under the pre-1996 law. The cases the district court covered included *Johnny L. Banks, et ux. v. United States,* 81 F.3d 874 (9th Cir. 1996), *Doc 96-11602 (7 pages), 96 TNT 77-7* (excluding intangible damages flowing from breach of fiduciary duty claim); *Elton E. Dotson v. United States,* 87 F.3d 682 (5th Cir. 1996), *Doc 96-20362 (28 pages), 96 TNT 140-8* (recognizing that dignitary losses are compensable as personal injuries); and even the Supreme Court's pronouncement in *Commissioner v. Erich E. Schleier,* 515 U.S. 323 (1995), *Doc 95-5972 (27 pages), 95 TNT 116-8*.

Completing its tour through the caselaw, the district court then went on to discuss the employment cases in which settlement agreements had been allocated amounts between taxable (and subject to withholding) severance arrangements and payments in the nature of tort payments for tort-type rights. The court cited *Taggi v. United States,* 835 F.Supp. 744 (S.D.N.Y. 1993), *94 TNT 57-9, aff'd* 35 F.3d 93 (2d Cir. 1994), *94 TNT 186-12,* in which a taxpayer was terminated and forced to sign a release in exchange for an enhanced benefit package. At the time Taggi signed the release, he apparently did not realize its gravity. In the year following the execution of his release, he sued his former employer for age discrimination.

The court dismissed his action, finding that the release was effective. Based on this court determination that the release disposed of tort-like rights, Taggi attempted to obtain a refund of taxes paid on his severance benefits, claiming that these were for settlement of age discrimination claims. Despite the persuasiveness of this argument, Taggi lost because the court ultimately found that he had never made any claim before signing a release. Where no personal injury claim is ever asserted, said the court, the settlement can be considered only severance pay. See also *McCelary v. Armstrong World Industries, Inc.,* 913 F.2d 257 (5th Cir. 1990).

The court in *Greer* referred to several other cases in which claims were not asserted. In some cases, claims may not be explicitly asserted or be the subject of a formal complaint and yet the potential claims may lead to a settlement. Indeed, Greer did not explicitly threaten Ashland with a wrongful discharge suit, and no suit was filed. Ashland merely paid Greer what the court referred to as a "princely sum to buy his silence." The court found that vague threats of pursuing available remedies did create a bona fide dispute. Consequently, the court in *Greer* believed that that $280,968 of the damages were not taxable.

A Cautionary Note on Apportionment

The last step for the court in *Greer* was how to apportion the claims. It had already concluded that $51,000 was appropriate severance pay. But what of the balance? Again referring to many of the seminal cases in this area, the court said that there was no question that Greer provided the company with roughly 25 years of satisfactory service. There was also no question that what really worried the company was the continued confidentiality of the environmental data. As for whether Ashland intended to compensate Greer for any type of claim other than wrongful discharge, the court simply found no evidence of any such intent on Ashland's part. It was true, said the court, that the release the plaintiff was expected to sign mentioned contract, Title VII, and ADEA claims. However, testimony showed that these were boilerplate provisions included in every employment release. Thus, Mr. Greer was able to receive tax-free the bulk of his "princely sum." Only the $51,000 in severance pay was deemed to be taxable income and wages.

Next Judicial Round

This dispute, however, was not yet over. After the district court gave its views about taxes, the Sixth Circuit also weighed in. On appeal, the appeals court agreed with Greer that he had *bona fide* tort-based claims for wrongful discharge, and that no more than $51,000 could be taxable as severance. Despite that, the Sixth Circuit remanded the case to the trial court because it found that Greer had not proven that the remainder of the settlements (in other words, $332,000 minus the $51,000 of severance) was paid "on account of" personal injuries. The court therefore remanded the case to the district court to determine what portion was excludable as tort damages.

Observations

The *Greer* case is an important reminder of the principle that existing severance policies will be considered in determining what portion of an amount is excludable from income. Although the application of these cases might arguably be restricted to pre-1996 Act law, at least it is important that the court took into account the severance policy, and considered that the remainder of the payments must have been for something else.

On the other hand, the case is unfortunate in that Greer apparently relied on the notion that "if it isn't severance, it must be excludable." According to the Sixth Circuit, there needs to be more of a showing of what the payment on top of the severance was intended to be. Of course, in this case, the settlement agreement was silent on any allocation of the award.

That, as we all know, is a major mistake. Any settlement agreement should specifically allocate the payment. Greer might not have had to go to the Sixth Circuit (or possibly even the district court) nor, for that matter, even to file a tax refund claim, had his settlement agreement been clear. In this case, he did not know that the company would withhold on the entire $332,000 settlement. This should have been anticipated!

Final Time in the Courts

The last chapter came on remand. In *Daniel C. Greer v. United States,* 87 AFTR2d Par. 2001-844, (E.D. Ky. Apr. 5, 2001), *Doc 2001-11957 (11 original pages), 2001 TNT 82-19,* a magistrate judge ruled that Greer was entitled to a tax refund because nearly all of the settlement proceeds he received from his employer stemmed from personal injuries. Despite the voluminous prior opinions, the magistrate found that Greer had proved his case and was entitled to a refund of the taxes he sought, minus those withheld from the $51,000 payment. The court determined that at least part of the settlement was paid to Greer because of personal injuries. The court found his testimony credible regarding mental and emotional pain he suffered. It also found that Greer's settlement did not include back pay, front pay, or punitive damages, precluding a finding that the proceeds were includable in his income.

It bears repeating that *Greer* was a pre-1996 Act case, i.e., before the word "physical" was added to section 104. Still, when one thinks of the various court proceedings, first the substantive dispute that led to a settlement agreement, then the declaratory judgment action brought in district court, then in the Sixth Circuit, and then on remand, the cost and time involved is truly stupendous.

Just decided, the case, on remand, contains interesting reference to expert testimony, but a good deal of the case simply relies on the credibility of Greer's testimony concerning his own injuries. The end of the opinion sums up with conclusions of law to the effect that Greer had payments of $280,968 "on account of" personal injuries — within the meaning of the pre-1996 version of section 104. The court also concluded as a matter of law that this amount was not taxable income to Greer. He was therefore ruled entitled to the refund of any taxes withheld and paid on this $280,968. The court noted that of Greer's lump-sum payment of $331,988, $51,000 was taxable income. Withholding on that money was therefore not refundable to Greer. In a footnote, the court noted that he, Greer, had not appealed the district court's finding that $51,000 of the package Ashland gave him was normal severance pay.

Like a Hair Shirt

Maybe it bothers me more than others, but I find ongoing legal disputes on this particular issue an irritant. These cases often follow a strange and tortured path. No one wants (or should want) to fight through multiple layers of the court system to have a recovery treated in a way that is favorable. Were I representing either Greer or Ashland Oil, after all is said and done, I would be thinking back to the time at which the original deal was struck, when he got his settlement in the early 1990s. Plus, I'd be wishing that I had come to an agreement with the other side about precisely how it would be taxed.

In *Bowden v. United States,* 106 F.3d 433 (D.C. Cir. 1997), the Court of Appeals for the D.C. Circuit faced just such an issue. This case involved a former Immigration and Naturalization Service employee who had accused the INS of race discrimination in 1978. He settled his claim in 1990 in exchange for a lump-sum back pay award.

Under the settlement agreement, the INS paid Bowden $190,000, which represented $242,000 (the agreed amount of the settlement) minus payroll tax deductions. The IRS and the Maryland Tax Department then notified Bowden in April of 1991 that he owed additional taxes on this settlement. He wrote to the INS several times beginning in December of 1991, asserting that the agency had agreed to pay all taxes on the settlement. The INS, predictably, responded that it had already paid appropriate payroll taxes and that any further tax problems were Bowden's alone.

Bowden then filed suit in the U.S. District Court for the District of Columbia arguing that his settlement agreement with the INS had been breached. The district court dismissed this suit without prejudice, finding that the suit would have to be brought within the U.S. Federal Court of Claims. The court also found that he had failed to exhaust administrative remedies regarding negligence under the Federal Tort Claims Act.

Then Bowden went to the Court of Claims. There, the INS argued that the first two counts Bowden asserted were outside the jurisdiction of the Court of Claims. In response, the Court of Claims sent the case back to district court. Once again, the district court dismissed Bowden's suit, this time with prejudice. The district court found that Bowden failed to make a timely claim of breach of the settlement agreement, that he was not entitled to interest under the Back Pay Act, and that he failed to exhaust administrative remedies on his tort claim.

The matter went to the D.C. Circuit. There, the court found that Bowden failed to file an administrative complaint within 30 days of receiving the tax bills, as is required by 29 C.F.R. 1613.217(b). The court further found that the INS had no responsibility to notify him of this time limit. However, the court found that the INS did waive a defense by responding to the merits of Bowden's complaint without requesting his timeliness. The INS also failed to raise the defense in the first suit before the district court, or before the Court of Claims in its contradictory jurisdictional arguments.

According to the court, the crux of Bowden's position was that he and an INS official had reached an oral agreement that the INS would pay all taxes, and this oral agreement was inadvertently omitted from the written settlement document. The government argued that evidence of prior oral agreements is barred by the parol evidence rule, and that the written agreement included an integration clause that voided all prior agreements.

Despite what might seem the appeal of that legal argument, the D.C. Circuit remanded the case to the district court for a determination of whether the agreement was partially or fully integrated. According to the appellate court decision, if the lower court finds that the agreement is fully integrated, it may not consider extrinsic evidence about an alleged oral agreement to pay taxes.

Eighth Circuit, Too

Bowden was not the only case to present such a mess. In 1995, the Eighth Circuit decided in *Sheng v. Starkey Laboratories, Inc.*, 53 F.3d 192 (8th Cir. 1995), after remand, *rev'd in part and aff'd in part* 117 F.3d 1081 (8th Cir. 1997). There, the failure of the parties to agree on the tax treatment of a settlement in a sex discrimination case was considered a material issue that prevented the finding of an enforceable contract between the parties. The federal district court ordered enforcement of a settlement between the parties after one of the parties balked at the deal. The Eighth Circuit reversed. See 53 F.2d 192 (8th Cir. 1995).

This story has its beginning in a simple employment dispute. The underlying claim was made by Beihua Sheng, a former employee of Starkey Laboratories who sued for sexual harassment and retaliation. Although a settlement was reached at the $73,500 figure, there was confusion about just what happened in the settlement conference. The respective parties met for a settlement conference in front of a magistrate in the U.S. District Court for the District of Minnesota. The parties were referred to the settlement conference by a judge who had presided over the litigation of Sheng's discrimination claims.

After some discussion, the attorneys for Sheng and Starkey Laboratories shook hands on the $73,500 figure. Unfortunately, the attorneys could not agree on the tax treatment of the settlement. Not surprisingly, Sheng's attorney asked for an assurance that Starkey Laboratories would not withhold taxes from the proceeds. Starkey Laboratories, on the other hand, asked for an indemnification clause that would protect the company in the event the IRS believed withholding was required. According to Sheng's lawyer, the parties had agreed to meet again to iron out this nettlesome tax question.

Is This Settlement Complete?

Later that day, the parties learned that the judge presiding over the substantive discrimination suit had granted summary judgment to Starkey Laboratories on December 17, 1993, three days before the settlement conference before the magistrate had even begun. When this judge became aware of the settlement on December 20, he withdrew his December 17 order, which had granted summary judgment. On December 21, he issued a new order endorsing the settlement and dismissing the plaintiff's case without prejudice.

The plaintiff tried to enforce the alleged settlement for $73,500. Starkey Laboratories, on the other hand, sought to reinstate the December 17 summary judgment ruling so that it could escape payment altogether. Starkey Laboratories argued that there could not have been an enforceable settlement either because: (1) the parties were negotiating without the knowledge that summary judgment had already been granted; or (2) they had failed to reach a complete agreement on material terms — because the tax treatment of the settlement proceeds had not been addressed.

The district court determined that the summary judgment ruling had not "matured" into a court order before the settlement was reached. The court also determined that the failure to agree on tax consequences did not preclude a finding that the settlement had been reached. Indeed, the court noted that on December 20, 1993, the IRS had issued Rev. Rul. 93-88, 1993-2 C.B. 61, ostensibly settling the question that settlement proceeds in a post-1991 Title VII claim are not taxable. Regardless of what the parties thought, then, the court acknowledged that the IRS would not attempt to tax the proceeds. Rev. Rul. 93-88 has been since suspended by Notice 95-45, 1995-2 C.B. 330 (August 21, 1995), and then obsoleted by Rev. Rul. 96-65, 1996-2 C.B. 6.

One More Appeal

Starkey Laboratories did not give up here. On appeal to the Eighth Circuit, the defendant argued that no settlement was ever reached because the parties had not agreed on the tax consequences of the settlement payment when they became aware of the summary judgment ruling. A "mutual mistake of fact" on the part of the parties existed, argued Starkey. The Eighth Circuit listened to these arguments, and reversed the district court because the settlement was inchoate.

Applying basic contract law, the Eighth Circuit concluded that no contract exists unless the parties agree to all material terms. What is a "material" term has to be evaluated when the contract is being formed. Events occurring subsequent to the settlement agreement — in this case, Rev. Rul. 93-88 — could not make terms that were material at the time a deal was being considered into nonmaterial terms. The tax and indemnity issues, reasoned the court, were material terms on which no agreement had been reached between the parties. That vitiated the settlement. See 53 F.2d 192 (8th Cir. 1995).

On Appeal Again

The final chapter in *Sheng v. Starkey Laboratories* came on remand to district court. The court found the parties had reached agreement on all essential terms of settlement. Consequently, the court rescinded the dismissal order and reinstated the summary judgment order in Starkey's favor. Sheng appealed. On appeal, the Eighth Circuit agreed with the district court (on remand) that the settlement did not hinge on the tax issues. Plus, the Eighth Circuit found that summary judgment motion and the judge acting on it did not give rise to a mistake of fact that vitiated the settlement. See *Sheng v. Starkey Laboratories*, 117 F.3d 1081 (8th Cir. 1997).

Conclusion

These cases should present sufficient reason for virtually everyone to try to address tax consequences in every settlement document, purely because of the risk that the settlement may fall apart entirely for failing to do so. Still, more substantive tax considerations may be the deciding factor. Most of the litigated cases to consider what tax treatment ought to apply to a certain type of payment involve general releases with no allocated settlement. In my experience, the IRS (and state taxing authorities, too) are far less likely to inquire into the background of a settlement if the settlement document is explicit as to tax consequences. True, the IRS and other taxing authorities can certainly do so, and they are not bound by mere recitations of tax treatment in a settlement document. Still, one ought to take one's bite of the apple if one can.

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