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Tax Issues in Employment Mediations

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It is 9 p.m. After 12 brutal hours of mediation, the parties have finally reached an agreement. The former employee who had claimed wrongful termination will receive $100,000 in exchange for dismissing his lawsuit and executing a general release in favor of his former employer. Everyone is fatigued: The lawyer for the terminated employee has fought all day to persuade the mediator and the employer to pay a decent sum and he has finally succeeded. The lawyer for the employer has worked just as hard to keep the settlement amount within a reasonable range and has persuaded his client to pay it. The mediator is exhausted but elated that the parties have finally agreed to a number. All three now want to prepare a quick and simple term sheet to memorialize the settlement and leave the heavy drafting for another time. The last thing anyone wants to think about is taxes.

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There is surely nothing wrong with preparing a term sheet instead of a formal agreement at the end of mediation. However, it can be a huge mistake to ignore tax issues. None of the lawyers needs to be a tax expert as long as they keep a few key issues in mind, including: 1) Are all the payments and wages subject to withholding? 2) If some portion of the payment is non-wages, what is the allocation between wages and non-wages?

How will tax forms such as 1099 or W-2 be handled by the employer the following January? In the case of an employee who earns benefits other than straight salary, the parties must also consider whether any equity or stock option compensation will be paid as part of the settlement and, if so, whether it should be taxed as equity rather than ordinary income. Furthermore, if the plaintiff claimed physical injury or illness, some of the settlement may be treated as tax-free damages — though this can be a red herring. Damages for plain old emotional distress — including its physical consequences such as headaches and stomachaches — are fully taxable.

Negotiating Terms

Once the tax issues are identified, the parties need to negotiate the terms. Hopefully, this process will not be nearly as complex or gut-wrenching as the original settlement negotiation, but it needs to be done. If the tax issues are left unresolved when the initial term sheet is prepared, they can come back to haunt the parties who thought they had a deal when they left the mediation.

One common issue is whether any portion of the settlement is non-wages. Plaintiffs in employment cases often request the entire settlement to be paid for emotional distress with no taxes withheld. Plaintiffs sometimes tell the employer that it is a simple matter to characterize the payment as emotional distress; indeed, the employer can save its share of payroll taxes. However, the employer may be concerned that failure to withhold any taxes is unlawful, and could lead to an obligation to pay the employee's taxes, as well as penalties.

In response to a statement that the employer could be burned by failing to withhold any taxes from the settlement payment, the employee or her counsel will often offer to provide a tax indemnity to the employer.

Under the terms of such an indemnity, the employee promises to reimburse any costs that the employer incurs as a result of not withholding taxes. This indemnity is common and may make the employer feel somewhat more comfortable — but it is worth asking whether the employee will have the money to indemnify the employer when that time comes. After all, the need for an indemnity would only arise if the employee failed to pay her taxes. If the employee does not have the money to pay taxes herself, it is unclear that she will have the money to abide by the indemnity agreement.

Determining Non-Wages

In determining whether any part of the settlement payment should be considered non-wages, it is appropriate to look at the nature of the underlying claim. For example, an employee suing for unpaid wages, such as overtime, would have a hard time arguing that the settlement payment should be completely attributed to non-wages. On the other hand, an employee seeking both back pay and emotional distress damages due to a wrongful termination clearly has an argument that at least some of the payment should be allocated to her emotional distress. While the employee will ultimately have to pay taxes on the entire settlement as ordinary income, some of the taxes may be deferred by allocating a portion of the settlement to non-wages. Such allocation needs the cooperation of the defendant, which is why tax issues should be considered before the parties leave the mediation.

In addition, if the parties fail to determine the allocation, the employer could be in a quandary the January following the mediation when it needs to send out W-2 and 1099 forms. Absent an agreement, the employer will make its own decision on allocation, if any, and do what it thinks is required. An employee can complain to the former employer if he is unhappy with that decision, but would be unlikely to get any action. If the employer does agree to reallocate the payment, amended Forms W-2 and/or 1099 would need to be issued, which entails a somewhat cumbersome process. This is one more reason that the matter should be hashed out at the mediation.

Assuming that the parties do agree to deal with tax issues at the mediation, what guidance is there for proper allocation? First, as suggested above, the nature of the claim must be considered. Moreover, if the employee has filed a complaint prior to the mediation, its various allegations should be considered. For example, if the complaint seeks back wages and is silent on emotional distress, it may be more difficult to assert that a large allocation goes to the emotional distress damages.

If both lost wages and emotional distress damages have been alleged in the complaint, the parties can and should make reasonable estimates as to allocation. For example, suppose an employee worked for an employer for a short time and was the victim of extreme racial harassment. The employee quits the job and quickly finds replacement employment at a comparable salary. This employee will have limited wage loss, but a potentially large emotional distress award. An allocation of the settlement should reflect that reality. By contrast, an employee claiming unjust termination who is seeking years of back pay due to being unable to find replacement employment may be seeking a much larger award of wages as compared with emotional distress damages. In such a case it may be unrealistic to allocate the lion's share of the settlement payment to emotional distress damages. As these examples illustrate, there is no one-size-fits-all solution. There is usually some fluidity in these decisions, yet another reason they should be addressed whenever possible.

Physical Injury or Sickness

The question of whether any amount can or should be allocated to tax-free personal physical injury or physical sickness is sometimes the elephant in the room. Prior to 1996, emotional distress damages were tax-free. Since then, the tax code requires physical injury or physical sickness in order to justify an exclusion. There is little guidance from the IRS on these issues, although it is clear the IRS expects "observable bodily harm," generally meaning bruises or broken bones.

Nevertheless, some tax cases have upheld the exclusion of damages in employment cases where the plaintiff experienced serious physical sickness, such as the exacerbation of multiple sclerosis or a heart attack. *See* Robert W. Wood, Tax-Free Physical Sickness Recoveries in 2010 and Beyond, Vol. 128, No. 8, Tax Notes (Aug. 23, 2010), p. 883. These issues require additional time to work out, and if there has been no evidence presented about the physical claims until the tax discussion commences, the employer can be expected to be reluctant to go along with any exclusion. If any exclusion is appropriate, it will be important to document it, and there should be no IRS Form 1099 issued for that portion of the settlement payment. Thus, once again, an agreement between the parties is all but essential.

The IRS

It bears noting that these tax agreements between the parties will not bind the IRS. The latter or the courts can later reallocate the settlement and determine the tax consequences of the payment. In practice, this occurs very infrequently. Indeed, as a practical matter, the IRS often accepts the agreement of the parties, particularly if it seems reasonable on the facts. The intent of the payor is important in determining the tax consequences of a settlement, which is one more reason to expressly set out an agreed treatment.

Conclusion

If the parties do leave this issue for later as part of negotiating a comprehensive settlement agreement, they usually will be able to do so. Yet the corollary is worth mentioning. Once in a great while, a settlement actually falls apart over such issues, or leads to disputes about whether a bare bones term sheet was itself enforceable. If the parties come to the mediation armed with the tax awareness and can work out the allocation language at the mediation, they will not face that risk.