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Minimize Taxes In Business Litigation Settlements

Parties should use clear terms to characterize reason for payment

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The lack of clear guidance from the Internal Revenue Service on the taxability of various forms of employment litigation settlement payments is a familiar difficulty for employment law practitioners.

A less common but equally important concern is the characterization of payments for settlement of litigation involving both employment and corporate claims. Examples can arise in all sizes and types of business, from the expulsion of a minority member and employee of a closely held limited liability company to the termination of an executive of a publicly traded corporation with an elaborate equity compensation plan.

In cases involving both employment and corporate claims, post-settlement disputes can arise over the tax treatment of payments made, with each party usually favoring a treatment disadvantageous to the other. By enunciating an allocation of settlement amounts as between theories of the case, however, the parties can reduce the chance of such a post-settlement tax dispute. Even more, they can take advantage of a powerful value-maximizing opportunity: to advocate tax treatment more favorable in the aggregate than what the IRS might advance were they to remain silent.

Consider the following hypothetical. Local LLC buys an established but struggling delicatessen and hires Smith, the seller, to stay on as the store manager. Local pays Smith a salary, but also gives him, at no cost, a 25 percent ownership share in the limited liability company.

Smith's employment agreement provides that for a two-year term, he can be discharged only for cause. The operating agreement for the LLC provides that in the same period, Local can unilaterally buy back Smith's ownership interest at a predetermined price. After 18 months, Local discharges Smith and notifies him that it intends to buy back his interest. Smith sues, claiming that Local can do neither.

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If the parties agree to a settlement payment from Local to Smith in exchange for a general release, that payment could be seen to represent lost wages for the remaining term of Smith's contracted employment, losses attributable to receiving the prearranged purchase price for Smith's interest rather than the true value of that interest, or a combination of the two.

The payment's character will affect: 1) whether the payment is deductible by the employer; 2) whether and how much of the payment is includible by the employee, and at what effective rate (note, for example, that if we changed our hypothetical so that Smith had a nonzero basis in the LLC interest, he could potentially realize no income from payments attributable to the purchase of that interest); 3) whether the payment constitutes wages to the employee, making it subject to FICA withholding and employer contributions; and 4) whether the employer must file an informational return (*e.g.* Form W-2 or Form 1099).

Considering that combined federal and state taxes for a corporation or a well-paid employee can amount to nearly 50 percent, a change in the includibility or deductibility of settlement payments can have an enormous impact on the real value and cost of those payments to the parties and hence on the monetary limits within which the parties are willing to settle.

'Intent Of Payor'

So how can the parties to such a settlement maximize its value, minimize its costs and, perhaps equally importantly, make those consequences more predictable before tax filing time? Generally, they can do this by specifying the allocation of the settlement payment as clearly as possible in the written settlement agreement.

When examined retroactively by a court, characterization of such a payment turns on the "intent of the payor as to the purpose in making the payment," *Knuck-*

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les v. Commissioner of Internal Revenuer, 349 F.2d 610, 613 (10th Cir.1965), which in turn is to be determined by identifying "the claim the parties, in good faith, intended to settle for." *Green v. C.I.R.*, 507 F.3d 857, 868 (5th Cir. 2007). In determining whether a settlement payment is attributable to employment claims or to a non-employment cause of action an employee may also have against the employer, courts "first look to the agreement itself for indicia of its purpose," and secondarily to factors such as "the amount paid, … other agreements the company has entered into, … [and] the factual circumstances that led to the agreement." *Greer v. U.S.*, 207 F.3d 322, 329 (6th Circuit, 2000).

Although the burden of showing an allocation's respectability may rest with the taxpayer, a clear and proactive allocation of payment amounts to theories of recovery can certainly help the parties meet that burden when the need arises.

When looking behind a contractual characterization of an employment settlement, the IRS has articulated in recent guidance to its employees (PMTA 2009-35) only two broad criteria to be applied: "whether there was a bona fide adversarial settlement as to the allocation of payment," and "whether the terms are consistent with the true substance of the underlying claims."

By its express terms, the first criterion can seemingly be satisfied by almost any agreement where the allocation is actually negotiated at arm's length, and the IRS's own explanation of the second suggests that it is limited to a determination of whether the type of damages to which a payment is attributed is in fact available under law for the sort of claim actually asserted by the employee (*e.g.,* emotional distress damages, not being available for violations of the Age Discrimination in Employment Act, would not be a valid characterization of a payment made to settle an ADEA claim).

In other words, judicial and IRS guidelines appear to afford settling parties relatively wide latitude to make explicit and preemptive tax characterizations by written agreement. Because of the enormous swings in the value and costs of settlement payments that can result from such characterizations, parties and their counsel engaged in cases involving mixed employment and corporate claims would do well to avail themselves of the value-maximizing potential of tax characterization language in settling the claims. ■