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TAX UPDATE

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Who Bears Withholding Tax When a Settlement of Litigation Agreement Is Silent?

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IF A SETTLEMENT AGREEMENT IS SILENT, A DEFENDANT IS NOT REQUIRED TO 'GROSS UP' THE SETTLEMENT, AND THE PLAINTIFF WILL SUFFER THE WITHHOLDING TAX BURDEN.

What happens when settling parties agree that the defendant will pay a specific sum to the plaintiff, and the defendant discovers later that withholding of taxes is required? Does the defendant withhold and pay the net amount to the plaintiff, or is the defendant required to gross up the payment, such that the plaintiff receives the agreed-upon amount net of taxes?

The U.S. District Court for the Eastern District of Michigan ruled on this question in *I.E.E. International Electronics & Engineering, S.A. v. TK Holdings Inc.* (E.D. Mich. July 27, 2015). In *I.E.E.*, the parties reached a settlement at a conference conducted by the district court. However, the parties later reached an impasse on account of a withholding

tax issue when they sought to memorialize their settlement in a written agreement. The oral settlement that they reached called for the defendant, Takata A.G., to pay I.E.E. $1.1 million, but there was no discussion with respect to withholding taxes. After the conference, Takata was informed by its tax advisors that the contemplated payment from a German corporation to a Luxembourg entity was subject to tax withholding under German law. The plaintiffs took issue with the defendant's stated intention to withhold the German taxes.

The court first observed that the parties failed to anticipate the possibility that withholding taxes might be payable. It then determined that the parties' silence on this issue could not be construed as evidencing their tacit agreement that the defendants would pay the full $1.1 million and also would shoulder the burden of the withholding tax. Because there was mutual unawareness of the withholding tax issue, the court was required to determine how the unanticipated tax obligation should be handled in the settlement agreement. There were two bases for the court's conclusion that the tax obligation rested solely on the plaintiff.

First, it cited the settled principle of contract interpretation that the terms of an agreement should be presumed to comply with applicable law. German law required withholding tax, and, therefore, the defendants were required to withhold the tax.

Second, the court cited and relied on three cases in which the parties had reached a settlement that obligated the defendant to pay the plaintiff a specific sum, but where the parties had not considered the tax consequences, specifically tax withholding. The courts in all three cases were called on to determine whether the defendant was required to gross up the settlement payment or whether the burden of the tax would be borne by the plaintiff. The courts reached the same result, namely that a settlement agreement's silence with regard to tax consequences leaves the paying party free to withhold taxes from its settlement.

The court in *I.E.E.* also rejected the plaintiffs' suggestion that the defendants should ignore the tax withholding and let the plaintiffs be solely responsible for their tax liability, taking cognizance of the defendants' assertion that this course of action would not comport with German law. The three cases relied on by the *I.E.E.* court were:

- *International Union, United Automobile Aerospace & Agricultural Workers v. Hydro Automotive Structures North America, Inc.*, 2015 WL 630457 (W.D. Mich.

2015), in which the court rejected the plaintiffs' contention in a class action settlement that the silence in the settlement agreement required the defendants to gross up the payment

- *Powertech Tech. Inc. v. Tessera, Inc.*, 2014 WL 2538973 (N.D. Cal. 2015), in which the case law was viewed as establishing that, when there is a withholding requirement imposed on one party, that party must comply with the requirement as it applies to settlement payments and that silence as to tax withholding leads to a presumption that taxes are levied on the total settlement amount agreed upon

- *Josifivich v. Secure Computing Corp*., 2009-2 U.S. T.C. (CCH) P50, 543 (D. N.J. 2009), where a settlement agreement regarding unpaid commissions and employment discrimination was silent concerning the withholding of employment taxes, and the court held that it would not alter the terms of the voluntary settlement agreement and require the defendant to pay more because the plaintiff was dissatisfied with the anticipated tax consequences of the agreement.

In applying the cases to the instant situation, the *I.E.E.* court held as follows:

> Defendants may comply with the withholding requirements of German tax law without "grossing up" their payment to Plaintiffs to account to and offset this tax withholding. As the courts have recognized, the withholding of taxes is a natural and wholly foreseeable consequence of a payment made by one party to another pursuant to a settlement agreement, and the parties here were free to allocate this withholding burden among themselves as they negotiated their settlement. Having failed to address this issue, the parties are subject to the presumption that "each side has to bear the tax consequences" attendant to the performance of their obligations under the settlement agreement. Although Plaintiffs suggest that Defendants should simply pay the entire $1.1 million settlement amount and leave it to Plaintiffs to fulfill any obligations imposed by the pertinent tax authorities, Defendants state without contradiction that this proposed course of action would not comport with German law, and that they have no choice but to withhold taxes from their settlement payment. Thus, if Defendants were required to pay the full $1.1 million settlement amount to Plaintiffs and ***also*** make the payment demanded by the German taxing authorities, this would result in payments by Defendants in excess of the $1.1 million figure they agreed to in the parties' settlement. Moreover, Plaintiffs would obtain ***both*** the

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> full value of Defendants' $1.1 million settlement payment ***and*** the economic benefit derived from Defendants' satisfaction of the tax obligation owed by the parties to the German taxing authorities as a result of their agreed-upon settlement transaction.
>
> As observed in above-cited cases, silence in a settlement agreement as to the tax consequences of payments surely does not warrant such a reapportionment of the parties' benefits and burdens under their agreement. Rather, if Plaintiffs wished to ensure that they would receive a full $1.1 million settlement payment without regard to any tax consequences of the parties' agreed-upon transaction, they should have negotiated for such a term in the parties' settlement agreement. Because they did not, the Court declines to alter the terms of a settlement reached in hard-fought, arms-length negotiations among sophisticated parties, each of which was represented by highly skilled counsel and had ample opportunity to consider the tax consequences of the opposing party's settlement proposals. By resort to the principles articulated in the pertinent case law, the Court construes the parties' settlement here as calling for Defendants to withhold taxes from their $1.1 million payment to Plaintiffs in accordance with German tax law, without any obligation for Defendants to "gross up" its payment to ensure that Plaintiffs receive the full $1.1 million settlement amount. [Citations omitted.]

Pepper Takeaway

The tax consequences of a settlement should be addressed in the settlement agreement, particularly where withholding tax is involved. If the agreement is silent, *I.E.E.*, and the cases it cited, show that the plaintiff will suffer the withholding tax burden. The court in *I.E.E.* stated conclusively that the defendant is not required to gross up the settlement for the plaintiff because that would increase the amount of the agreed-upon settlement.

Consolidated Return Update

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NEW PROPOSED REGULATIONS FROM THE IRS PROVIDE TAXPAYER-FRIENDLY SOLUTIONS TO ISSUES WITH TAX RETURN DUE DATES AND CIRCULAR ADJUSTMENT TO BASIS.

In the last six months, the U.S. Department of the Treasury has issued two sets of proposed regulations that provide needed guidance in the area of consolidated returns. Two of these provisions are highlighted below.

Tax Return Due Dates

A corporation's year ends when it becomes a member of a consolidated group. Joining a group may create a shortened tax year if the corporation joins before the end of its taxable year. The due date for the return of a domestic corporation (without an extension) is the 15th day of the third month following the close of the corporation's tax year. *See* Treas. Reg. § 1.6072-2.

Treasury Regulations section 1.1502-76(b)(4), however, provides an exception to the general due date rule for a short-period return. That exception changes the deadline

for a short-period return to the earlier of the due date had the corporation not joined the consolidated group (including extensions) or the due date of the consolidated group's return (including extensions). If a corporation ceases to exist during the same consolidated return year in which it becomes a member, the due date for the corporation's tax return for the short period that ends as a result of becoming a member could be accelerated and cause the corporation to file a late return.

For example, a corporation that is acquired in a forward triangular merger ceases to exist, and the return is due (without regard to extensions) on the 15th day of the third month from the end of the month it ceases to exist. If the merger is midyear, the tax return would be due earlier than if the corporation had not ceased to exist.

A short-period return that is not timely filed may trigger a penalty for late filing and for late payment of tax. If certain international information returns are required to be filed with the corporate return, those returns could also be late, causing additional penalties. A final short-period return that the Internal Revenue Service (IRS) treats as not timely filed may also result in the IRS treating an election made on the return as not timely.

On March 23, the IRS issued proposed regulations under section 1.1502-76 that would amend paragraph (b)(4) to prevent a taxpayer from inadvertently missing a filing date for a short-period return. The proposed regulations provide that, if a corporation goes out of existence in the same consolidated return year in which it becomes a member of a consolidated group, the due date for filing the separate return is determined without regard to the corporation's ceasing to exist. A return that has an accelerated due date will not be considered late under the proposed regulations if filed by the original return date or by the consolidated return due date. Thus, companies that are merged out of existence or liquidated following a merger will no longer have an accelerated due date for filing the final stub return. The proposed regulations will be prospectively effective when finalized.

Circular Adjustments to Basis

To prevent the income, gain, deduction or loss of a subsidiary from being reflected more than once in a consolidated group's income, the consolidated return regulations adjust an owning member's basis in a subsidiary's stock to reflect those items. When a consolidated group takes into account a member's items of income or gain, the owning member's stock basis in the subsidiary increases. Conversely, when the group absorbs that member's deductions or losses, the owning member's basis in the subsidiary's stock decreases under Treasury Regulations section 1.1502-32.

If a group absorbs a portion of a subsidiary's loss in the same consolidated return year in which an owning member disposes of that subsidiary's stock, the owning member's basis in the subsidiary's stock is reduced immediately before the disposition by the amount of the loss. Any reduction in the stock basis from the disposition may, in turn, affect the amount of the subsidiary's loss that the group absorbs. This would require additional absorption of the member's losses that would then result in further adjustments to the member's stock basis. Due to the circularity in the reduction in stock basis and absorption of loss, taxpayers sometimes were left with no ability to claim the entire loss after multiple iterations.

To illustrate the issue, P has a $500 basis in S's stock. In year one, P has ordinary income of $30 of its own, and S has a $100 ordinary loss. P sells the S stock for $520 at the close of year one. Before determining the amount of the gain from the sale of S, the consolidated net income for the group is a net $50 loss. Because $30 of S's loss is absorbed by P to offset its income, P's basis in S's stock is reduced to $470. Since the gain is now $50 due to the basis adjustment, $50 of S's remaining carryover loss is used to offset the $50 of gain. Because an additional $50 of loss is absorbed by P, P's basis in S's stock would drop by $50, causing additional gain and additional loss to be absorbed.

Treasury Regulations section 1.1502-11 was intended to coordinate and limit the effect of the stock basis adjustments in the year of a subsidiary's disposition. These rules prevent the circular basis problem in certain situations. However, the current rules do not prevent iterative computations in all situations. This has led taxpayers to take a broad range of approaches to ameliorate circular basis problems.

On June 10, the IRS released proposed regulations that would provide relief and certainty to this problem. The proposed regulations "turn off" the normal ordering rules under Treasury Regulations section 1.1502-32 and require a group first to determine the amount of each disposed-of subsidiary's loss that will be absorbed by computing consolidated taxable income (CTI) without regard to gain or loss on the disposition.

Determining each disposed-of subsidiary's absorbed amount establishes an immutable number that will also be the amount of reduction to the basis of the owning member's stock taken into account in computing the owning member's gain or loss on the disposition of the disposed-of member's stock.

As noted in the preamble, in some instances, applying the generally applicable rules would result in less than all of a disposed-of subsidiary's absorbed amount being used. The proposed regulations aim to prevent such a result by providing for an alternative four-step computation of CTI if, by applying the general ordering rules, less than all of a disposed-of subsidiary's absorbed amount would be used. Under the four step process:

1. Any income, gain or loss on any share of subsidiary stock would be excluded from the computation of consolidated taxable income, and the group would use losses of each disposed-of subsidiary equal in both amount and character and from the same tax years as those used in the computation of its absorbed amount.

2. A disposing member would offset its gain on the disposition of subsidiary stock with its losses on subsidiary stock. If the disposing member has net income or gain on the subsidiary stock, and if the disposing member also has a loss of the same character (determined without regard to the stock net income or gain), the disposing member's loss would be used to offset the net income or gain on the subsidiary stock to the extent of such income or gain. Any remaining net income or gain would be added to the group's remaining income or gain as determined under point one above.

3. If, after the application of the second step of the alternative computation, the group has remaining income or gain and a disposing member has a net loss on subsidiary stock, that income or gain would then be offset by the loss on the disposition of subsidiary stock, subject to generally applicable tax rules. The amount of the offset, however, would be limited to the lesser of the total remaining ordinary income or capital gain of the group (determined after the application of the second step) or the amount of the disposing member's ordinary income or capital gain (determined without regard to the stock loss).

4. If the group has remaining income or gain, the unused losses of all members would be applied on a pro rata basis.

The proposed regulations will be prospectively effective when finalized.

Pepper Perspective

Both of these sets of proposed regulations are very taxpayer friendly and will alleviate issues taxpayers may currently be facing. The revised circular basis rules, in particular,

provide a simple, reasonable approach to situations where a company could be losing significant losses from the unintended consequences of Treasury Regulations section 1.1502.32.

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‘Property Taxes - A Curse or Path to Sustain Real Estate Growth & Profitability - Recent Developments in Europe and the United States’

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‘Regulatory Overview’

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