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THE TAX LAWYER

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# IRS Taxes Colin Kaepernick's NFL Settlement, Here's Why

The news that [Colin Kaepernick and the NFL settled their collusion case](#) has been replaced by talk about who “won,” and speculation about just how much money changed hands. The details are not public, but [Mike Freeman](#) of Bleacher/Report has said there is speculation that Kaepernick was paid something on the order of \$60 to \$80 million. There is no official figure, but if the rumored range is true, that's a nice payday. But how much the lawyers take, and how much taxes take, should be considered. After all, is the money taxable? Plainly yes, unlike the NFL's concussion settlement, where monies were to go to injured players. Most legal settlements are fully taxable as ordinary income, and Kaepernick's settlement would be viewed as lost earnings. The same tax rules apply whether you are paid to settle, win a judgment, or if your dispute only reaches the letter-writing phase.

However, plaintiffs almost always have more flexibility to reduce taxes if a case settles. You can influence how your recovery is taxed by how you deal with these issues, including cash v. installments. Some plaintiffs argue their settlement is capital gain not ordinary income, but it would be tough for Kaepernick to do so. Isn't anything completely tax free? Sometimes, yes. If you sue for personal physical injuries like a slip and fall or car accident, your damages are tax-free, as long as you don't receive punitive damages or interest. Section 104 of the tax code shields damages for personal physical injuries and physical sickness. Before 1996 "personal" injury damages were tax-free, so emotional distress, defamation and many other legal injuries also produced tax-free recoveries. Since 1996, your injury must be "physical." If you sue your employer for sexual harassment involving rude comments or even fondling, that's not physical enough for the IRS.



Plaintiffs routinely argue in Tax Court that their damages are sufficiently physical to be tax-free, but the IRS usually wins these cases. The IRS distinguishes between money you receive for physical symptoms of emotional distress (like headaches and stomachaches) and physical injuries or sickness. In settling an employment dispute, if you receive \$50,000 extra because your employer gave you an ulcer, is an ulcer physical or is it merely a symptom of your emotional distress? Some plaintiffs take aggressive positions on tax returns, claiming damages of this nature are tax-free. Ideally, plaintiff and defendant agree on what is being paid and its tax treatment, including IRS Forms 1099. It isn't binding on the IRS, but what the parties put in the agreement is often followed. There's even more focus on these issues under the Trump [tax reform law](#) passed at the end of 2017.

Now, many people are taxed on their *gross* recoveries, as a [new tax on litigation settlements gives no deduction for legal fees](#). In a \$100,000 case, that means paying tax on \$100,000, even if \$40,000 goes to the lawyer. In some cases, [IRS taxes can kill even a huge verdict. The new law should generally not impact qualified physical injury](#) cases, where the entire recovery is tax free, or plaintiffs who bring claims against their employers. They are still allowed an above the line deduction for legal fees. However, plaintiffs in *sexual harassment* cases face new tax problems. The new law denies tax deductions for legal fees and settlement payments in sexual harassment or

abuse cases, if there is a nondisclosure agreement. Virtually all settlement agreements include confidentiality or nondisclosure provisions. Even legal fees paid by the *plaintiff* in a confidential sexual harassment settlement are evidently covered.

Congress probably intended only to deny *defendant* tax deductions. But even plaintiffs may have to worry about [tax write-offs in sexual harassment cases after Harvey Weinstein](#). Until 2018, even if you could not deduct your legal fees above the line, you could deduct them *below* the line. But the new tax law wiped away miscellaneous itemized deductions. Plaintiffs must generally report 100% of their recoveries, even if their lawyers take a share. See [Commissioner v. Banks](#), 543 U.S. 426 (2005). That means plaintiffs must try to *deduct* fees paid to their lawyers.

Congress enacted an above the line deduction for employment claims and certain whistleblower claims. In the past, there was also a below the line miscellaneous itemized deduction for legal fees, but no more. Do two checks (one to lawyer, one to plaintiff) obviate the income to plaintiff? Not according to [Commissioner v. Banks](#). IRS Form 1099 rules require defendants to issue a Form 1099 to the plaintiff for the full settlement, even if part of the money is paid to the plaintiff's lawyer.

How about Kaepernick's taxes? He will surely be able to deduct his legal fees and costs under one of several theories, and he probably has sophisticated tax advisers who can help him. But not every plaintiff is so lucky. One way of deducting legal fees can be a business expense if the plaintiff is in *business*, and the lawsuit relates to it. Some plaintiffs claim that a lawsuit *itself* is a business, but in the past, that tax argument usually failed. It can be tempting to just bring your dispute to an end and to let the tax chips fall where they may. But plaintiffs should consider the tax aspects before they settle. They almost always have to consider taxes at tax return time the following year. Considering taxes earlier can sometimes save money by planning ahead.

*This is not legal advice. For tax alerts or tax advice, email me at [Wood@WoodLLP.com](mailto:Wood@WoodLLP.com).*