PERSPECTIVE
Los Angeles Daily Journal
THURSDAY, FEBRUARY 26, 2015

Rodman's Groin Shot Echoes Through Tax Law

By Robert W. Wood

As Resolving litigation usually involves income taxes. That is so whether the case is settled or goes to judgment. A defendant usually deducts the settlement or judgment, although some payments must be capitalized and deducted over time. Plaintiffs inevitably hope to minimize any taxes they face on their recovery.

Of course, plaintiffs also hope to minimize the tax impact of their attorney fees, something that isn't always easy. Depending on the type of case and whether the legal fees are paid over time or via contingency at settlement, even those tax issues can be nettlesome. More fundamentally, individual plaintiffs who were physically injured seek to qualify their payments as excludable from income under Section 104 of the tax code.

Plaintiffs who were defrauded or experienced property damage hope that their recovery can be treated as merely restoring their lost or damaged property. They hope such a recovery is not taxable income at all. Regardless of the type of case (contract, fraud, IP, you name it), plaintiffs who end up ahead financially may also hope that their excess cash qualifies as long term capital gain, not ordinary income. Paying 20 percent is better than 39.6 percent.

Plaintiffs in employment cases hope their wage recoveries are small and their non-wage damages are large. Perhaps some of their damages are in lieu of employee benefits and therefore are tax-favored. Some litigating employees claim physical injury or physical sickness damages, seeking tax-free treatment under Section 104.

Section 104 has posed a thorny tax problem for decades, especially since 1996. For 70 years, the law said personal injury damages were tax-free, but the Internal Revenue Service actively litigated what was really an injury (for example, how about defamation, race, gender or age discrimination?). The tax law was confused.

Then, in 1996, Section 104 was amended to say there had to be physical injuries or physical sickness for damages to be tax-free. Emotional distress damages are taxable unless they flow from physical injuries or physical sickness. That 1996 change was supposed to clear up all the confusion.

It hasn't, and if anything, there is more. Since then, there has been great controversy about what is physical and what is not. Numerous tax cases going to court.

But until Dennis Rodman came on the scene, there was no controversy about the tax treatment of confidentiality provisions. Confidentiality provisions feature in almost every settlement agreement. Parties seek to keep the details of cases, especially financial details, private.

Yet in *Amos v. Commissioner*, T.C. Memo. 2003-329, the Tax Court had to address whether a payment for confidentiality was taxable to the plaintiff who received it. Since then, there has been unending confusion about how litigants should write confidentiality provisions in settlement agreements. Dennis Rodman had kicked Mr. Amos in the groin as he stood courtside at a basketball game.

Amos went to the hospital briefly but was uninjured. Hoping to settle quickly and quietly, Rodman paid him $200,000. But a key feature of the settlement agreement was confidentiality.

The IRS *knew* Amos really was not injured. It also knew the only reason Rodman paid $200,000 for a minor bump worth far less was strict confidentiality. The Tax Court even found as a factual matter that confidentiality was the dominant reason for Rodman's payment.

Ultimately, the Tax Court held that $120,000 settlement could fairly be attributed to the physical injuries Amos *claimed* he suffered. The balance of $80,000, however, was really for confidentiality. And that, said the court, meant it fell into the broad catchall category of income subject to tax.

It has been 12 years since Rodman's contribution to the tax law, and there is still great worry about it. It is odd, since there has been no subsequent tax case I can find that follows *Amos* or that expands upon it. Although the *Amos* case on unique facts makes confidentiality a taxable item, the tax sky has not fallen.

Nevertheless, there are all manner of solutions to this perceived tax problem on offer. Usually, they are suggested not by tax lawyers, but by well-meaning litigators or general practitioners who once had a tax class or who read about *Amos* on a P.I. firm's website.

Among the offered solutions are:

1. *Don't agree to confidentiality in a settlement agreement.* This hardly seems practical. At least one side in a settlement almost always wants confidentiality. To settle cases, one must agree.

2. *Demand tax indemnity.* Agree to confidentiality, but make the defendant indemnify the plaintiff for tax consequences, thus guaranteeing that the proceeds are tax free. This too seems impractical since virtually no defendant will agree.

3. *Agree to confidentiality, but allocate a set dollar amount—preferably small—to that clause*. That way, if it is taxable, this theory goes, it is only a *small* amount. In a million dollar serious injury cases, perhaps $5,000 for confidentiality would do the trick?

Unfortunately, this too may be unworkable. A plaintiff may readily agree, figuring that tax on $5,000 is no big deal. But doesn't a provision stating that confidentiality is worth $5,000 mean the plaintiff can go on TV, talk about it, or write a book? Isn't the defendant's *sole* remedy for the breach to collect $5,000 from the plaintiff? The tax tail wags the dog.

4. *Truly bargain, and allocate a dollar amount for confidentiality*. The parties can try to really bargain over the relative value of the confidentiality provision. However, this is rare and can be a mistake, at least if you are doing so for tax reasons. Perhaps a fair amount for a confidentiality provision with teeth is $100,000. Perhaps $200,000?

Here, the tax treatment would probably be that such a specific amount for confidentiality would be taxable. Moreover, if a plaintiff breaches, intentionally or not, that would also probably be the damages. Depending on how the provision is written, it would probably be a liquidated amount.

In reality, most parties usually want confidentiality. Confidentiality may not be the *most* important part of resolving the case. The certainty and the amount of money is. But discretion is almost always a big part of it. That is one reason why a specific dollar amount for confidentiality is often a mistake from a tax viewpoint, and perhaps for enforcement as well.

Without regard to tax consequences, suppose that a defendant wants confidentiality and wants large liquidated damages if it is breached? That is not common, but it happens. And if the parties can agree, they should.

Even post-*Amos*, it is not entirely clear whether the allocated liquidated damages should be taxable to the plaintiff when received. After all, *Amos* was not a serious injury case. It was questionable whether there was any significant injury. There was a physical striking, but not much else, and the settlement amount seemed out of proportion to the injury. The Tax Court's exclusion of $120,000 for the injury and taxing $80,000 seemed generous.

The tax case would probably not have been brought, in my judgment, if the same confidentiality issues had arisen in the settlement of a catastrophic injury case (say an auto rollover with a quadriplegic plaintiff). Damages in such a case would clearly be tax-free, as long as there are no punitive damages or interest, which are always taxable. Without a specific dollar amount allocated to confidentiality, the tax issue would probably not come up.

And if the defendant required a liquidated damages confidentiality provision, would that amount be taxable? Perhaps, but it still may be possible to see such a case as 100 percent involving physical injuries. In short, there has been great notice and great confusion done by Dennis Rodman. Given Rodman's other antics (North Korea?), I'll bet he might enjoy this very much.

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