Taxing Confidentiality In Legal Settlements

By Robert W. Wood


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Robert W. Wood practices law with Wood LLP in San Francisco (http://www.WoodLLP.com) and is the author of *Taxation of Damage Awards and Settlement Payments*, *Qualified Settlement Funds and Section 468B*, and *Legal Guide to Independent Contractor Status*, all available at http://www.TaxInstitute.com. This discussion is not intended as legal advice and cannot be relied on for any purpose without the services of a qualified professional.

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The Litigation Tax Landscape

Resolving litigation typically involves income taxes. The tax rules are basically the same whether money is paid through settlement or judgment,[1] but there is typically more flexibility in a settlement agreement. Plaintiffs and defendants alike should be aware of the tax issues.

Defendants usually deduct the settlement or judgment, although some payments must be capitalized. Moreover, some payments to the government are fines that cannot be deducted at all.[2] Legal settlements by individuals of their personal disputes may also be nondeductible.

However, most business defendants can deduct most litigation payments as business expenses. Even civil punitive damages are tax deductible by businesses. Thus, defendants worry far less about tax issues than plaintiffs do.

Plaintiffs worry a lot about taxes and inevitably hope to minimize the taxes they will face on their recoveries. Injured plaintiffs hope their recovery is considered "on account of" personal physical injuries or physical sickness under section 104 and thus tax free. Plaintiffs in business and investment loss cases hope for the tax-free recovery of basis treatment. A recovery for lost or damaged property may restore the basis in the plaintiff's property. In effect, a plaintiff who paid $100 for property and suffered $25 of damage might collect $25 in tax-free damages and thereafter have an adjusted basis of $75.

Plaintiffs in employment cases hope that their wage recoveries are small and their non-wage damages are large. Some damages may be in lieu of employee benefits. Some employees claim physical injury or physical sickness damages, seeking tax-free treatment under section 104.

Some plaintiffs recognize that they will pay taxes on their recoveries, but hope for capital gain treatment. Regardless of the type of claim (contract, fraud, intellectual property, etc.), long-term capital gain looks better than ordinary income. Of course, litigation is varied. In a single case, there may be a tax-free recovery, some wages, some other income reported on Form 1099, and some basis recovery or capital gain.

There may be interest or punitive damages. There are often concerns about the deductibility of attorney fees. In 2005 the Supreme Court held that plaintiffs are generally treated as receiving 100 percent of their recovery.[3]

This is so even if their lawyer is paid directly by the defendants, and even if the lawyer receives 100 percent of the settlement and disburses only the net

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[1] *See Longino Estate v. Commissioner*, 32 T.C. 904 (1959) (involving a settlement); *Levens v. Commissioner*, 10 T.C.M. 1083 (1951) (involving an arbitration award); *see also Sager Glove Corp. v. Commissioner*, 36 T.C. 1173 (1961), *aff'd*, 311 F.2d 210 (7th Cir. 1962).

[2] *See* section 162(f). For a discussion of the IRS's position, see former IRS Chief Counsel B. John Williams Jr. letter to then-Senate Finance Committee Chair Chuck Grassley (Apr. 1, 2003).

[3] *See Commissioner v. Banks*, 543 U.S. 426 (2005).

two-thirds (or other share) to the plaintiffs. Plaintiffs do not want to end up with miscellaneous itemized deductions for their legal fees, given the code's limitations and the alternative minimum tax.

The Quagmire of Section 104

Many plaintiffs and lawyers assume that the tax issues in personal injury cases are simple. Some are not, and mistakes can be costly. For 70 years the tax law said personal injury damages were tax free. During the 1970s and 1980s, as employment litigation expanded, the IRS actively litigated what constituted an injury for this purpose. Recoveries for defamation and race, gender, and age discrimination raised new tax issues.

The tax law was confusing, and many similarly situated plaintiffs were treated differently. In employment cases, many litigants allocated a few dollars to taxable wages, with the balance of the settlement to emotional distress. The latter category was thought to be tax free. Then, in 1996, section 104 was amended to require *physical* injuries or *physical* sickness for damages to be tax free.[4]

Over the same decades, the IRS was litigating the treatment of interest and punitive damages. With government-favorable holdings and an additional statutory change in 1996, this area, too, was clarified. Now, it is quite clear that interest and punitive damages are taxable.

But the biggest change was in the "physical" requirement. Emotional distress damages are now taxable unless they flow from physical injuries or physical sickness. That 1996 change was supposed to eliminate all the confusion. It has not, and if anything, there is more confusion.

Since then, there has been persistent controversy about what is considered physical. Many tax cases go to court, and the results have been mixed. But until former NBA player Dennis Rodman came on the scene, there was almost no controversy about the tax treatment of confidentiality provisions.

Confidentiality provisions feature in almost every settlement agreement. Parties usually seek to keep the financial details of a settlement private. Yet in *Amos v. Commissioner*[5] — Rodman's settlement case — the Tax Court had to address whether a payment for confidentiality was taxable to the plaintiff who received it.

Since the debut of *Amos*, there has been nagging confusion about how litigants should write confidentiality provisions in settlement agreements. What tax treatment can the parties expect from those provisions? And what should be done in writing them to recognize or sidestep the tax rules?

The Kick That Sparked Controversy

Rodman kicked Eugene Amos Jr., a television cameraman, in the groin as he stood courtside during a game in 1997. 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 a strict confidentiality provision.

The IRS *knew* that Amos was not really injured. It also knew the only reason Rodman paid $200,000 for a minor bump worth far less money 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 in *Amos* held that $120,000 of the 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 Tax Court, meant that the $80,000 fell into the broad catchall category of income subject to tax.

Rodman's 12-Year Itch

It has been 12 years since Rodman's contribution to the tax law. In some circles, there is still considerable worry about it. That is odd, because there has been no subsequent tax case I can find that follows *Amos* or expands on its reasoning.

Amos, it must be recognized, makes confidentiality a taxable item. Yet it does so on unique facts. And even then, it holds only $80,000 out of $200,000 to be taxable when the court could perhaps have justified treating a far larger portion as subject to tax. In this sense, the reaction to *Amos* by plaintiffs and their lawyers has been puzzling.

Over the last 12 years, confidentiality provisions still feature in virtually every settlement agreement. In true personal physical injury cases in which (without interest or punitive damages) the parties all recognize that the entire recovery is tax free, the presence of a confidentiality provision does not mean the IRS will come collect. In short, despite Rodman's kick, the tax sky has not fallen.

Nevertheless, all manner of solutions to this perceived tax problem have been offered. In my experience, the solutions are generally not suggested by tax lawyers. They are often proposed by well-meaning litigators or general practitioners who once took a tax class.

Some have their fears fueled by hyperbole on a private injury firm's website about the tax problems posed by *Amos*. Mediators, too, sometimes get caught up in the Rodman hype. The normally sanguine details of a confidentiality provision can take on alarming proportions.

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[4]H.R. Conf. Rep. No. 104-737, at 301 (1996).
[5]T.C. Memo. 2003-329.

Among the offered solutions are:

1. Do not agree to confidentiality in a settlement agreement. I do not see how this is practical. At least one side in a settlement almost always wants confidentiality. Actually, both sides typically benefit from confidentiality. For example, plaintiffs should generally not want the amount of their settlement in the press for tax and other reasons.

In any event, to settle cases, one must agree. To allow what is really a small, unique, and generally unimportant tax matter to drive an issue this fundamental seems unwise.

2. Demand tax indemnity. Agree to confidentiality but make the defendant indemnify the plaintiff for tax consequences. In a 100 percent physical injury case, that would mean making the defendant guarantee that the proceeds are all tax free. This idea, too, seems completely impractical.

The tax law is such that getting this kind of tax indemnity from a defendant is impossible. Indeed, even in catastrophic injury cases, I have never encountered a defendant who would make this guarantee. Putting in appropriate and helpful tax language is one thing; guaranteeing tax treatment is another.

3. Agree to confidentiality but allocate a fixed dollar amount — preferably small — to confidentiality. Under this theory, if the settlement is taxable, it is only a *small* amount. For example, in a $1 million serious injury case, perhaps $5,000 for confidentiality would do the trick.

Unfortunately, this, too, seems unworkable in most cases. A plaintiff may readily agree with this idea, figuring that tax on $5,000 would be no big deal. But a provision stating that confidentiality is worth only $5,000 is likely to mean that the plaintiff can go on television, talk about the settlement, or write a book about the case. Because the agreement allocates only $5,000 to confidentiality, the defendant's sole remedy for the breach would probably be to collect $5,000 from the plaintiff. Surely, the defendant would not agree to such a small allocation.

4. Bargain over the dollar amount for confidentiality. The parties can try to bargain at arm's length over the relative value of the confidentiality provision, coming up with a dollar figure. Yet the parties will surely differ, and it invites another round of discussions apart from the total value of the case. In any event, I find that this is rarely done, and I believe it is generally a mistake, particularly if you are doing it for tax reasons.

Perhaps a fair amount for a confidentiality provision with teeth in a $1 million case would be $100,000. Perhaps $200,000? This really becomes a liquidated damages discussion. Here, the specific allocated amount for confidentiality could well be taxable. At least the IRS could conceivably argue that in that it's taxable based on *Amos*. Thus, this may be the one scenario in which the *Amos* holding might apply, although even here the point can be debated. I still believe a settlement agreement can allocate 100 percent to tax-free damages despite a liquidated damages provision for confidentiality.

Moreover, if the plaintiff breached the confidentiality provision, intentionally or not, the specific allocated amount would presumably be the damages. But I find that parties usually do not want to really bargain over the dollar amount payable for a breach of confidentiality. Another potential reason for not doing so is a concern that allocating an amount to confidentiality might tempt fate concerning the IRS's position — unlikely I think, but possible.

Uneasy Conclusions

In reality, most parties generally want confidentiality. Confidentiality may not be the *most* important part of resolving the case. The certainty and the amount of money usually are. But discretion is almost always a part of it.

That is one reason why a specific dollar amount for confidentiality is often a mistake in terms of enforcement, and probably from a tax viewpoint, too. Tax consequences aside, suppose a defendant wants confidentiality and wants large liquidated damages if it is breached. In my experience, that is uncommon, but when the parties do want this, if they can agree, the tax rules should not prevent it.

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

Indeed, the tax case would not have been brought, in my judgment, if it had been a catastrophic injury case. Consider an auto rollover with a quadriplegic plaintiff. All the damages in that case would clearly be tax free, as long as there were no punitive damages or interest, which are always taxable.

If the defendant in that rollover case required a liquidated damages confidentiality provision, would that amount be taxable? The IRS *could* argue that it would, but I have not seen the IRS make that argument, nor do I think it is likely. Even if the IRS made that assertion, the damages would hopefully still be treated as 100 percent attributable to physical injuries.

In short, there has been great notoriety over the smoldering tax issues emanating from *Amos*. Given Rodman's other antics (to which we can add his diplomacy efforts in North Korea), I would bet that Rodman might find considerable satisfaction in the persistence of his unique tattoo on the tax law.