

Blake Lively and Justin Baldoni lawsuits have tax aspects, too

By Robert W. Wood

Sometimes movies involve lots of backstory and controversy, well beyond whatever happens on the screen. Controversies can hurt or help a movie, often the latter. In any case, the legal drama that has exploded from "It Ends With Us" has been big. The first legal blow was Blake Lively's lawsuit against her co-star and director Justin Baldoni, causing a media stir in Hollywood and beyond.

The suit alleged that Baldoni exhibited behavior that caused her severe emotional distress. According to the lawsuit, the movie was supposed to conform to requirements including "no more showing nude videos or images of women to Blake, no more mention of Baldoni's alleged previous 'pornography addiction,' no more discussions about sexual conquests in front of Blake and others, no further mentions of cast and crew's genitalia, no more inquiries about Blake's weight, and no further mention of Blake's dead father."

Lively's lawsuit says that Sony Pictures approved her requests, but that Baldoni began a campaign to destroy her reputation. In a statement, Lively said, "I hope that my legal action helps pull back the curtain on these sinister retaliatory tactics to harm people who speak up about misconduct and helps protect others who may be targeted." She has a list of celebrity supporters.

Baldoni suits

Baldoni fired back in two ways. He sued the New York Times for defamation based on what he called the paper's "cherry-picked and altered communications" that he claims were out of context. A New York Times spokesperson responded that:

"The role of an independent news organization is to follow the facts where they lead. Our story was meticulously and responsibly reported. It was based on a review of thousands of pages of original documents, including the text messages and emails that we quote accurately and at length in the article. To date, Wayfarer Studios, Mr. Baldoni, the other subjects of the article and their representatives have not pointed to a single error. We published their full statement in response to the allegations in the article as well. We plan to vigorously defend against the lawsuit."

If you are a public figure, suing for defamation can be difficult, as plenty of other media cases have shown. But that was not Baldoni's only legal action. He also launched a counter lawsuit against Lively and her husband, Ryan Reynolds. The claims in that case include alleged civil extortion, defamation, and a slew of other charges.

Baldoni's complaint is lengthy and includes his selection of communications. He alleges that Lively and her husband conspired to take over control of the film. Baldoni claims Lively's allegations of sexual harassment are false, and that she and her husband mounted their own smear campaign.

Settlements and taxes

In this kind of highly charged dispute, quick settlements seem unlikely. But if and when there is a settlement, how will it be taxed? Lively's suit is for reputation damages and emotional distress. Some tax cases support viewing damage to professional reputation and damage to one's ability to conduct their business as capital gain rather than ordinary income. Paying tax at capital gain rates is a lot better than paying tax on ordinary income.

The IRS taxes ordinary income at up to 37%, while the top capital gain rate is 20%, plus the 3.8% investment income tax. Paying 23.8% is better than 37%. Of course, there may be state taxes too, and in California, there is no lower rate for capital gain. That can mean paying up to 13.3% in California tax too.

How about the emotional distress damages? They are taxable, even in the context of sexual harassment.

Compensatory damages for personal physical injuries are tax free under Section 104 of the tax code. But what is "physical" isn't clear, and tax issues arise in nearly every sexual harassment settlement. If you make claims for emotional distress, your damages are taxable. If you claim that the defendant caused you physical injuries or caused you to become physically sick, your damages may be tax free.

But many sexual harassment plaintiffs have a hard time doing that. Even if there is groping or other assaults, taxes may apply. However, a pending tax bill would exempt sex abuse and assault settlements. In the meantime, some plaintiffs claim the harassment gave them post-traumatic stress disorder, and PTSD is arguably physical for tax purposes.

There is still considerable ambiguity on these tax issues, but some plaintiffs win on the tax front. For example, in *Domeny v. Commissioner* T.C. Memo., 2010-9 (2010) Domeny suffered from multiple sclerosis. Her MS got worse because of stress caused by workplace problems, including an embezzling employer. Her employer terminated her, leading to another spike in her MS symptoms. She settled her employment case and claimed some of the money as tax free.

The IRS disagreed, but Domeny won in Tax Court. In another case, *Parkinson v. Commissioner*, T.C. Memo. 2010-142 (2010), a man suffered a heart attack while at work. He sued, alleging that the employer's misconduct caused him to suffer a heart attack at work. He settled and claimed that his payment was tax free. When the IRS disagreed, he went to tax court. The IRS said that it was just a taxable emotional distress recovery, but the court agreed with Parkinson that intentional infliction of emotional distress can result in bodily harm.

One lesson from these cases is that, whenever possible, settlement agreements should be specific about taxes. Tax language in a settlement agreement does not bind the IRS, but the IRS pays attention if you have a settlement agreement that is explicit about taxes. In some tax audits of settlements, the IRS asks to see the settlement agreement. If the language is explicit and the plaintiff's tax returns match up with the

settlement agreement, the IRS may be satisfied and may conclude the audit.

It pays to be explicit in the settlement agreement about tax forms, too. If you are the plaintiff, you don't want to be surprised by an IRS Form 1099 that arrives around January 31 of the year after the settlement. The only bargaining position you have as a plaintiff, and the only input you have in how IRS Forms 1099 will be prepared, is before the settlement agreement is signed.

What if Baldoni recovers, either from the New York Times or from Lively and Reynolds? The IRS presumption would be ordinary income tax on any recovery. However, as noted above, some tax cases have upheld treating damages for professional reputation as capital gain rather than ordinary income. But what would Baldoni's tax treatment be if he ends up paying Lively?

Since 2018, the tax law denies tax deductions for confidential settlements in sexual harassment and sex abuse cases. It is sometimes called the Harvey Weinstein tax, and related legal fees are also not deductible. The overwhelming majority of legal settlement agreements have a confidentiality or nondisclosure provision.

In some cases, plaintiff and defendant agree on a particular tax allocation so the defendant can still try to write off most of a confidential sexual harassment settlement. Other defendants assemble a separate "confidentiality preference agreement" that they hope will sidestep the Weinstein tax deduction limits.

Last word?

We probably have not heard the last of the legal wrangling from these parties, or of the only feeding frenzy either. Whatever happens in the Lively-Baldoni drama, there are going to be tax issues for both sides. These parties are sophisticated and likely have a cadre of legal and other advisers, including about taxes. Not everyone embroiled in a lawsuit is so fortunate.

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