Dennis Rodman

His Single-Handed, Lasting, Misunderstood Contribution to Settlement Agreements

By Robert W. Wood

Whether a case is settled or goes to judgment, resolution of a litigation usually involves income taxes. As a practical matter, there is usually far more flexibility when it comes to taxes in a settlement agreement.

However, the fundamental tax rules are basically the same whether money is paid under a settlement agreement or pursuant to a judgment.[1] Defendants consider taxes important because they usually deduct the settlement or judgment. Some payments must be capitalized and deducted over time; others, like 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. But most business defendants can deduct most litigation payments as business expenses.

Even civil punitive damages are tax deductible by businesses. That means defendants worry far less about tax issues than plaintiffs. Some defendants, however, do not worry sufficiently about the tax liabilities they may face if they fail to consider withholding of employment taxes or for payments to foreign plaintiffs.

Plaintiffs inevitably hope to minimize any taxes they will face on their recoveries. Some hope their recovery is tax-free on account of personal physical injuries or physical sickness under Section 104 of the Internal Revenue Code. Some hope for tax-free recovery of basis treatment.

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Plaintiffs who were defrauded or experienced property damage hope their recovery can be treated as merely restoring their lost or damaged property. They hope such a recovery is not taxable income, but rather can restore the basis in their property. In effect, a plaintiff who paid $100 for property, experienced damage to it in the amount of $25, might collect $25 in tax-free damages, and thereafter have an adjusted basis of $75 in the future.

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.

Some plaintiffs recognize they will pay taxes on their recoveries, but hope for capital gain treatment rather than ordinary income. Regardless of the type of claim (contract, fraud, intellectual property, etc.), long-term capital gain looks better than ordinary income. Paying a 20% tax is better than paying a 39.6% tax.

Of course, litigation is varied, and there are many differences in fact patterns and in tax treatments. There may be a mixture of types of claims and different tax treatments. In a single case, there may be a tax-free recovery, some wages, some other income reported on a Form 1099, and some basis recovery or capital gain.

There may be interest or punitive damages, and there are often attorney-fee tax concerns. One axiom for plaintiffs is that punitive damages and interest are always taxed.[3] And since contingent legal fees are often payable by plaintiffs, they must worry about those too.

In 2005, the U.S. Supreme Court held that plaintiffs are generally treated as receiving 100% of their recovery.[4] This is so even if their lawyer is paid directly by the defendants, and even if the lawyer receives 100% of the settlement and disburses only the net two-thirds (or other share) to the plaintiff. There are exceptions, but this is the general rule.[5]

As a result, where any of the money is taxed to the plaintiff, there are questions about the type of tax deduction the plaintiff can claim for the associated legal fees. Understandably, plaintiffs do not like to end up with miscellaneous itemized deductions for their legal fees. Such deductions are subject to numerous limitations, and they can trigger the dreaded alternative minimum tax.

This is the classic context in which plaintiffs say, quite correctly, that they are being taxed on attorney fees paid to their lawyer.[6] This happens even though a plaintiff may never physically receive the lawyer's contingent fees. It is so even though the plaintiff's lawyer inevitably must also pay taxes on the same fees.

Thus, plaintiffs hope to minimize the tax impact of their attorney fees too, something that is not always easy. The result can depend on the type of case, the size and nature of the underlying taxable damages, and whether the legal fees are paid over time or are contingent. These tax issues can be challenging.

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The Tax-Free Quagmire of Section 104

Many plaintiffs and many lawyers may assume that the tax issues in personal injury cases are simple. Some are, but some clearly are not, and mistakes can be costly. Section 104 of the Internal Revenue Code has posed thorny tax problems for decades, and especially since 1996.

For 70 years, the tax law said personal injury damages were tax-free. However, during the 1970s and 1980s, particularly as employment litigation increased, the IRS began to actively litigate the question of what was really an injury for this purpose. For example, how should recoveries for defamation be treated? And what about race, gender, and age discrimination?

The tax law was confusing, and thus many similarly situated plaintiffs were treated differently. In a number of employment cases, litigants allocated a few dollars to taxable wages, with the balance of the settlement coming under the heading of "emotional distress," which was thought to mean "tax-free." Then, in 1996, Section 104 was amended to say that there had to be *physical* injuries or *physical* sickness for damages to be tax-free.[7]

Over the same time, the IRS was litigating the treatment of interest and punitive damages. With the court cases the IRS won, and an additional statutory change in 1996, that treatment too was clarified. Now, it is quite clear that interest and punitive damages are taxable.

But the biggest change was in the "physical" requirement. Now, emotional distress damages are taxable unless they flow from physical injuries or physical sickness. The 1996 change was supposed to clear up all the confusion. It has not, of course, and if anything, there is more confusion.

Since then, there has been persistent controversy about what is physical and what is not. Numerous tax cases have gone to court, and the results have been mixed. But until 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 details of a settlement, especially the financial details, private. Yet in *Amos v. Commissioner of Internal Revenue*,[8] the Tax Court had to address whether a payment for confidentiality was taxable to the plaintiff who received it.

Since the debut of Mr. Rodman's settlement case, there have been nagging questions about how litigants should write confidentiality provisions in settlement agreements. What tax treatment could the parties expect from such provisions? And what should be done in writing them to recognize or sidestep those tax rules?

The Kick That Sparked Controversy

In January 1997, Dennis Rodman kicked TV cameraman Eugene Amos in the groin as he stood courtside at a basketball game. Mr. Amos went to the hospital briefly but was uninjured. Hoping to settle quickly and quietly, Mr. Rodman paid him $200,000. But a key feature of the settlement agreement was confidentiality.

The IRS *knew* Mr. Amos was not really injured. It also knew the only reason Mr. 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 Mr. Rodman's payment.

Ultimately, the Tax Court in *Amos* held that $120,000 of the settlement could fairly be attributed to the physical injuries Mr. 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 Mr. Rodman's contribution to the tax law. In some circles, there is still considerable worry about it. It is odd, since there has been no subsequent tax case I can find that follows *Amos* or that expands upon its reasoning.

The *Amos* case, it must be recognized, makes confidentiality a taxable item. Yet it does so on unique facts. Even then, it holds only $80,000 out of $200,000 to be taxable, when the court could perhaps have justified treating far more as subject to tax.

Over the last 12 years, confidentiality provisions still feature in virtually every settlement agreement. In true personal physical injury cases where (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 Mr. Rodman's kick, the tax sky has not fallen.

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

I'm afraid that some suggestions are from worried practitioners who once took a tax class or who read of inflated versions of the tax problems posed by *Amos* on a personal injury firm's website. Sometimes their clients also get caught up in the Dennis Rodman hype. The normally sanguine details of a confidentiality provision can take on alarming proportions.

Among the Offered Solutions

1. Do Not Agree to Confidentiality in a Settlement Agreement

I do not see how this is very practical. At least one side in a settlement almost always wants confidentiality. Actually, though, 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 issue 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% 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 not possible. 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

That way, if it is taxable, this theory goes, it is only a *small* amount. For example, the suggestion may continue, 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. Since 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 will not agree.

4. Truly 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 it happens rarely, and I believe it is generally a mistake, particularly if you are doing so for tax reasons.

Amos's True Effect

Perhaps a fair amount for a confidentiality provision with teeth in a $1 million case would be $100,000? $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 so argue based on *Amos*. It thus could be the one place where the *Amos* holding could possibly have effect, although even here the point can be debated. I still believe a settlement agreement can allocate 100% to tax-free damages despite a liquidated damages provision for confidentiality.

Moreover, if the plaintiff were to breach the confidentiality provision, intentionally or not, that figure would presumably be the damages. But I find that parties usually do not really want to bargain over the dollar amount that is payable for a breach of confidentiality. Besides, perhaps another reason not to do so is that it might conceivably be tempting fate concerning the possible IRS position – unlikely, I think, but possible.

In reality, most parties generally want confidentiality. And 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.

Without regard to tax consequences, suppose that a defendant wants confidentiality and wants large liquidated damages if it is breached? In my experience, that is uncommon, but where the parties do want this, if the parties can agree, the tax rules should not prevent it.

Even post-*Amos*, it is not clear whether the allocated liquidated damages would be taxable to the plaintiff when received. After all, *Amos* was not a serious injury case. It was questionable whether there even 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 Mr. Amos.

Indeed, the 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 of the damages in such a case would clearly be tax-free, as long as there are no punitive damages or interest, which are always taxable.

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

In short, the smoldering tax issues emanating from the *Amos* case have earned great notoriety. Given Mr. Rodman's other antics, however (to which we can add North Korea in the intervening years), I would bet that Mr. Rodman might find considerable satisfaction in the persistence of his mark on the tax law. ■

1. *See Estate of Longino v. C.I.R.*, 32 T.C. 904 (1959) (involving a settlement); *Levens v. Comm'r*, 1951 T.C. Memo LEXIS 45 (1951) (involving an arbitration award); *see also Sager Glove Corp. v. Comm'r*, 36 T.C. 1173 (1961), *aff'd*, 311 F.2d 210 (7th Cir. 1962).
2. *See* I.R.C. § 162(f). For a discussion of the IRS's position, *see* IRS, *Letter to Senator Grassley*, Apr. 1, 2003 (2003 TNT 68-20).
3. *See* Rev. Rul. 85-98, 1985-2 C.B. 51; *Wheeler v. Comm'r*, 58 T.C. 459 (1972).
4. *Comm'r v. Banks*, 543 U.S. 426 (2005).
5. *Id.* at 430 ("We hold that, as a general rule, when a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee.").
6. *See, e.g.*, *Noons v. Comm'r*, T.C. Memo 2000-106; *Benci-Woodward v. Comm'r*, T.C. Memo 1998-395, *aff'd*, 219 F.3d 941 (9th Cir. 2000); *Brenner v. Comm'r*, T.C. Memo 2001-127; *Spina v. Forest Preserve Dist. of Cook Cnty.*, 207 F. Supp. 2d 764 (N.D. Ill. 2002).
7. H.R. Conf. Rep. No. 104-737, at 301 (1996).
8. T.C. Memo. 2003-329.

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