

Uncle Sam Scores in the NFL's Settlement With Kaepernick, Too

By Robert W. Wood

Colin Kaepernick and the NFL have settled their collusion case. Mum is the word, so it is not clear how much money was involved or exactly what the settlement agreement may say. Even so, there is talk about who got the better deal by settling. There is also speculation about how much money was involved.

Some observers have suggested that Kaepernick may have been paid something in the range of \$60 to \$80 million. 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?

Clearly yes. Unlike the NFL's concussion settlement, where monies were supposed to be for player injuries, this money is taxable. 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.

Of course, plaintiffs almost always have more flexibility to reduce taxes when a case settles. Plaintiffs often influence how a recovery is taxed by installment payments or structures, tax language, and Form 1099 provisions. Some plaintiffs argue their settlement is capital gain not ordinary income, but it is hard to see how Kaepernick could do so.

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 produced tax-free recoveries. Since 1996, the 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.

The IRS distinguishes between money for physical symptoms of emotional distress (like headaches and stomach-aches) 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 or California's FTB, but what the parties put in the agreement is often followed. There is 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, with no ability to deduct their contingent legal fees. In a way, that is a new tax on many litigation settlements. In a \$100,000 case, it can mean paying tax on \$100,000, even if \$40,000 goes to the lawyer. It can seem like a true form of double taxation.

After all, the lawyer must report the legal fees as income. If the client is *also* reporting the same income, isn't that double tax? Yes, but this type of double taxation is allowed (or no one has ever prevailed in arguing otherwise). Of course, 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.

The legal fees in those cases 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. There are new California law provisions restricting the use of nondisclosure agreements. But if there is a confidentiality or nondisclosure provision, even legal fees paid by the *plaintiff* in a confidential sexual harassment settlement could be 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 percent 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. Again, there is 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*. Plus, 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.

Will Kaepernick face any of these tax problems? 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.

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