

Confidentiality provisions feature in almost every legal settlement agreement. Parties generally want to keep the details private. Yet there can be extra tax considerations, particularly in [sexual harassment settlements](#). The tax code denies tax deductions in confidential sexual harassment or sexual abuse settlements. Notably, this “no tax deduction” rule applies to the lawyer fees as well as settlement payments. Section 162(q) of the tax code provides:

(q) PAYMENTS RELATED TO SEXUAL HARASSMENT AND SEXUAL ABUSE. — No deduction shall be allowed under this chapter for — (1) any settlement or payment related to sexual harassment or sexual abuse if such settlement or payment is subject to a nondisclosure agreement, or (2) attorney’s fees related to such a settlement or payment.

Sexual Harassment or Abuse

The provisions does not cover race, gender or age discrimination, but only sexual harassment or abuse. Yet sexual harassment allegations feature as at least part of the claim in many employment disputes. The new law is broad enough that it could apply to all of the money, even though only a relatively minor amount might be for sexual harassment. Traditionally, of course, almost all legal settlement agreements have some type of confidentiality or nondisclosure provision.

It is unclear whether *any* mention of sexual harassment will trigger this provision. If it does, it might bar *any* tax deduction, even if the sexual harassment part of the case is minor. Plaintiff and defendant may want to agree on a particular tax allocation, attempting to head off the provision. Legal settlements are routinely divvied up between claims, though being reasonable is important. The IRS is never bound by allocations in settlement agreements,

but the IRS often respects them. Some companies use a separate confidentiality preference agreement to attempt to sidestep the provision.

Physical Injuries

As second tax consideration involves physical injury cases. The tax code excludes compensatory damages for physical injuries. Most settlement agreements in physical injury cases include confidentiality provisions. Yet in *Amos v. Commissioner*, T.C. Memo 2003-329, the Tax Court addressed whether a payment for confidentiality was taxable to the plaintiff who received it.

Dennis Rodman kicked Mr. Amos in the groin as he stood courtside at a basketball game. Amos went to the hospital briefly, and Rodman paid him \$200,000. But a key feature of the settlement agreement was confidentiality. Rodman paid \$200,000 for a minor bump but strict confidentiality was the dominant reason for Rodman's payment. Amos didn't pay taxes, the IRS audited, and Amos went to Tax Court.

In 2003, the Tax Court said that of the \$200,000, \$120,000 settlement was for the physical injuries Amos claimed he suffered. The balance of \$80,000 was for confidentiality, and the court said that made it taxable. It has been more than 20 years since this tax case, and there appear to be no other tax cases repeating this theory. *Amos* was not a serious injury case, and the tax case would probably not have been brought if the same confidentiality issues had arisen in the settlement of a catastrophic injury case.

As a result, most tax advisers appear not to worry about this. In most cases, the parties want confidentiality, and the tax issues can be addressed. Plaintiffs

and defendants may both have their reasons for not wanting to trumpet details of a settlement.