PERSPECTIVE
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Tax Problems Too for Johnny Depp & Amber Heard?

By Robert W. Wood

Sometimes it can seem like Hollywood is its own country. The Johnny Depp Amber Heard defamation trial seems like pure Hollywood, even if the actual courtroom is in the DC suburbs of Fairfax County Virginia. Court watchers say that Johnny Depp has a more ardent fanbase, which makes sense given that he has been a heartthrob and big- ticket movie star for so many years, particularly as compared with the lesser known Heard.

But whichever side of this spectacle you are supporting, you may not end up entirely happy. Perhaps watching it might make you feel lucky that you're not among the rich and famous. Of course, with my own myopia, I tend to look for tax issues. Are there, any taxes lurking in this drama being played out in Virginia? Yes, there are some big tax issues at play that might be creeping up on the once smitten couple. Depp's $50M suit against Amber Heard is for defamation, so if he wins, how is that taxed?

As ordinary income of course, which means 37% federal tax and 13.3% California tax. And if you don't play your tax cards just right with passthrough entities and elections, no matter how many millions in California tax you pay, your tax deduction on your federal tax return is only $10,000. If Depp is using a contingent fee lawyer, his taxes could get even worse. Suppose that Depp wins $50M, but must pay 40% to his lawyer. That means Depp would net $30M. You might assume that he would pay tax on $30M.

However, since 2018, some plaintiffs in contingent fee cases are taxed on their gross recoveries, not net after legal fees. Some call it a new tax on legal settlements. Being creative is needed and checklists of ways to deduct legal fees can help. Why worry about deducting legal fees in the first place? Most plaintiffs would rather have the lawyer paid separately and avoid the need for the deduction, but it is not that simple. If the lawyer is entitled to 40%, the plaintiff generally will receive only their net recovery after the fees.

But under *Commissioner v. Banks*, 543 U.S. 426 (2005), plaintiffs in contingent fee cases must generally include 100% in income, even if the lawyer is paid directly. It's just one of many odd rules how legal settlement are taxed. This harsh tax rule usually means plaintiffs must figure a way to *deduct* their 40% fee. With a connection to his business, Depp may be able to deduct his fees as a business expense, but it's not clear the *origin* of the suit was business.

Sometimes, even though your business is impacted, the IRS can call a dispute personal, which can mean no deduction. Another avenue for a deduction is civil rights, so Depp might be able to argue that his legal fees are deductible under the above the line. But is a defamation claim a claim impacting civil rights? It may depend on how you read the tax law. Of course, Depp isn't the only one who might be thinking about taxes.

There's also Amber Heard's donation issues from the time of their divorce. Donations to charities are tax deductible, but you can't deduct a payment made by someone else. A recent story suggested that Elon Musk may have paid portion of Amber Heard's pledged ACLU donations. That hearkens back to the fact that taxes featured in the Depp and Heard divorce in a big way. For a time, it looked as if Depp might have to pay Heard $50,000 a month in alimony.

Divorce and taxes have always had a push-me, pull-you relationship. Up until 2019, alimony, was tax deductible by the person paying it, and taxable income to the recipient. That led to vast numbers of people getting audited. Get divorced, get audited by the IRS, it seemed. The IRS figured out that often one person deducted "alimony" but the recipient did not report it. But the tax code was changed in a big way, and since 2019, alimony is a payment that does not have a tax impact to either person.

Depp and Heard eventually settled for a one-time payment from Depp to Heard of $7 million. Under current tax law, and under the tax law prevailing when the couple divorced, property settlements are tax neutral. They are not income to Heard and not tax-deductible by Depp. When the $7 million deal was struck, Heard said she would give the entire $7 million to charity, splitting the money between her two favorite charities: the American Civil Liberties Union to prevent violence against women, and Children's Hospital of Los Angeles.

Heard may have thought she would come out OK tax-wise if she received the $7 million from Depp, and then handed the full $7 million to charity. What's wrong with that, you might ask? If she had to include $7 million in income, couldn't she deduct the $7 million she immediately gave to charity? Not hardly. There are annual limitations on charitable contributions—usually 50% of adjusted gross income. So in very rough numbers, with income of $7 million, her maximum deduction could be only $3.5 million.

That means she might have had to pay tax on $3.5 million she had just given away! Donations to charity are tax deductible, of course. But they are subject to limitations, depending on the nature of the property being donated and the tax status of the donee organization. There are carry-overs of unused tax deductions to future years, but carryovers don't help you in the current year. Giving away $7 million, but paying tax on $3.5 million would hurt.

So, without getting too far into the math, she actually might have had to pay taxes on *considerably more* than the $3.5 million. However, not long after Heard's $7 million to charity announcement, a Depp representative announced that the actor had decided to donate the settlement money directly to the charities in a series of installments. In response, a member of Heard's team made a statement rejecting Depp's payment plan, and stating that: "Amber Heard appreciates Johnny Depp's novel interest in supporting two of her favorite charities, the ACLU for domestic violence and the Children's Hospital of Los Angeles. This is great and unexpected news. However, if Johnny wishes to change the settlement agreement, we must insist that he honor the full amount by donating $14M to charity, which, after accounting for his tax deduction, is equal to his $7M payment obligation to Amber. We would also insist that the full amount be paid immediately and not drawn out over many years. Anything less would be a transparent attempt by Johnny's counsel, Laura Wasser and Patti Glaser, to reduce their client's true payment by half under the guise of newfound concern for charities that he has never previously supported."

At least these discussions were taking place before the divorce was finalized in January of 2017. Some of the worst tax messes occur when documents are signed and money is paid, only to discover later that there's a tax problem. Speaking of charity, does it even work for a plaintiff to settle a lawsuit and say, "don't pay me, pay my charity?" That might be for all of the money, or a part, the latter being more common. The details matter, but many defendants take the position that they will report it (on a Form 1099) to the plaintiff, even if the money goes direct to charity. So plan ahead, you don't want to be surprised in January of the year after a settlement with a Form 1099 you didn't expect.

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