PERSPECTIVE

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Taxing Confidentiality In Settlements, Another View

By Robert W. Wood

I read with interest David I. Brown's "Tax Consequences of Confidentiality and Non-Disparagement Clauses in Personal Injury Cases in the Mediation Context: A Practicum," Daily Journal, July 14, 2022, #1197. He is right that it is always wise in mediation—and with legal settlement agreements negotiated in any context—to think about the tax issues as you negotiate and before you sign. But I have a different view of the seriousness of the tax threat of confidentiality clauses.

Confidentiality provisions feature in almost every settlement agreement. Parties usually want the details private. Plaintiffs inevitably hope to minimize taxes on their recoveries, and many hope that some or all of their recovery is tax free for personal physical injuries or physical sickness. This is even true in employment cases. Section 104 of the tax code has posed thorny tax problems for decades, especially since 1996.

For 70 years, the tax law said "personal" injury damages were tax free, so emotional distress damages were routinely tax free. Then, in 1996, Section 104 was amended to require *physical* injuries or *physical* sickness for damages to be tax free.

Since then, there has been persistent controversy about what is physical and what is not.

But until Dennis Rodman came on the scene in 2003, there was almost no controversy about the tax treatment of confidentiality provisions. 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. Since then, some people worry about how litigants should write confidentiality provisions. What tax treatment could the parties expect from such provisions, and how can you sidestep tax dangers?

Kick Heard Round the World

Judge Brown nicely summarized Dennis Rodman's groin kick to Amos, the photographer. Hoping to settle quickly and quietly, Rodman paid him $200,000, but a key feature of the settlement was confidentiality—and an unusually explicit dollar amount for it. The IRS *knew* that Amos *really* was not injured. It also knew that the only reason Rodman paid $200,000 for a minor bump was strict confidentiality. The Tax Court even found that as a factual matter, confidentiality was the dominant reason for Rodman's payment.

Ultimately, the Tax Court held that $120,000 could fairly be attributed to the physical injuries Amos *claimed* he suffered. The settlement agreement expressly said that. The balance of $80,000, was really for confidentiality—and the settlement agreement *expressly* said that too. In that sense, I'm not sure the Tax Court had much choice.

It has been 19 years since Dennis Rodman's contribution to the tax law, but I have not seen a tax case since that follows or expands it. Perhaps that is because the *Amos* case had unique facts. Confidentiality provisions still feature in every settlement agreement. In true personal physical injury cases (without interest or punitive damages) the parties can all recognize that the entire recovery is tax-free. Adding a confidentiality provision to that does not mean that the IRS will try to collect.

Despite Rodman's kick, the tax sky has not fallen. After seeing an extremely large number of cases (and defending an extremely large number of cases in IRS audits), I have never seen the IRS try to invoke the *Amos* case to tax confidentiality. Part of that, I suppose, is because I don't think anyone writes a settlement agreement that says what Rodman did ($120k is for physical injuries, $80k is for confidentiality). Perhaps the Tax Court felt it didn't have much choice on those unicorn facts.

Some people have offered solutions to this perceived tax problem. These solutions may not be suggested by tax lawyers, but by well-meaning litigators. Sometimes their clients also get caught up in the Dennis Rodman hype. A plain vanilla confidentiality provision can seem to take on alarming proportions. Among the offered solutions I've heard are:

1. Do Not Agree to Confidentiality. I don't see how this is practical. At least one side in a settlement always wants confidentiality, and both sides typically benefit. To settle, you usually must agree. To allow a small, unique, and generally unimportant tax issue to drive an issue doesn't make sense, to me at least.

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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 too seems impractical, getting this kind of tax indemnity from a defendant would be hard. Even in catastrophic physical injury cases, putting in appropriate and helpful tax language is one thing, but guaranteeing tax treatment is another.

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3. Agree to Confidentiality with a Small Fixed Amount. That way, if it is taxable, this theory goes, it is only a *small* amount. For example, in a $1 million serious injury case, perhaps $5,000 for confidentiality would do the trick? A plaintiff may agree, figuring that tax on $5,000 would be no big deal. But could a provision stating that confidentiality is worth only $5,000 mean that the plaintiff can go on television, talk about the settlement, or write a book about the case, and tell the defendant that its sole remedy for the breach is $5,000? I don't know, but I don't think the small dollar amount is needed or is a good idea.

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4. Bargain Over the 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. In any event, I find it to be rare to do this, and I believe it is generally a mistake if you are doing it for tax reasons.

Perhaps a fair amount for a confidentiality provision with teeth in a $1 million case would be $100,000. Perhaps $200,000, or perhaps more? It could become a liquidated damages discussion. The IRS could *conceivably* argue that it should be taxed based on *Amos*, although the point can clearly be debated. I still believe that a settlement agreement can say that 100% of the settlement is tax-free, WITH a confidentiality provision.

I also think you can have 100% tax free damages despite a liquidated damages provision for confidentiality. I have seen it and done it, so far, without adverse tax repercussions. In the

case of liquidated damages, if the plaintiff were to breach the confidentiality provision, intentionally or not, that figure would presumably be the damages. But I find that parties often do not 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, even though I think that is highly unlikely. In reality, most parties want confidentiality. Confidentiality may not be the *most* important part of resolving the case, certainty and the amount of money may be. But discretion is almost always a part of it. That is one reason a specific dollar amount for confidentiality can be a mistake in terms of enforcement, and 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 even questionable whether there was *any* injury at all. 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 Amos. Indeed, I believe *Amos* would have never been brought—or if it had, it would have come out differently—if it had been a serious physical injury case.

Consider an auto rollover with a quadriplegic plaintiff. All the damages 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 is likely. Even if the IRS made the argument, I believe it is likely that the damages would still be treated as 100 percent attributable to physical injuries.

In 19 years, the smoldering tax issues emanating from the *Amos* case have just not materialized. However, something *else* has that impacts the tax treatment to *defendants* of confidential sexual harassment and sexual abuse cases. I will address that separate topic in another article.

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