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CAUTIONARY TALES OF CONFIDENTIALITY CLAUSES

By Steven H. Kruis

Introduction. The confidentiality clause (and its cousin, the non-disparagement provision) may result in unintended taxable income in settlements of personal injury and emotional distress claims. In sexual harassment and FEHA employment matters, confidentiality provisions are void and unenforceable. Thus, counsel must carefully draft settlement agreements to minimize the impact of these provisions and avoid potential malpractice claims by surprised and disappointed clients.

Physical Injury Damages Not Taxable. The Internal Revenue Code (IRC), 26 USC §104(a)(2), excludes from gross income "compensation for personal injuries or sickness." The exclusion of an award "hinges on whether it actually compensates for personal injury or does something else."

Emotional Distress and Other Damages May Be Taxable. Damages received for non-physical injury such as emotional distress, defamation and humiliation, although generally includable in gross income, are not subject to Federal employment taxes. To be excluded from gross income, emotional distress damages must result from personal physical injuries or sickness, unless the amount is for reimbursement of actual medical expenses related to emotional distress that was not previously deducted under IRC § 213. See *Emerson v. Comr.*, T.C. Memo 2003-82, and *Witcher v. Comr.*, T.C. Memo 2002-292.

Punitive damages are not excludable from gross income with one exception - where under state law only punitive damages are recoverable in wrongful death claims.

Employment-related Claims. In wrongful discharge and breach of contract matters, damages received to compensate for economic loss, lost wages, business income and benefits, are not excludable from gross income unless a personal physical injury caused such loss. Discrimination suits for age, race, gender, religion, or disability can generate compensatory, contractual, and punitive awards, none of which are excludible under §104(a)(2). Generally, dismissal pay, severance pay, or other payments for involuntary termination of employment are wages for federal employment tax purposes.

Tax Exposure from Confidentiality Clauses. The insertion of a confidentiality clause into a settlement agreement could subject an otherwise non-taxable settlement to federal income tax. Any portion of the settlement allocated to the confidentiality provision would *not* be excluded from gross income.

The landmark tax case of *Amos v. Comm'r*, 86 T.C.M. (CCH) 663, 665-66 (2003), is a cautionary tale on point. In an NBA basketball game between the Chicago Bulls and Minnesota Timberwolves, Chicago player Dennis Rodman fell into a group of photographers, twisted his ankle, and kicked cameraman Eugene Amos in the groin. Rodman agreed to pay Amos \$200,000 and required a confidentiality clause in the settlement agreement. The clause included a liquidated damages provision of \$200,000 should Amos violate it, but was silent



as to any allocation between the personal injury and confidentiality provision. On audit, the IRS claimed the entire settlement amount was for confidentiality and subject to tax. The Service emphasized the fact that the liquidated damages for breach of the confidentiality clause equaled the settlement amount. Amos claimed the entire settlement was for the personal injury he suffered from Rodman's assault and excluded from gross income.

The tax court held that \$120,000 (60%) was excluded from gross income as payment for personal injury, and \$80,000 (40%) included in gross income for confidentiality. Absent an allocation in the settlement agreement, the intent of the payor is most important – what was the dominant reason for the payment? Here, the tax court concluded Rodman intended to compensate Amos for his injury. While the IRS questioned the validity of the injury, the tax court observed it is the nature and character of the claim that is relevant, not its validity. Amos was clearly assaulted and was entitled to bring a claim for personal injuries. Nevertheless, the court also noted the confidentiality clause required Amos not to defame Rodman, disclose the terms of the settlement, or publicize facts relating to the incident. Consequently, these “non-physical injury provisions” had value to Rodman and fell outside the scope of §104(a)(2) exclusion from gross income.

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Practice Pointers to Mitigate Tax Exposure. Confidentiality provisions in personal injury and emotional distress matters may result in tax consequences. To mitigate the tax exposure, consider these strategies: (1) make the confidentiality mutual and recite in the agreement that the consideration for nondisclosure is limited to the mutual promises between the parties; (2) allocate a minimal amount of the settlement to the confidentiality with the expectation that it will be subject to income tax; and/or (3) provide that defendant shall defend and hold plaintiff harmless from any tax liability imposed by virtue of the confidentiality. It is unclear whether these strategies would be successful, although they are better than leaving the agreement silent as in *Amos*. Of course, the safest approach is to seek advice from a tax professional before finalizing the confidentiality clause in any settlement agreement.

Confidentiality Provisions in Sexual Harassment and FEHA Cases. In 2018 the California Legislature enacted a number of statutes in response to #MeToo, including the *Stand Together Against Nondisclosure (STAND) Act*. The law added Code of Civil Procedure § 1001 that voided any confidentiality provisions in settlement agreements resolving claims for sexual harassment under Civil Code § 51.9, workplace sexual harassment or discrimination, failure to prevent harassment, and retaliation for reporting sexual harassment or discrimination.

In late 2021, SB 331 was enacted to expand § CCP 1001 beyond sexual harassment to *any* protected characteristic under FEHA, including race, religion, color, national origin, ancestry, physical disability, mental disability, medical condition, genetic information, familial status, sex, gender, gender identity, gender expression, age, sexual orientation, and veteran or military status. Any nondisclosure agreement that violates SB 331 is *void as a matter of law* and against public policy. The law distinguishes agreements reached in litigation, separation agreements, and other employment-related agreements.



When attending mediation with a client seeking a confidentiality provision, let the mediator know early in the process. The better and more effective practice is to introduce the term early in the negotiation.

A litigation settlement agreement may not prevent the disclosure of factual information concerning any form of FEHA harassment or discrimination regarding claims asserted by an employee in civil court or before an administrative agency. However, *employers may require that the settlement amount remain confidential*. If requested by the employee, the employee's identity, and all facts that could lead to the discovery of that identity, shall remain confidential.

Deductibility by payor. Under 26 USC § 162(q), no deduction is allowed for a settlement or payment related to a sexual harassment or sexual abuse claim if the settlement is subject to a nondisclosure agreement. Likewise, attorney fees related to such a settlement or payments are not deductible.

Conclusion. When attending mediation with a client seeking a confidentiality provision, let the mediator know early in the process. The better and more effective practice is to introduce the term early in the negotiation. The parties can discuss strategies to minimize the tax exposure. In sexual harassment and FEHA cases, a confidentiality clause is void and unenforceable, although the employer may request that the *amount* of settlement remain confidential. By following these guidelines, plaintiffs will not be surprised by unintended income taxes, nor defendants with ineffectual confidentiality clauses; and counsel will avoid his or her settlement agreement becoming another cautionary tale of confidentiality clauses.

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