LOS ANGELES & SAN FRANCISCO
Daily Journal
www.dailyjournal.com

WEDNESDAY, NOVEMBER 23, 2022

PERSPECTIVE

Unintended consequences of confidentiality clauses

By Steven H. Kruis

Introduction. The insertion of a confidentiality clause (and its cousin, the non-disparagement provision) into a settlement agreement may convert an otherwise nontaxable settlement into a taxable one. In sexual harassment claims, an employer's request to keep the amount of the settlement confidential may result in the non-deductibility of the employer's settlement payment and defense fees. To avoid these unintended consequences, a quick review of a few tax rules is helpful.

IRC § 104(a)(2): An Overview. Internal Revenue Code, 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." 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.

Emotional Distress Damages. 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.

Emotional distress damages are not taxable if the distress flows from physical injuries or physical sickness. Stated differently, for these damages to be excluded from gross income, the physical injury or sickness must come first, thereby causing emotional distress. Conversely, if the emotional distress causes the sickness or injury, the damages will be taxable.

Punitive and Employment Damages. Punitive damages are not excludable from gross income with one exception - where under state law only punitive damages are recoverable in wrongful death claims. In wrongful termination, breach of contract, and discrimination 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.

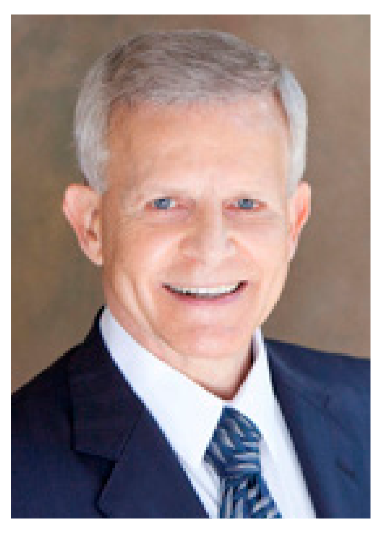
Confidentiality Clauses. The insertion of a confidentiality clause into a settlement agreement of a personal injury claim, or one for emotional distress damages (where the distress flows from a physical injury or sickness), could subject an otherwise non-taxable settlement to federal income tax. Any portion of the settlement allocated to the confidentiality provision would not be excluded from gross income.

> **'Counsel may effectively draft a settlement agreement so that plaintiffs will not be surprised by unintended income taxes, nor defendants with unintended nondeductible expenditures.'**

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

Steven H. Kruis *has mediated thousands of matters throughout Southern California since 1993, and is with the San Diego Office of ADR Services, Inc. He may be reached at skruis@adrservices.*



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.

Practice Pointers to Mitigate Tax Exposure. *Amos* demonstrates how a confidentiality clause can render a nontaxable settlement into a taxable one. To mitigate this risk, 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.

No Deductibility by Payor in Sexual Harassments Cases. 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.

Pursuant to California Code of Civil Procedure § 1001, any confidentiality provision in the settlement of a sexual harassment claim is void and unenforceable, though the employer may request the settlement amount remain confidential. However, doing so may result in loss of the federal tax deduction, even though the underlying facts and circumstances of the claim would be subject to disclosure. Defense counsel should make sure their client understands the potential loss of the deduction before requesting the settlement amount remain confidential.

Conclusion. By keeping these guidelines in mind, counsel may effectively draft a settlement agreement so that plaintiffs will not be surprised by unintended income taxes, nor defendants with unintended nondeductible expenditures.