

TAX TRAPS IN SETTLEMENT AGREEMENTS

A Thank You to Dennis Rodman for the Heads Up

By Michael L. Weiner

Dennis Rodman is known for many things beyond playing NBA basketball – his cross-dressing, ever-changing hair color, full employment for tattoo artists, and eight-day marriage to Carmen Electra among them. Now, he has one more item of notoriety. Since December 1, 2003, his name has become the short hand reference for income tax concerns for the unwary personal injury plaintiff.

Here in Minnesota, many remember the January 1997 incident that ultimately led to the U. S. Tax Court ruling for which Rodman has now become famous in legal circles, because it occurred at the Target Center in downtown Minneapolis. During a basketball game between the Minnesota Timberwolves and the Chicago Bulls, Rodman, playing for the Bulls, landed on a group of photographers at court-side. Rodman twisted his ankle, and in anger kicked at one of the photographers, Mr. Eugene Amos, Jr.

Amos was taken by ambulance to Hennepin County Medical Center, complaining of shooting neck pain (after having been kicked in the groin). The next day, Amos sought medical treatment at the VA Medical Center, where x-rays were essentially normal. *Less than a week later*, Rodman and Amos entered into a settlement agreement for \$200,000. Rodman's attorney demanded certain language in the release that Amos signed; language that ultimately caused Amos severe heartburn.

The release drafted by Rodman and signed by Amos had the usual personal injury boilerplate language. However, the release also had extensive additional language on other issues, including keeping the settlement confidential, imposing harsh consequences on Amos should he disclose such information, and binding Amos not to pursue criminal charges against Rodman.

The confidentiality clause read in pertinent part:

It is further understood and agreed that, *as part of the consideration* for this Agreement and Release, the terms of this Agreement and Release shall forever be kept *confidential* and not released to any news media personnel or representatives thereof or to any other person, entity, company, government agency, publication or judicial authority for any reason whatsoever except to the extent necessary to report the sum paid to appropriate taxing authorities or in response to any subpoena issued by a state or federal governmental agency or court of competent jurisdiction Any court reviewing a subpoena concerning this Agreement and Release should be aware that *part of the consideration* for the Agreement and Release *is the agreement of Amos and his attorneys not to testify regarding the existence of the Agreement and Release or any of its terms.*

* * *

It is further understood and agreed that Amos . . . shall not . . . disclose, disseminate, publicize . . . any of the allegations or facts relating to the Incident, including . . . facts or opinions relating to Amos' potential claims against Rodman or any allegations, facts or opinions relating to Rodman's conduct on the night of January 15, 1997. . .

It is further understood and agreed that any material breach by Amos or his attorney, agent or representative of the terms of this Agreement and Release will result in immediate

and irreparable damage to Rodman, and that the extent of such damage would be difficult, if not impossible, to ascertain. *To discourage any breach of the terms of this Agreement and Release, and to compensate Rodman should any such breach occur*, it is understood and agreed that Amos shall be liable for liquidated damages in the amount of TWO HUNDRED THOUSAND and No/100 Dollars (\$200,000) in the event such a material breach occurs. Amos agrees that this sum constitutes a reasonable calculation of the damages Rodman would incur due to a material breach.

* * *

Amos further represents, promises and agrees that, as part of the consideration for this Agreement and Release, he has communicated to the Minneapolis Police Department that he does not wish to pursue a criminal charge against Rodman, and that he has communicated that *he will not cooperate in any criminal investigation concerning the Incident.* Amos further represents, promises and agrees that *he will not pursue any criminal action against Rodman* concerning the Incident, that *he will not cooperate should any such action or investigation ensue.* . . .¹ (emphasis added)

Section 61(a) of the Internal Revenue Code ("I.R.C."), defining gross income, is broad in its scope. Exclusions from gross income are narrowly construed.² Among the common exclusions from gross income, and the one that personal injury practitioners rely upon, is I.R.C. section 104(a)(2), which excludes "the amount of

any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness.”

When Amos filed his 1997 tax returns, he excluded, pursuant to section 104(a)(2), the full \$200,000 he received in settlement from Rodman. Unfortunately for Amos, the Internal Revenue Service claimed that he was not entitled to exclude *any* of the settlement amount under section 104(a)(2) (except for a nominal amount, i.e. \$1.00) because Amos had failed to introduce any evidence about his injuries, and further, the IRS claimed Rodman was skeptical about the extent of Amos’ physical injuries. Ultimately, the IRS argued to the U. S. Tax Court that Amos’ injuries were minimal, and further, that because the liquidated damages payable back to Rodman if Amos breached the confidentiality clause equaled the settlement amount (i.e. \$200,000), none of the amount in question was to compensate Amos for his physical injuries.

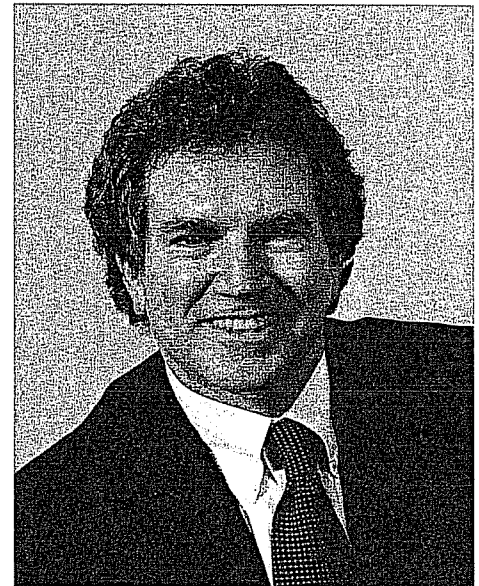
The Tax Court did not exactly “split the baby” but came fairly close, ruling that 60% of the settlement related to personal injuries and 40% was non-injury related. The court concluded that the “dominant” reason for Rodman to pay Amos was to compensate Amos for his physical injuries. However, because there was no specification in the settlement agreement as to what portion of the \$200,000 related to Amos’ physical injuries, and what amount was for the nonphysical injury provisions of the settlement agreement, the Tax Court was free to examine the record and make its own apportionment. It also noted that Amos, as the taxpayer, had the burden of proving the amount of the settlement that was due to physical injuries. Because the court determined that 40% of the settlement was not

excludable under I.R.C. section 104(a)(2), Amos was required to pay taxes on \$80,000.³

As might be expected, Mr. Amos’ case has become the subject of much discussion and commentary in the legal community.⁴ The Internet is also replete with warnings from structured settlement companies and law firms to “don’t let this happen to you!”

It is perhaps no great surprise that a personal injury settlement for \$200,000, reached less than a week after the injury occurred, and in light of very little medical treatment or findings, might arouse the suspicion of the IRS. According to the Tax Court decision, while there was some evidence from Hennepin County medical personnel that Amos was limping and complained of pain, he was already taking pain medication for a pre-existing back condition and refused additional medications at Hennepin County Medical Center. At the VA Medical Center the day after the incident, x-rays were taken of Amos’ back, and with the exception of pre-existing disk problems, the vertebrae and remaining disk areas were normal. Although Amos mentioned his groin to the VA doctors, he did not advise of any symptoms related to the groin, nor was there any objective evidence of swelling or bruising. Hence, the question: In light of this limited medical evidence of injury, was the money really paid to buy silence from Amos and avoid criminal action?

Fortunately for Amos, the Tax Court found that whether Rodman was skeptical about the injuries was *not* the important consideration. Instead, the court focused upon the “*nature and character of the claim settled, and not its validity*” to determine whether exclusion from gross income would be appropriate under section 104 (a)(2).⁵ As to the liquidated damages provision in the settlement agreement,



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which equaled the amount of the settlement, the court also found that this was not “determinative of the reason for which Mr. Rodman paid petitioner the settlement amount at issue.”⁶

On the state of the record, which included the settlement agreement itself, Rodman’s declaration, and the testimony of Amos’ attorney, the court focused on the language of the settlement agreement in which Amos released all injuries “of any type, known

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and unknown.” Amos’ attorney also testified the entire amount was paid due to physical injuries. However, the Court found that position “belied by the terms of the settlement agreement.”⁷ Although the court concluded that the attorney’s testimony supported the argument that the dominant reason for paying Amos was physical injuries, the court also considered other things for which Amos was compensated, including Amos’ agreement not to: “(1) defame Mr. Rodman, (2) disclose the existence or the terms of the settlement agreement, (3) publicize facts relating to the incident, or (4) assist in any criminal prosecution against Mr. Rodman with respect to the incident.”⁸

The question, of course, is where the *Amos*

decision leaves the practitioner when a defendant requests (or demands) confidentiality provisions. Even after separating out the facts that were unique to the Amos/Rodman case and unlikely to be present in the typical personal injury action (i.e., the defamation and publicity issues, and potential criminal prosecution), the Tax Court’s decision has put all plaintiffs’ attorneys on notice that they must be exceptionally careful in agreeing to confidentiality provisions. Even though Amos’ attorney testified that *all* of the \$200,000 was for physical injuries, the court found this position “belied by the terms of the settlement agreement.”⁹ Hence, Plaintiffs’ attorneys who do agree to confidentiality provisions must ensure that settlement *terms* explicitly reflect payment only for personal injuries, and not

for confidentiality. How to do so can be accomplished in varying ways.

One of the most effective methods to avoid linking confidentiality to any dollar value may also be the simplest. Since *both* parties may desire and benefit from confidentiality, their *mutual* promises to keep the amount confidential would serve as the *sole* consideration for this provision.

Plaintiffs’ attorneys, and more importantly, their clients, obviously have a wide variety of views on settlement confidentiality. Although there may be benefits to exposing wrongdoing by defendants that result in settlements, many plaintiffs are highly

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desirous of their privacy and would be happy to tell friends, relatives, and the media that they are barred from disclosing the amount of the settlement. (Unless they want to find the many friends and relatives they never knew they had.) Indeed, twenty years ago, after the tragic Galaxy Airlines crash in Reno, Nevada, that killed 70 people, most from Minnesota, the victims' families successfully kept the amount of their settlements private when the news media attempted to use Minnesota's wrongful death approval process to learn the amounts of the settlements.¹⁰

Keeping in mind that the scope of this article goes only to confidentiality of the amount paid by a defendant (and *not* the far more significant and troubling attempts by defendants to buy complete secrecy in order to hide their wrongdoing from other potential victims), that fact that each party may benefit from confidentiality provides a basis to limit the value of this settlement term and completely sever it from any connection to the amount of money paid to the plaintiff. Because *each* party receives a benefit from the confidentiality provision, the *sole* consideration for the confidentiality provision is each side's *mutual promise* to keep the amount confidential. An example might read as follows

The Parties to this agreement represent and acknowledge that no portion of the settlement amount in this agreement represents consideration or payment for anything other than personal injuries within the meaning of Section 104 (a)(2) of the United States Tax Code; and further, the Parties represent and acknowledge that the sole consideration for the mutual promise of the Parties to maintain confidentiality of the settlement amount of this agreement is each other's reciprocal promise to do so.

Other advice to avoid the tax bite includes (1) simply avoid confidentiality agreements, (2) use express language, such

as that above, to negate payment for confidentiality, (3) expressly disclaim consideration for confidentiality for the settlement amount itself, (4) apportion or segregate the amounts paid for confidentiality (such as \$1.00 or other good and value consideration), or (5) if the issue of confidentiality arises, separately negotiate the issue so it is clear the amount is separate.

At the end of the day, one point is now clear. Caution is the watchword when the issue of confidentiality arises, but with careful drafting of release language, the parties can make clear their intent to apportion all settlement dollars to non-taxable personal injuries.

¹ *Amos v. Comm'r*, 86 T.C.M. (CCH) 663, 2003 W.L. 22839795 (U.S.T.C. Dec. 1, 2003) (emphasis added).

² *United States v. Burke*, 502 U.S. 229 (1992).

³ *Amos v. Comm'r*, 86 T.C.M. (CCH) 663.

⁴ Noah Burton, *The Taxation of Contingent Attorney's Fees: How the Court Got Lost in the Forest*, 36 *RUTGERS L.J.* 953 (2005); Benjamin T. Cory, *Amos v. Commissioner: The Ambiguous and Ever-Changing Definition of What Constitutes a Personal Physical Injury Under Internal Revenue Code Section 104(A)(2)*, 66 *MONT. L. REV.* 247 (2005); John Freeman, *Another Reason to Avoid Confidential Settlements: Taxation*, 16 *S. CAROLINA LAWYER* 9 (July 2004); Randall O. Sorrells, *Plaintiffs' Attorneys Beware: Little Known Tax Consequences Associated with Confidentiality Provisions*, 6 *Hous. Bus. & Tax L.J.* 258 (2006).

⁵ *Amos v. Comm'r*, 86 T.C.M. (CCH) 663 (emphasis added).

⁶ *Id.*

⁷ *Id.* (emphasis added).

⁸ *Id.*

⁹ *Id.*

¹⁰ See *Minneapolis Star & Tribune Co. v. Schumacher*, 392 N.W.2d 197 (Minn. 1986).

