



How Will Your Confidential Sexual Harassment Settlement Be Taxed?

February 2018

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The #MeToo movement has helped bring to light disturbing instances of sexual assault and harassment in the workplace. In reaction to that movement, on December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act (the “Act”) which, among other things, changes the federal income tax treatment of settlements of claims for sexual harassment and sexual abuse.

KEY CHANGES

New Internal Revenue Code Section 162(q) of the tax code eliminates the ability of an employer to take a tax deduction for:

1. any settlement or payment related to sexual harassment or sexual abuse, if such settlement or payment is made subject to a nondisclosure agreement, or
2. attorneys’ fees related to such a settlement or payment.

This is a significant change from prior law, which allowed employers to take an “ordinary and necessary business expense” tax deduction for settlement payments and related attorneys’ fees for confidential settlements of claims of sexual harassment.

PRACTICAL IMPLICATIONS OF ELIMINATION OF DEDUCTION

1. Most employment settlement agreements have a confidentiality or non-disclosure provision. Given the changes in the Internal Revenue Code, before including a confidentiality provision in a settlement agreement, employers will have to carefully choose between either taking a tax deduction for settlements of sexual harassment claims and related attorneys’ fees, or keeping the settlement amount confidential.



2. The Act does not change the income tax treatment of settlement of claims of other forms of harassment and discrimination (e.g. race, color, age, disability). So, arguably, employers faced with a claim of sexual harassment and other claims not covered by the Act can allocate some or the entire confidential settlement payment to the other claims and still take the tax deduction. Currently, it is unclear whether the Internal Revenue Service ("IRS") will interpret the Act as a complete bar to the tax deductibility of any confidential settlement of a claim of sexual harassment or sexual abuse, thereby preventing an employer faced with multiple claims, including a claim of sexual harassment, from deducting confidential settlement payments and related attorneys' fees.
3. Another ambiguity not addressed in the Act is whether the IRS will interpret the denial of a tax deduction for attorneys' fees related to sexual harassment or sexual abuse to apply to all sexual harassment/abuse settlements, including where the settlement agreement has no confidentiality or nondisclosure provision.

The language in Section 162(q) raises many questions about the proper structure of settlements involving sexual harassment or sexual abuse following its enactment. The Treasury Department and the IRS are expected to issue additional guidance on the interpretation of the Act.

Employers have plenty of reasons to avoid sexual harassment claims already, and the tax ramifications of the Act create one more reason. Among the steps employers should take to limit sexual harassment claims are having a legally compliant sexual harassment policy, strict enforcement of that policy, and proper training of managers.