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COZEN O'CONNOR

Unnoticed Provision of New Tax Bill Makes Sex Harassment Settlements Subject to NDAs Not Deductible

A provision in the tax bill President Trump signed into law on December 22, 2017, has important implications for the settlement of sexual harassment claims. The new law includes a post-Weinstein, #MeToo era provision aimed at stemming the use of nondisclosure agreements in settlement of sexual harassment and sexual abuse claims. Any settlement payment including attorney's fees (apparently made to either the employer's or the claimant's attorney), related to sexual harassment or sexual abuse cannot be deducted as a business expense if the settlement payment is subject to a nondisclosure agreement. Of course, nondisclosure or confidentiality provisions are commonplace in any settlement agreement, including sexual harassment settlements.

This provision was originally proposed by Senator Robert Menendez, (D-N.J.), and survived the fast-paced drafting process. Due to the speed with which it was drafted, the vague language of Section 162(q) introduces a number of questions for both employers and claimants in sex harassment claims. Effective as of December 22, 2017, Section 162(q) of the Internal Revenue Code provides:

> (q) PAYMENTS RELATED TO SEXUAL HARASSMENT AND SEXUAL ABUSE. — No deduction shall be allowed under this chapter for — (1) any settlement or payment related to sexual harassment or sexual abuse if such settlement or payment is subject to a nondisclosure agreement, or (2) attorney's fees related to such a settlement or payment.

Because this provision became effective upon enactment, it applies to any payments (including attorney fees) related to sexual harassment or sexual abuse made after December 22, 2017, if such payments are subject to a nondisclosure agreement. Existing settlement agreements with nondisclosure provisions that contemplate payments extending past December 22 could also be affected. The Act does not provide a transition rule exempting pre-existing agreements.

Employers considering whether or not to settle sexual harassment cases must take this new provision into account as they determine the value of a case and how to structure a settlement. Unfortunately, it is not clear how exactly the language in the provision will be interpreted. For instance, the statutory language does not define "sexual harassment," "sexual abuse," or "nondisclosure agreement." Would an agreement keeping only a settlement amount, but not the underlying claims or the fact of the settlement, confidential constitute a nondisclosure agreement?

In addition, Section 162(q) does not provide guidance for determining whether or not a payment is "related to" sexual harassment or sexual abuse. Many cases involving sexual harassment claims also contain other allegations. Are payments made to settle those other allegations related to sexual harassment? Could the parties avoid some or all of the negative tax implications by allocating the payment towards other claims and agreeing that none — or only a small amount — of the payments are related to the sexual harassment allegations? The IRS is not bound by the parties' settlement allocations, but it often follows them. Will the IRS continue to follow settlement allocations involving sexual harassment allegations or will it more closely examine these claims?

There is additional ambiguity in the phrasing of the attorney's fees subsection, which disallows a deduction for "attorney's fees related to such a settlement or payment." If the settlement is global and encompasses claims other than sexual harassment, could attorneys separate out fees related to sexual harassment claims from other fees so clients can determine what portion of the fees can be deducted?

Section 162(q) could also end up hurting plaintiffs — or dissuading them from coming forward —

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by barring deductions of attorney's fees paid by or on behalf of plaintiffs. Senator Menendez has stated that Congress' speedy drafting process led to this potential unintended consequence. Plaintiffs are required to report the full amount of a settlement as income. However, prior to adoption of this provision, plaintiffs could take an above-the-line tax deduction on the attorney's fees they paid, so they were only taxed on the portion of the award they kept. With enactment of the new tax bill, plaintiffs who enter into nondisclosure agreements are no longer permitted this deduction. Plaintiffs may be taxed on the entire amount of a settlement — or more than they actually keep. If attorney's fees are a large portion of a settlement, a plaintiff actually might end up worse off after taxes than if s/he had never come forward at all. While a plaintiff could refuse to agree to a nondisclosure agreement to avoid the negative tax implications, the employer may refuse to settle without such a provision, and, in many cases, the employee might prefer the protection of confidentiality for privacy reasons.

Faced with this new law, and the lack of clarity surrounding it, employers should review any settlements that were not fully paid out prior to December 22. Employers should also examine their standard settlement agreements and practices and consider the financial impact of section 162(q) on their incentives to settle and for what amount. Employers would also do well to examine their sexual harassment policies and reporting procedures to ensure they are doing everything they can to prevent harassment and avoid claims in the first place.

Cozen O'Connor's Tax and Labor & Employment attorneys are available to provide counsel and guidance on the issues discussed in this Alert.