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Confidential Sexual Harassment Settlements No Longer Tax Deductible

Insight — 01/09/2018

The recently enacted tax reform bill contains a short provision that could significantly affect whether and how employers settle sexual harassment claims. Section 13307 of the Tax Cuts and Jobs Act states that no deduction is allowed for any settlement or payment related to sexual harassment or sexual abuse if the settlement or payment is subject to a nondisclosure agreement. The new provision also prohibits a tax deduction for attorney's fees related to confidential sexual harassment settlements or payments.

Deductibility Hinges On Confidentiality of Settlement

The new tax provision eliminates a tax deduction for sexual harassment-related settlements only if the settlement or payment is subject to a nondisclosure agreement. In other words, if an employer requires the alleged victim of sexual harassment or abuse to keep the settlement (and presumably the underlying claim) confidential, then the amount of the payment and any attendant attorney's fees are not tax deductible. Sexual harassment/abuse settlements and related attorney's fees remain tax deductible if they are not subject to a nondisclosure agreement.

The policy behind this provision appears to be in response to the recent spate of sexual harassment and abuse claims coming to light. The "#MeToo" campaign has raised significant concerns about companies and their high-level employees hiding behind nondisclosure agreements to avoid public scrutiny about unlawful sexual conduct in the workplace. Repeat offenders often keep their jobs when their employers pay off the victims in secret. By eliminating the tax deduction for confidential settlements and related attorney's fees, companies will be forced to weigh confidentiality against tax deductibility when deciding whether to settle each claim.

What If Sexual Harassment/Abuse Is Only One of Multiple Claims Being Settled?

One of the questions left unanswered in this new tax reform provision is what happens to the tax deduction for payments that settle more than one kind of employment claim. In many cases, the victim of sexual harassment or sexual abuse brings other claims against his or her employer, such as retaliation, gender discrimination, violation of the Equal Pay Act, or defamation. The language of the provision is unclear as to what is meant by any settlement or payment related to sexual harassment or sexual

abuse. One could argue that a retaliation claim that arose from an adverse action following a complaint of sexual misconduct would be related to the sexual harassment claim. But what about an Equal Pay Act claim? Is that related to sexual harassment or sexual abuse?

It is unclear whether confidential settlement payments related to these other types of employment claims will remain tax deductible when lumped in with a sexual harassment settlement. This open question will likely lead employers to separate settlement agreements and payments for non-sexual harassment claims in order to keep the settlement of these other types of claims confidential and tax deductible. It also could lead employers (on likely advice from their attorneys) to structure settlements of multiple claims with an allocation of only a small amount, say \$100, to the settlement of the sexual harassment claim, with the remainder of any settlement payment attributed to other types of claims alleged by the victim. Absent any clarification on this issue, we expect this will be the subject of much litigation down the road. In the meantime, companies and their attorneys likely will use creative drafting of settlements to try to separate unrelated claims in order to keep the settlement of non-sexual-harassment claims confidential and retain the deductibility of payments and attorney's fees incurred for non-harassment matters.

Deductibility of Victim's Attorney's Fees

Another open question is whether the denial of deductibility applies only to the companies making settlement payments and their own attorney's fees related to such settlements, or if it applies to the attorney's fees incurred by the victim as well. The new provision denying deductibility for settlements subject to nondisclosure agreements amends section 162 of the Internal Revenue Code (IRC) which is the section that allows deductions for ordinary and necessary trade or business expenses paid or incurred during the course of a taxable year. Generally, an individual would not be able to take a business deduction under IRC Section 162. However, the language in the provision does not make it clear that it applies only to the business's own attorney's fees, thus leaving open an interpretation that it also prohibits the victim of sexual harassment or sexual abuse from deducting his or her attorney's fees related to settlements of such claims. It also could be interpreted to deny the deduction to a business that pays the victim's attorney's fees as part of a confidential settlement.

This could hit victims hard as those who sign nondisclosure agreements may have to pay taxes on the entire settlement, including any amounts paid to cover his or her attorney's fees. Or, it could lead victims to reject any settlement containing a nondisclosure provision in order to avoid paying taxes on the attorney's fee portion of the settlement payment. It also may make employers less likely to agree to pay the victim's attorney's fees as part of a confidential settlement because the total amount of fees paid to attorneys on both sides would not be deductible as a business expense. It is unclear whether Congress meant to hamstring victims in this way, or if it was the result of inarticulate drafting. We will have to see whether a correction or guidance is issued to clarify how the new denial of deductibility provision affects a victim's ability to deduct attorney's fees.

Get Advice Before Settling

The denial of deductibility provision affects any amounts paid or incurred after December 22, 2017 (when the tax reform act became effective). This makes one thing about this new tax deduction provision clear – employers should get advice from competent counsel and tax professionals before settling any sexual harassment or sexual abuse claims. Employers will need to evaluate each case individually to decide whether confidentiality trumps deductibility. Then, after the employer decides whether to impose a nondisclosure requirement on the alleged victim of sexual harassment/abuse, the settlement agreement must be drafted carefully in light of this new provision. If the victim asserts multiple claims, employers may be able to keep the settlement of non-harassment claims both confidential and deductible, if the settlement agreement is drafted correctly.

The bottom line is seek advice early and don't use boilerplate settlement agreements without considering the tax deductibility consequences of nondisclosure provisions.

If you have questions, please don't hesitate to contact me at SGutierrez@hollandhart.com or the Holland & Hart attorney with whom you work.

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