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CLIENT ALERT: Tax Reform Act Eliminates Deductions for Sexual Harassment Settlement Payments that Require Nondisclosure – By Jeffrey S. McAllister

On December 22, 2017, Congress passed the much-publicized "Tax Cuts and Jobs Act," hailed by many as comprehensive income tax reform for both corporations and individuals. A little-publicized provision changed the taxation status of settlements in sexual harassment claims. The relevant language, now codified as 26 U.S.C. § 162(q), provides:

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.

"Payment" is defined as "any gross amount which is used in computing any net amount which is transferred to or from the taxpayer." The remaining provisions are otherwise not defined. The amendment took effect immediately.

The legislative change reflects a policy to discourage confidentiality in sexual harassment claim settlements by using taxation status to the detriment of both employees and employers. For employers, the inclusion of a confidentiality provision likely means that neither the settlement payment amount nor any attorney's fees related to that settlement may be deducted by the employer as a business expense. For employees, the inclusion of a confidentiality provision would likely preclude an offset of the amount paid to an attorney against the amount taxable to the employee.

The policy intention is clear but may have unintended consequences. Litigating parties may both prefer non-disclosure terms in a settlement agreement, not because of clear liability or the desire to cover up wrongdoing, but to avoid publicity, ensure better transition to new employment, avoid stress, and as with any settlement, to limit legal costs and personal and business interruption. Parties with legitimate and mutual reasons for non-disclosure terms will now be faced with a higher expense due to the non-deductibility of the payments and will consider that expense when attempting to settle claims.

The provision also leaves unresolved questions, such as:

- What constitutes a claim that is "related" to sexual harassment?
- In a general release, may the portion that is not related to sex-based claims be separated from the non-disclosure agreement, such that a portion of the payment and associated legal fees are deductible?
- May the parties enter into two separate releases, one that addresses sexual harassment and the other all remaining employment-related claims?

It is unlikely that the IRS will issue guidance on this relatively narrow topic, at least in the short term. Employers and their counsel should therefore be thorough in identifying the associated risks when negotiating the settlement of sexual harassment claims and weighing the issue of whether to request a non-disclosure agreement.

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