

## Alert | Tax/Labor & Employment



December 2017

### **Sexual Harassment Settlements With Nondisclosure Agreement Will Not Be Deductible Under New Tax Law**

A provision in the Tax Cuts and Jobs Tax Act will increase the “after-tax cost” for companies to settle “sexual harassment” or “sexual abuse” claims if they wish to maintain a “nondisclosure agreement” of the details. The law will disallow a business deduction for the amounts paid to settle such claims (including attorneys’ fees) if the settlement contains a nondisclosure agreement. This provision addresses the use of nondisclosure agreement terms to possibly prevent public disclosure of sexual harassment allegations or reports.

The language of the new law is very simple. Its application to structuring settlements of claims will likely be complex. The tax law adds § 162(q) to the Internal Revenue Code as follows:

“(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.”

The effective date is after the enactment of the law – Dec. 22, 2017 when President Donald Trump signed the Tax Cuts and Jobs Act into law. This deduction disallowance provision now applies to settlements of “sexual harassment or sexual abuse” claims where the parties are bound by a nondisclosure agreement.

One issue with interpreting the scope of this rule is that there is no definition of “sexual harassment or sexual abuse” provided in the statute. A second issue is that the law does not define “employers” or “payers” subject to this prohibition.

There is no indication of legislative intent on these questions in the Joint Committee Explanation of the new tax law. As a result, further guidance will be needed in the form of IRS rulings or regulations, which will take time to issue. In the meantime, an employer settling a claim of conduct that might not squarely be within the definition of harassment or abuse may not immediately know the tax implications of inserting a “nondisclosure” clause into a settlement agreement.

Some employers may attempt to structure a settlement to avoid language indicating the underlying cause of the claim, to avoid classification as a settlement of a sexual harassment or sexual abuse claim. However, a judicial doctrine of tax law, the “origin of the claim” doctrine, would allow the IRS to look behind the terms of the settlement agreement to determine the underlying nature of the claim, which might result in a determination that the agreement was related to sexual harassment or abuse. The employer would have the opportunity to litigate such a finding in federal courts, but that would likely result in public disclosure because the pleadings and ultimate ruling in such a tax controversy would be public documents.

If an employer wishes to characterize a particular settlement as something other than a “sexual harassment or sexual abuse” matter, and the IRS takes a contrary view, the employer’s hands could be tied in defending this position in the courts if it wishes not to disclose the underlying facts to the public. An IRS auditor will likely be aware of the employer’s conundrum here, knowing that the employer will have little leverage in audit negotiations should it wish to maintain confidentiality.

When an employer settles an employment claim where alleged “sexual harassment and sexual abuse” may be just one element of the claim, it will face some serious challenges if it wishes to provide a nondisclosure provision and deduct the payments. What if an employee alleges that she or he were both the victim of racial or religious discrimination as well as sexually harassed? The language of the bill is very broad, and does not differentiate between the merits of the parallel claims, or whether another claim predominates over the sexual harassment claim – if one of the claims is related to sexual discrimination, it apparently would come under this deduction disallowance rule if a nondisclosure agreement is part of the settlement.

The law also fails to address situations where the aggressor is terminated and receives a severance package. If the termination is related at all to the settlement, then the IRS might take the position that the severance payment is likewise non-deductible. If the agreement requires the employer to take any other action, such as implementation of an educational program to raise awareness of sexual harassment, the cost of such a program might also not be deductible.

Finally, this deduction disallowance rule will be applicable even if the employee making the claim wishes to have a nondisclosure agreement so that the employer is unable to comment. Often employees desire language stating that the employee voluntarily terminated their employment and a non-disclosure agreement prohibiting the employer from stating otherwise. This is not unusual since claimants want to put the matter behind them and move on with their lives. However, there is no distinction in the provision between a bilateral nondisclosure prohibiting both parties from commenting on the settlement, and a unilateral agreement that would only prohibit one side, even the employer, from commenting. Any nondisclosure provision would trigger a disallowance of the deduction.

This new provision will complicate the process of settling harassment claims. It will further encourage employers to implement sexual harassment education programs to avoid such claims.

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