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Sexual Harassment Settlements With Nondisclosure Agreement No Longer Deductible

The new Tax Cuts and Jobs Act adds a provision to the tax code which disallows a deduction for amounts paid to settle a sexual harassment or abuse claim if that settlement includes a nondisclosure agreement. Section 162(q) to the Internal Revenue Code now disallows a deduction for any payment "related to sexual harassment or abuse if such settlement or payment is subject to a nondisclosure agreement."

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The language of the act is simple, but its ramifications are far-reaching. First, this will materially increase the after-tax cost of settling harassment or abuse claims when accompanied by a nondisclosure agreement. In addition, because of the broad language of this provision, there are many open questions as to its scope.

There are several concerns that general counsel should consider due to the uncertainties that may arise when settling a sexual harassment or abuse claim with a nondisclosure clause. These include the following:

Disallowance may apply to all payments to the claimant. If the settlement payment includes back-pay to the employee/claimant, the deduction for wages might also be disallowed where there is a nondisclosure agreement because the payment is "related to sexual harassment."

Attorney Fees. The disallowance of the deduction applies not only to the amount paid to settle the claim, but also to the attorney fees as well. Furthermore, the language of the statute is so broad that it appears that the attorney fees paid to claimant's counsel may also not be deductible by the claimant—yet they will be included in the claimant's and his or her attorney's income. Even though attorney fees paid by an employee are treated as an above-the-line deduction (rather than an itemized deduction), Section 162(q) disallows any deduction which seemingly would apply to the employee's above-the-line deduction. This issue has already received attention by the plaintiffs bar and might cause employees to significantly increase their financial

demand to compensate them for the additional taxes that will result if they are unable to deduct their attorney fees.

There is no definition of sexual harassment. The statute does not define sexual harassment or abuse. This leaves open the possibility that an aggressive tax auditor might say that any claim of inappropriate behavior will trigger this disallowance provision.

Disallowance may apply even if harassment is not the primary claim. If sexual harassment is just one of several claims, the IRS might contend the entire payment should not be deductible, even if it is not the predominant claim because the payment is "related to sexual harassment." For example, if the claimant alleges religious discrimination as the primary claim, but also alleges inappropriate sexual comments made by a supervisor, the IRS may contend that the entire payment should be nondeductible if there is a nondisclosure agreement.

One likely cannot avoid new law merely by reclassifying claims. An employer who wants to avoid application of the new law may attempt to change the character of the claim by the wording of the settlement agreement. Such an attempt may be met with IRS resistance. For example, if the employee claims sexual harassment, but the settlement agreement casts the claim as racial discrimination, the IRS might look into the history of allegations and seek to recharacterize the settlement as one for sexual harassment, pursuant to the "origin of the claim" test. This test looks to the underlying facts of a claim to determine the tax treatment of payments.

Disallowance applies even if the claimant unilaterally wants a nondisclosure agreement. The deduction disallowance applies even if the nondisclosure agreement is unilateral, and only prohibits the employer (but not the claimant) from discussing the matter. So if the employer is willing to do without a nondisclosure agreement, but the claimant insists on one to prohibit the employer from discussing the case, the deduction disallowance will still be triggered.

Disallowance might be argued to apply to severance payments paid to the harasser. If the agreement contemplates termination of the harasser's employment, the IRS might seek to disallow a deduction for any severance payments made to the aggressor.

Be wary of release language. If a claim had nothing to do with sexual harassment or abuse, but the general release includes language releasing harassment claims, the IRS might argue that the deduction should be disallowed if there is a nondisclosure agreement. Consider not including specific language in the release referring to sexual harassment or abuse. If the specific sexual harassment language needs to be in the release, then the file should contain evidence that the claimant made no allegations of sexual harassment or abuse in the event of a tax audit.

IRS may have leverage. If the IRS disallows a deduction for a settlement that the employer believes is not a sexual harassment claim, and the employer wishes to challenge the disallowance, the IRS will know that any litigation over the deductibility will result in public disclosure, because the pleadings in federal tax controversies are public. Consequently, a legal challenge might result in unwanted publicity for events that may have occurred many years earlier. The IRS will know that it has such leverage where public disclosure of the allegations would be embarrassing, possibly resulting in a more aggressive position than it might take in other types of audits.

This new deduction disallowance provision therefore can have far-reaching ramifications that may not have been contemplated by Congress. Until the IRS provides guidance, or Congress passes additional legislation to clarify the scope of this new law, there is a risk that the IRS will seek to enforce this new provision broadly.

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