

Retail Detail



Sexual Harassment Legal Settlements: What Employers Need to Know About the New Tax Act

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Seyfarth Synopsis: The new Tax Act prohibits employers from deducting payments to individuals alleging sexual harassment or sexual abuse if the settlement or payment requires the Claimant to execute a nondisclosure agreement.

The #MeToo movement continues to have a significant impact on all employers, forcing human resource professionals to review their protocols for preventing, reporting and investigating sexual harassment claims. Now, Congress has passed the Tax Cuts and Jobs Act (the "Tax Act"), which may make sexual harassment settlements more expensive for employers who seek to keep these settlements private.

Under current tax law, an employer may deduct the ordinary and necessary expenses it incurs in carrying on its trade or business. This deduction generally includes legal settlements or payments to a plaintiff (including plaintiff's attorney fees) and any legal fees the employer has incurred for its defense.

There has been an outcry by high profile victims' advocates who have characterized confidentiality payments in settlements as "hush money" arguing that they mask inappropriate corporate conduct. In response, Congress included a provision in the Tax Act which is aimed directly at deterring employers from using nondisclosure agreements in sexual harassment settlements. Pursuant to new Internal Revenue Code Section 162(q), the government will no longer permit employers to deduct "any settlement or payment related to sexual harassment or sexual abuse if such settlement or payment is subject to a nondisclosure agreement" or "attorney's fees related to such a settlement or payment."

Implications and Challenges

New Section 162(q) has important implications for employers but there remain a number of questions regarding its application. We expect the IRS to issue guidance in the future which will clarify some of the current ambiguities, but employers must devise a plan now for new legal settlements since Section 162(q) applies to payments made after December 22, 2017.

First, the price for confidentiality just increased. When an employer settling a sexual harassment claim includes a nondisclosure provision in the agreement, it will be unable to deduct any payments related to the matter, including the settlement payment and attorney's fees. This may backfire on the Plaintiff's Bar, because there are certainly instances where the plaintiff desires confidentiality for a variety of reasons, including that publication of the agreement may make it more difficult for the plaintiff to find another job. In cases where the plaintiff desires confidentiality more than the employer, the employer may use this leverage to lower its settlement offer, essentially charging the plaintiff for the additional cost of confidentiality.

Second, the broad language of the statute makes it uncertain whether the IRS will consider payments made pursuant to a confidential agreement that does not settle sexual harassment claims but which contains a broad waiver of claims, including for sexual harassment, as “related to sexual harassment” and, thus, preclude the deduction. Unfortunately, we do not know the answer yet. Until this issue is clarified, employers may want to consider adding a provision to their settlement agreements by which the parties acknowledge that even though the claimant is waiving a broad range of potential claims, there was no claim of sexual harassment or sexual abuse and none of the settlement payments are related to such claims.

It is also unclear exactly which deductions the IRS is precluding in connection with the confidential settlement of a sexual harassment claim. The statute is clearly intended to apply to the settlement payment itself, as well as attorney’s fees. But what about other payments? If an employer hires an investigator or expert to assist with its case, are those costs deductible? What if the employer provides outplacement services for the plaintiff or pays the plaintiff’s COBRA premiums, are those costs deductible? Finally, if an employer has Employment Practices Liability Insurance and the insurance carrier makes the settlement and/or attorney’s fees payment, will the insurance company be denied a deduction for those payments? These are questions that will hopefully be answered with future official guidance. Plaintiffs often bring sexual harassment claims along with other discrimination claims like age and race. We will need the IRS to clarify whether a portion of the settlement may be allocated to sex harassment, so that the employer may deduct remaining payments.

Third, the statute explicitly provides that attorney’s fees related to the confidential settlement of a sexual harassment or sexual abuse matter are not deductible. This provision creates separate implications for both plaintiffs and employers.

We read the new statute to prohibit any deduction for an employer’s own attorney’s fees incurred for defense, or the payments made to the plaintiff’s attorneys. The provision would also seem to prohibit a plaintiff from deducting any attorney’s fees the plaintiff pays to his or her attorneys. A plaintiff has income if the employer pays his or her attorney’s fees. In the past, a plaintiff was generally allowed to deduct the amount of the plaintiff’s attorney’s fees that the employer paid, resulting in no net income to the plaintiff for the attorney’s fees. The broad language of new Section 162(q) appears to change that general rule and prohibit a plaintiff from deducting the attorney’s fees the employer paid. As such, the plaintiff may now owe tax on income that the plaintiff never received and this will significantly reduce his or her net recovery.

Although it is unlikely that Congress intended to place a tax burden on plaintiffs who raise sexual harassment claims, there is no clear guidance on these issues. As a result, until the IRS issues further clarification, plaintiffs may look to employers to cover their additional tax liability, which will add to the cost of settlement and make negotiations more difficult.

The result of all of this is that employers will have to carefully evaluate the cost/benefit of confidentiality. It will remain important to continue to monitor developments concerning the new tax law and incorporate the issues discussed above into the legal and financial analysis when settling cases involving sexual harassment or sexual abuse. Seyfarth Shaw will provide further alerts as new developments occur.

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