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Harvey Weinstein Tax Would Prevent Sex Harassment Settlement Write-Offs

In business, lawyer's fees and legal settlements are usually tax deductible. In fact, even punitive damages are tax deductible, no matter how bad the conduct. In general, only fines and penalties paid to the government are not. Even some of those can be, where the fines have a remedial rather than punitive purpose. Every time a big corporate wrongdoer pays punitive damages or settles a big regulatory mess, there are calls to eliminate the tax deduction for punitive damages, but so far none has passed. That these issues are again in the public eye is underscored by the latest tax bills.

The Senate's tax cut bill, which is expected to come up for floor debate after Thanksgiving, includes what some are calling a Harvey Weinstein tax. It isn't a tax exactly, but it would deny tax deductions, which amounts to a tax. The legal fees and legal settlements in sexual harassment cases often end up as deductible business expenses. The idea is to deny tax deductions for settlement payments in sexual harassment or abuse cases, if there is a nondisclosure agreement. Notably, this 'no deduction' rule would apply to the lawyers' fees, as well as the settlement payments. In some ways, it is a far bigger deal to deny tax deductions for the attorney fees. (The House bill, which passed on a party line vote last night, doesn't include such a provision.)

Note that most legal settlement agreements of any type have some type of confidentiality or nondisclosure provision. So that limitation is not much of a qualifier. Under current law, employers deduct legal fees and legal settlements relating to their trade or business. Business expenses must be "ordinary and necessary". However, an expense can be ordinary even if it occurs once in a career. And it is considered necessary if it is appropriate or helpful, even if it turns out not to be a good idea. Deductibility is controlled by nexus to a trade or business, or to income producing activity.

In the case of celebrities, the connections between income and publicity seem symbiotic. So, when celebrities pay whopping fees or even legal settlements, they may be deductible too. Trade or business expenses are worth more than investment expenses. Yet, you get *no* deduction for personal legal expenses. That means the legal expenses of a divorce, a dispute over a fight at the local pub, or defending a rape or paternity charge, yield no tax deduction. Yet, what is personal and what is investment or business can be debated.

Although Harvey Weinstein's and Kevin Spacey's actions may seem purely personal, on the job harassment can be viewed in several ways. Many harassment cases arguably arise out of personal activity that could be considered outside the course and scope of employment. Legal claims are often made against a company and its employees. If a supervisor harasses another employee, the conduct may be personal and outside the course and scope of the supervisor's employment. Yet, it arises out of a working relationship, and often involves company property, business trips, and business activities.

Under current law, that usually makes the payments tax deductible. Tax deductions can even be available in some criminal cases. In *Clark v. Commissioner*, a man was wrongfully accused of assault with intent to rape during his employment. His legal expenses were deductible because he had been working within the course and scope of his employment, and because he had not committed the rape. But not every expense is deductible. In *Cavanaugh v. Commissioner*, James Cavanaugh was CEO and sole shareholder of Jani-King, a successful janitorial-services franchisor.

He vacationed in St. Maarten one Thanksgiving with his girlfriend, Jani-King employee, Claire Robinson. It wasn't a business trip, but they were accompanied by Cavanaugh's bodyguard, and another Jani-King employee. While on the trip, Robinson suffered fatal cardiac arrest after ingesting a large amount of cocaine. Her mother sued Cavanaugh and Jani-King. Jani-King's board worried that losing the case would trigger a backlash from franchisees, so settled for $2.3 million. Cavanaugh contributed $250,000, which Jani-King reimbursed. Jani-King deducted it all as a business expense.

The IRS challenged the deductions, but the Tax Court agreed with the IRS, suggesting that some corporate lawsuits are personal and nondeductible. The employees were on vacation, not on Jani-King business. And they were far from company property. For Cavanaugh, only the *consequences* of the suit—not its origin—were business-related.

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.