



Robert W. Wood

THE TAX LAWYER

TAXES 10/30/2018

In Weinstein Sex Harassment Settlements, Taxes Await Plaintiffs

The fact that settlement talks may be starting between Harvey Weinstein, his namesake company and some plaintiffs won't make most people think about taxes. But before anyone signs a settlement agreement, they should. After all, just about everything is taxed. Sexual harassment might be verbal, physical or both. And it might impact victims in a variety of ways. Those are some of the reasons there is no one-size-fits-all solution to the tax issues in this context. The tax treatment of litigation damages is varied and complex. But the rule for compensatory damages for personal physical injuries is supposed to be easy. They are tax free under [Section 104 of the tax code](#).

Harvey Weinstein, former co-chairman of the Weinstein Co., arrives at state supreme court in New York, U.S., on Thursday, Oct. 11, 2018. Weinstein's lawyer, Benjamin Brafman, has said in court filings that prosecutors withheld evidence that would have made the grand jury think twice about charging him, such as friendly emails one accuser sent after the alleged rape. Photographer: Peter Foley/Bloomberg

Yet exactly what is "physical" isn't clear. For that reason, many sexual harassment victims where there is little or no physical contact usually have to pay taxes on their recoveries. Some of it seems to be semantics. If you make claims for emotional distress, your damages are taxable. If you claim the defendant caused you to become *physically sick*, those damages can be tax free. If emotional distress *causes* you to be physically sick, that is taxable. The order of events and how you describe them matters to the IRS. If you are physically sick or physically injured, and your *sickness or injury* produces emotional distress, those emotional distress damages should be tax free.



Wording in the settlement agreement is important, and so are IRS Form 1099. Some of the line-drawing comes from a footnote in the legislative history to the tax code adding the ‘physical’ requirement. It says “emotional distress” includes physical symptoms, such as insomnia, headaches, and stomach disorders, which may result from such emotional distress. *See* [H. Conf. Rept. 104-737](#), at 301 n. 56 (1996). Tax free money is better than taxable money, and the wording in settlement agreements can sometimes matter in a very big way. However, you don’t want to face claims by the IRS or state tax authorities several years later, adding interest and penalties. If you have to pay tax, there’s a double whammy. You might assume that if you have a contingent fee lawyer, at least the lawyer’s fees are not income to you.

However, plaintiffs who use contingent fee lawyers are treated as receiving 100% of the settlement, even if their lawyer takes 40% off the top. The Supreme Court said so in *Commissioner v. Banks*, 543 U.S. 426 (2005). That means plaintiffs must figure a way to *deduct* the fees. In 2004, Congress enacted an above the line deduction for legal fees in employment cases, and many harassment cases arise in employment. Since 1994, plaintiffs in employment cases have been taxed on their net recoveries, not their gross, but only if they properly claim this above the line deduction. In sex harassment cases, though, that is now on hold.

Starting in 2018, if a sexual harassment settlement is confidential, the defendant cannot deduct legal fees or the settlement amount. However, it

unintentionally seems to also prevent plaintiffs from being able to deduct their own legal fees. The Repeal the Trump Tax Hike on Victims of Sexual Harassment Act of 2018 would change that, making clear that the plaintiffs can deduct their legal fees. But the bill has not yet been passed.

Whenever possible, get some tax advice [before your settlement is documented](#). The IRS isn't bound by the parties' tax characterization, but it is often respected if reasonable. And once the documents are signed it will be too late to try to address it. The interactions between physical and emotional injuries and sicknesses are starting to be explored. Some plaintiffs in employment suits have had settlements classified as tax-free. In one case, stress at work produced a heart attack, [physical sickness that qualified for tax free treatment](#). In another, stressful conditions made a worker's pre-existing multiple sclerosis worse, and that too was considered [tax-free physical sickness](#).

This is not legal advice. For tax alerts or tax advice, email me at Wood@WoodLLP.com.