Taxing Sexual Harassment Settlements and Legal Fees in a New Era

by Robert W. Wood

Robert W. Wood practices law with Wood LLP (www.WoodLLP.com) and is the author of Taxation of Damage Awards and Settlement Payments, Qualified Settlement Funds and Section 468B, and Legal Guide to Independent Contractor Status, all available at www.TaxInstitute.com. This discussion is not intended as legal advice.

Harvey Weinstein, Kevin Spacey, Bill O’Reilly, and many other figures in the business and entertainment worlds have recently been accused of serious acts of sexual harassment. In a few cases, criminal investigations have reportedly been opened. There have often been significant business consequences, including termination of employment, large legal settlements, and no doubt large legal fees.

The movement that was unleashed as many alleged sexual predators suddenly found themselves in the crosshairs came to be known on social media as the #MeToo movement. As 2017 drew to a close, Time magazine selected the “Silence Breakers” — all the people who spoke publicly about being victims of sexual harassment, assault, or abuse as a way to help others — as its person of the year.

With a major tax reform bill unfolding in late 2017, perhaps it was inevitable that these two movements would collide. The tax law concerning deductions for sexual harassment settlements and related legal fees was re-examined. Many people seemed shocked that for businesses, legal settlements are nearly always tax deductible, as are legal fees.

Even legal fees for clearly nondeductible conduct (such as a company negotiating with the SEC to pay a criminal fine) can be deducted. The criminal fine might not be deductible, but the related legal fees have always been fair game. This can even be true for legal fees in criminal matters and payments of restitution. Many people find it surprising that punitive damages are tax deductible for businesses, no matter how bad the conduct. In general, only fines and penalties paid to the government are not deductible.

And yet, even some fines or penalties can turn out to be tax deductible. This seeming sleight of hand is not illegal or inappropriate for fines or penalties that have a remedial rather than punitive purpose.

Yet there has long been tension over these rules. When big corporate wrongdoers pay punitive damages or settle regulatory disputes over terrible problems or conduct, there are periodic calls to change the tax rules. Over the last few decades, there have been several proposals in Congress to eliminate the tax deduction for punitive damages, but none has passed.

However, the final tax bill, recently passed with incredible speed, includes what some have labeled a Weinstein tax. It isn’t a tax exactly, but it

denies tax deductions, which is seen as a kind of tax.

**New Era**

Legal fees and settlements in sexual harassment cases often end up as deductible business expenses. The idea behind the new provision 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 applies to the lawyers’ fees as well as the settlement payments. The language is simple in the new law. Section 162 of the tax code generally lists business expenses that are tax deductible.

However, now new section 162(q) provides:

(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.

Arguably, denying tax deductions for attorney fees is more significant than denying deductions for settlement payments. Until now, legal fees have generally been seen as classic business expenses, assuming there is some business connection. Thus, the new law treats sexual harassment settlements and legal fees more harshly than nondeductible government fines (for which legal fees could still be deducted).

Of course, most legal settlement agreements have some type of confidentiality or nondisclosure provision. Thus, the fact that the new law applies only to confidential settlements is not much of a qualifier. There has been recent speculation that sexual harassment settlements may now start breaking that confidentiality mold.

If the settlement combined with related legal fees represents a large number, the loss of tax deductions might make the lack of a confidentiality provision worthwhile. Defense lawyers almost invariably ask for confidentiality because they assume that some plaintiffs will want to go public. But some plaintiffs may not want publicity or scrutiny that might affect their employment or other aspects of their lives.

In any event, for some defendants — particularly when the lawsuit has already been the subject of press coverage — the lack of a confidentiality provision might seem worth the risk of disclosure. Apart from these obvious points, there have been worrisome observations about the new tax.

The nondisclosure is clearly the trigger for the denial of the deduction for the settlement monies. The legal fees are not so clear. It is therefore possible — although I would hope unlikely — that the IRS or the courts might read the law as a denial of a tax deduction for legal fees regarding sexual harassment or abuse, even without a nondisclosure agreement.

Congress referred the competing Senate and House bills to a conference committee to determine which provisions would survive. For businesses trying to deduct legal fees for sexual harassment cases that do not include nondisclosure provisions, some support may be derived from the conference committee report. The new language was only in the Senate version of the tax bill, and not in the earlier House version.

The conference committee report describes new section 162(q) as disallowing a deduction “for any settlement, payout, or attorney fees related to sexual harassment or sexual abuse if such payments are subject to a nondisclosure agreement.”

Congress apparently intended for the new provision to apply only to legal fees paid for sexual harassment or sexual abuse settlements that are subject to a nondisclosure agreement. However, there may still be debates over whether the wording of the statute prohibits legal fee deductions, even when there is no express confidentiality clause. Defendants running the gauntlet of confidentiality will surely claim the deductions, despite the ambiguity.

---

2 P.L. 115-97, section 13307.

3 H. Rept. No. 115-466, at 279.
Plaintiffs’ Legal Fees?

The target of the new law is the alleged harasser and the defendant company. But what about legal fees paid by the plaintiff in a sexual harassment case in which a confidential settlement is reached? Are they deductible? It is shocking to think they might not be.

After all, normally, plaintiffs should somehow be able to deduct legal fees if they are receiving a recovery. Yet the tax treatment of legal fees a plaintiff pays to reach a recovery, often on a contingent fee basis, has been troubled for decades. There has been all manner of tax jockeying and a deep rift about the tax treatment of legal fees in different circuit courts.

Then, in 2005, the U.S. Supreme Court in *Banks*¹ held that plaintiffs in contingent fee cases must generally recognize gross income equal to 100 percent of their recovery, even if their lawyer subtracts a 40 percent (or other) contingent fee before they ever see the money. The plaintiff must therefore figure out how to deduct the 40 percent fee.

The type of deduction has varied, and it has been controversial. Plaintiffs were relieved when, a few months before the Supreme Court’s *Banks* decision, Congress provided an above-the-line deduction for legal fees in employment cases. In effect, the above-the-line deduction blunted the sting of the gross income in the first place. Since that 2004 statutory change, plaintiffs in employment cases have been taxed on their net recoveries, not their gross.

Now, however, there is real concern that the legal fee deduction rules are going backwards. It may be fine to deny Weinstein and Miramax any tax deduction for settlements and legal fees, but how about the plaintiffs?

The wording of the new law is at least debatable. On its face, it would seem to prevent *any* deduction for legal fees in this context. The target may have been the harasser and the harasser’s company. Yet it appears to deny *any* attorney fees, including fees paid by the plaintiff. Even the language in the conference committee report is not particularly helpful to plaintiffs trying to deduct their fees.

One answer to this surely unintended result might be to revisit the 2004 change that ushered in the above-the-line deduction for employment cases. That language is still in the tax code.

Yet the Weinstein provision says it trumps all others. New section 162(q) denies any deductions “under this chapter.” Section 162 is in Chapter 1 of Subtitle A, which extends all the way from section 1 through section 1400U-3. As a result, the new section 162(q) would appear to disallow deductions under section 62, section 162, section 212, and more.

Plaintiffs might wonder whether their legal fee deduction is disallowed. One would hope that the IRS would view the plaintiff’s legal fees as materially different from the defendant’s in this context. Since 2004, the above-the-line deduction in employment cases has generally been noncontroversial. The IRS has interpreted the above-the-line deduction liberally.

For example, in cases involving multiple claims, the IRS has generally not attempted to bifurcate the legal fees into constituent parts. If some of the claims are about employment, one might generally assume that the above-the-line deduction should apply to all the fees. Even large figures on tax returns appear to generate few disputes between taxpayers and the IRS about the above-the-line deduction for attorney fees.

Therefore, despite the somewhat worrisome wording of the new statute, perhaps plaintiffs and their return preparers may assume that this non-deduction provision couldn’t have been intended to apply to plaintiffs. Surely Congress would not want a sexual harassment victim to pay tax on 100 percent of her recovery when 40 percent goes to her lawyer. Besides, a below-the-line deduction appears to be unavailable. This is where the picture for plaintiffs arguably darkens further.

Below the Line?

One might think that even if the IRS were to read the Weinstein provision as applying to defendants and plaintiffs alike, there might be a fallback position. A below-the-line deduction is never as attractive. Yet, if there is a risk of an above-the-line deduction failing, at least an old-fashioned, miscellaneous itemized deduction for the legal fees could help.

---

Before the 2004 change, many employment claim plaintiffs had to be content with such a deduction. Some of the fees were nondeductible because of the 2 percent of gross income threshold. There were phaseouts of deductions depending on the size of the plaintiff’s income. Worse still, there could be alternative minimum tax repercussions.

In a few well-publicized cases, plaintiffs with high legal fees actually lost money after taxes by winning their case. But for many, a miscellaneous itemized deduction for the fees at least prevented the worst injustices. Now that deduction seems to be gone too — at least until 2026.

This is a feature not of the Weinstein tax, but of the other significant changes in the new tax law. With higher standard deductions, the law now eliminates such itemized deductions until 2026. Thus, for the sexual harassment plaintiff, the choice would appear to be either an above-the-line deduction or nothing.

Even if the tax law did not eliminate miscellaneous itemized deductions until 2026, all miscellaneous itemized deductions are found in Chapter 1 of Subtitle A of the tax code. The below-the-line deduction is in section 212. That is in the same chapter as the new section 162(q). As a result, the new section 162(q) also disallows below-the-line deductions under section 212.

This suggests a much broader tax problem outside the employment context. Now, plaintiffs who do not qualify for an above-the-line deduction for their legal fees evidently must pay tax on 100 percent of their recoveries, not merely on their post-legal-fee net. Only employment and some whistleblower claims are covered by the above-the-line deduction.

One other possible deduction would be a business expense deduction. Before the above-the-line deduction for employment claims, some plaintiffs argued that their lawsuit amounted to a business venture. A plaintiff doing business as a proprietor and filing Schedule C might claim a deduction there for legal fees regarding the trade or business. This argument will not be impacted for cases not covered by the Weinstein provision. But for Weinstein cases, even this argument appears to be precluded.

One other possibility for legal fee deductions might be capital recoveries, for which the legal fees can often be capitalized and offset against the gain. This does not appear to be affected even in Weinstein cases. Cases discussing the capitalization of legal fees generally mention section 263. Section 263 is part of the same chapter of the tax code as section 162, so section 162 would appear to override section 263 if they conflict.

New section 162(q) disallows only deductions. It is unclear whether capitalized expenses are deductions for purposes of new section 162(q), but hopefully they are not. After all, capitalized expenses are reported on Schedule D rather than claimed with other tax deductions on Schedule A or Schedule C.

Moreover, section 263 states that “no deduction shall be allowed” for capitalized expenses, which would seem nonsensical if capitalized expenses were a type of deduction. Reg. section 1.212-1(k) also uses language implying that capitalized expenses aren’t deductions. But perhaps the new law will be read broadly enough to cover even that.

In any event, in many circumstances the possibility that a plaintiff (outside the employment claim context) could be taxed on a gross recovery with no deduction for legal fees is quite significant. Eliminating miscellaneous itemized deductions means many plaintiffs (outside employment cases and some whistleblower cases) may have no legal fee deduction. If that is correct, plaintiffs in many types of litigation now face taxes on their gross recoveries, with no deduction for legal fees.

---

6 P.L. 115-97, section 11045.
7 See Alexander v. Commissioner, 72 F.3d 938 (1st Cir. 1995).
8 See Woodward v. Commissioner, 397 U.S. 572, 575 (1970); Dye v. United States, 121 F.3d 1399, 1405 (10th Cir. 1997).

For more Tax Notes content, please visit www.taxnotes.com.
Express Allocations

Most legal releases understandably cover a wide range of known and unknown claims. After all, a defendant paying money to resolve a case wants to know that any and all claims will now be barred. In an employment case, even if race, gender, or age discrimination claims were not explicitly made, they will be covered by the settlement agreement.

Sexual harassment is likely to be covered too. But will any mention of such claims trigger the Weinstein provision? If it does, will it bar any tax deduction, even if the sexual harassment part of the case is minor? Could plaintiff and defendant expressly agree on a particular tax allocation of the settlement to head off the application of the Weinstein tax?

In a $1 million settlement over numerous claims, could one allocate $50,000 to sexual harassment? This figure may or may not be appropriate on the facts. However, legal settlements are routinely divvied up between claims. There could now be good reasons for the parties to talk turkey about such allocations.

Of course, the IRS is never bound by an allocation in a settlement agreement. But the IRS often pays attention to such allocations and — in my experience — often respects them. Given the tax risks to both plaintiffs and defendants, such an allocation could help both sides.

I expect that we will start seeing explicit sexual harassment allocations. We may see aggressive allocations when sexual harassment was the primary impetus of the case. We may even see such allocations, presumably with nominal dollar amounts, when the claims are primarily about something else.

An allocation could reduce the tax exposure for both sides. And one might think the legal fees should be allocated pro rata according to the stated allocation. The IRS normally applies a pro rata approach to legal fees.

Suppose the parties allocate $50,000 of a $1 million settlement to sexual harassment. That amounts to 5 percent of the gross settlement. If $400,000 is for legal fees, 5 percent of those fees ($20,000) should presumably be allocated to sexual harassment.

One other possible answer might be for the parties to state that there was no sexual harassment and that they are not releasing any such claims. Yet it is hard to imagine a defendant agreeing to the latter. Defendants want complete releases, and excepting sexual harassment or abuse from a release would surely be unattractive to the defendant.

What about including a complete release but stating that the parties agree that no portion of the settlement amount is allocable to sexual harassment? That may make sense in some cases. It could be analogous to cases in which punitive damages were requested in the complaint.

When settlement time comes, one or both parties may want to state that no punitive damages are being paid. Including a complete release, but having both parties agree that the case isn’t primarily — or perhaps even remotely — a sexual harassment case, may make sense.

Technical Corrections?

It’s possible that Congress didn’t intend many of the problems with this provision. It seems likely that Congress didn’t intend the scope of the denial of legal fees to be any different from the scope of the denial of legal settlement payments, and that it particularly didn’t mean to hurt plaintiffs who bring sexual harassment cases.

In that sense, surely plaintiffs should be permitted to deduct legal fees above the line, but that is unclear. Moreover, how successful plaintiffs and defendants will be with allocation techniques in this sensitive new area is also unclear.

Finally, there is an elephant in the room posed by a new lack of miscellaneous itemized deductions. This astounding change should presumably not affect plaintiffs in employment cases. It also shouldn’t affect whistleblowers in federal False Claims Act and IRS whistleblower cases. Notably, SEC whistleblower plaintiffs are still not expressly covered by an above-the-line deduction. The Senate amendment to extend the

above-the-line deduction to SEC claims did not survive the conference committee.\textsuperscript{10}

For many types of cases involving significant recoveries and attorney fees, the lack of a miscellaneous itemized deduction could be catastrophic. There may therefore be new efforts to explore the exceptions to the Supreme Court’s 2005 holding in \textit{Banks}.

The Supreme Court in \textit{Banks} laid down the rule that plaintiffs generally have gross income on contingent legal fees. But the Court alluded to various contexts in which this general rule might not apply. We should expect taxpayers to more aggressively try to avoid being tagged with gross income on their legal fees. Who can blame them?

\footnotesize\textsuperscript{10} H. Rept. No. 115-466, at 166-167; see also Tax Cuts and Jobs Act, H.R. 1, 115th Cong., section 11078 (as amended by the Senate).