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How Sexual Harassment Plaintiffs Are Double Taxed By Trump Tax Law

The tax reform law passed in December 2017 prohibits tax deductions for hush money settlements in sexual harassment cases. Labelled a 'Weinstein Tax,' it prevents individuals and companies from writing off the settlements and the associated legal fees. But the law mistakenly says that plaintiffs too cannot deduct their legal fees. If a plaintiff recovers \$500,000 but must pay her lawyer 40%, the full \$500,000 is income, even though the plaintiff nets only \$300,000. The victim is paying tax on money she never receives. Of course, the legal fees are taxable to the lawyer too, who must also pay taxes. That sure sounds like double taxation.

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. The Weinstein provision was meant to stop *defendants* in sexual harassment cases from being able to deduct their legal fees and settlement payments where confidentiality is required. Of course, virtually all legal settlement agreements have some type of confidentiality or nondisclosure provision. This is so in virtually any kind of legal case, especially with sexual harassment. The double tax problem starts with the strange tax rules for legal fees.



Plaintiffs who use contingent fee lawyers are *treated as receiving 100% of the settlement amount, even if their lawyer takes 40% off the top*. So ruled the U.S. Supreme Court in *Commissioner v. Banks*, 543 U.S. 426 (2005). That means plaintiffs must figure a way to deduct the fees, which can be as high as 50%. In 2004, Congress enacted an above the line deduction for legal fees in employment cases. Since then, 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, that is now on hold.

However, one positive development is this [letter](#) by several Senators to the Treasury Secretary and head of the IRS. The Senators say they want to fix this. But that is hardly the same as *actually* getting the correction through Congress. In the meantime, plaintiffs are understandably worried about taxes. Some [legal settlements include tax indemnities](#), if the plaintiff can get the defendant to go on the hook for that risk. But most defendants are likely to say no to such a request. Some plaintiffs try to cut the risk by allocating nothing or close to nothing to the sex harassment claims.

Legal settlements are routinely divvied up between claims, and there could be more of this now. The IRS is not bound by an allocation in a settlement agreement, but the IRS often respects them. The parties might allocate \$50,000 of a \$1M settlement to sexual harassment, or perhaps even less. But whether that might work is debatable. Keep in mind that the case does not

have to be 100% sex harassment to trigger the provision. Many non-sex harassment cases could be covered by mentioning such claims in a release.

Hopefully a technical correction, such as the Repeal the Trump Tax Hike on Victims of Sexual Harassment Act of 2018 will be passed swiftly. But in the meantime, there is understandable worry. Of course, being taxed on your net after legal fees may not be such a good deal either. Some sexual harassment litigants may be able to claim at least some of their recovery as tax free under [Section 104 of the tax code](#). That section excludes damages for physical injuries and physical sickness. Yet exactly what is "physical" isn't so clear. And arguably, the tax law doesn't treat sexual harassment plaintiffs too well, quite apart from the Weinstein provision.

After all, if you make claims for emotional distress as is typical in sexual harassment cases, your damages are taxable. If you claim the defendant caused you physical injuries or caused you to become physically sick, those can be tax free. But most sexual harassment plaintiffs will have a hard time doing that. Of course, the plaintiff does not necessarily have to prove that the defendant caused the sickness. But she needs to show that she claimed it. In addition, she needs to show that the defendant was aware of the claim and considered it in making payment.

To prove physical sickness, the plaintiff should have evidence of medical care, and evidence that she actually claimed the defendant caused or worsened the condition. The more medical evidence the better, including statements from medical professionals. As with so many other rules in the tax law, it turns out that the [taxation of legal settlement payments](#) can make a huge difference in how much money a plaintiff actually gets to keep.

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