



Robert W. Wood

THE TAX LAWYER

TAXES 03/31/23

Hush Money And Taxes, Five Things To Know



Hush money sounds dirty or illegal, but many businesses pay it on occasion. There are important tax rules at play, and everyone in business should know the key rules. Let's start with the fact that just about every kind of payment has tax consequences, to both the recipient and to the one who paid the money.

1. Hush Money is Income. If you get paid hush money, is it income you have to report on your taxes? Yes, the IRS says almost everything is income, and that certainly applies to hush money, whatever the circumstances. In fact, almost all legal settlements are income. There are a few exceptions, mainly for compensatory personal physical injury damages. But the IRS is strict about what qualifies as physical.

Unless the money is a payment for physical injuries or physical sickness, it is taxable. To prove physical sickness, the plaintiff should have evidence of medical care, and evidence that she claimed the defendant caused or worsened the condition. Some plaintiffs claim the harassment gave them post traumatic stress disorder, and [PTSD is arguably physical](#) for tax purposes. But the [IRS taxes most lawsuit settlements, exact wording matters](#), and taxes can make a huge difference in how much a plaintiff gets to keep after legal fees.

What's more, in some cases the plaintiff is taxed on 100% of the money, even if the lawyer takes legal fees off the top. In 2005, the U.S. Supreme Court held in [Commissioner v. Banks](#) that plaintiffs generally have income equal to 100% of their recoveries, even if their lawyers take a share. Then, a massive tax law championed by then President [Trump, was passed in 2017 to restrict many plaintiff deductions for legal fees, a tax law that hurts legal settlements](#).

2. Defendants Deduct It. Businesses routinely settle legal claims of all sorts to keep claims and amounts quiet. No business wants bad publicity, and lawsuits are bad for business. Even settlements can be bad for business, especially if amounts are publicized, and settlements that become public can encourage *other* claims to be brought. As a result, nearly every legal settlement agreement requires confidentiality. You can say that the business is paying the claim or paying for silence, and it might be a bit of both. If the

company paying the money is in business, it is almost always tax deductible, except for the exception discussed below in #4.

3. Individual Defendants Usually Can't Claim a Write-off. Companies routinely pay hush money. Individuals do so less frequently, even though individual conduct at companies probably leads to most of the liabilities the hush money is intended to cover up. To claim a write off, an individual would have to be conducting a trade or business. Plus, the hush money would have to relate to that trade or business. For an individual, that can be a tall order.

4. Hush Money for Sexual Harassment or Abuse. Starting in 2018, the tax law says that businesses and individuals can no longer write off confidential legal settlements for sexual harassment or abuse. These restrictions only apply if confidentiality is *required*. So if you just pay hush money but do not *expressly* call for nondisclosure or confidentiality, companies can still write it off. Some companies settle without requiring confidentiality to get around the new rules. For example, it was reported that [Fox settled some suits without confidentiality](#).

However, most companies are willing to forgo a tax deduction to keep the settlement quiet. Then again, some companies want to have their cake and to eat it too by splitting the money into several parts. It works like this: In a \$1M settlement, how about saying that only \$50,000 is for sexual harassment, and the other \$950,000 is for other employment claims? In some cases, there is an argument that you can still [write off the bulk of confidential sexual harassment](#) settlements in that way. No one know yet whether these workarounds will actually work. On the plaintiff side, [legal settlements with tax indemnities are on the rise](#).

5. Legal Fees Can Be a Problem. For businesses, legal fees are *almost always* tax deductible, even if the legal fees are very expensive. They are just one of numerous business expenses. But since 2018, if you are paying hush money for sexual harassment or abuse, and if you require confidentiality, not even the legal fees can be deducted. But even bigger tax problems can await plaintiffs. As they face [IRS taxes on their legal settlements](#), they are often searching for some [way to deduct their legal fees under the new tax law](#).

Check out my [website](#).