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IRS Gives Tax Break To Sexual Harassment Victims

The tax reform law passed in December 2017 prohibits tax deductions for hush money settlements in sexual harassment cases. Sometimes called a Weinstein tax, it prevents individuals and companies from writing off the settlements and related legal fees. But the law seems to say 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. Some people call that double taxation. But more importantly, why penalize the poor plaintiff in the first place? The Weinstein tax was supposed to punish the *defendant*, not the plaintiff. There has been a lot of tax worry about this.

But fortunately, the IRS has posted an [FAQ](#) on the IRS website giving notice that it has fixed this problem, even if Congress can't seem to. The IRS asks this [Question](#): "Does section 162(q) [the Weinstein tax] preclude me from deducting my attorney's fees related to the settlement of my sexual harassment claim if the settlement is subject to a nondisclosure agreement?" [Answer](#): "No, recipients of settlements or payments related to sexual harassment or sexual abuse, whose settlement or payment is subject to a nondisclosure agreement, are not precluded by section 162(q) from deducting attorney's fees related to the settlement or payment, if otherwise deductible."



That is *awfully* welcome relief, particularly since the technical correction that some members of Congress moved to enact didn't go anywhere. The "Repeal the Trump Tax Hike on Victims of Sexual Harassment Act of 2018" was proposed, but seemed to die on the vine. Bravo to the IRS for fixing what Congress didn't. Of course, plaintiffs still have tax problems. 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. 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](#). 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. But emotional distress is taxable, and that includes physical symptoms, such as insomnia, headaches, and stomach disorders, which can result from

emotional distress. So says [H. Conf. Rept. 104-737](#). 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. Notably, 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, which the IRS has just confirmed they can in the recent FAQ.

Whenever possible, it is advisable for plaintiffs to get some tax advice [before a settlement is documented](#). The IRS isn't bound by the parties' tax characterization, but it is often respected if reasonable. Besides, 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 case, stressful conditions made a worker's pre-existing multiple sclerosis worse, and that too was considered [tax-free physical sickness](#). Former [President Obama once suggested that PTSD](#) may be physical too.

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