PERSPECTIVE

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Sexual Harassment Settlements and Confidentiality

By Robert W. Wood

Many people are surprised that for businesses, legal settlements are almost always tax deductible, as are legal fees. In fact, except for legal fees capitalized to an asset like a corporate acquisition or the purchase of real estate, legal fees are nearly universally deductible by businesses. Even legal fees related to clearly non-deductible conduct (such as a company negotiating with the government to pay a criminal fine) can be deducted. The criminal fine might not be deductible, but the legal fees are.

In fact—and this one surprises people too—even punitive damages are tax deductible for businesses, no matter how bad the conduct is. 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, one thing that did pass at the end of 2017, effective starting in 2018 denies tax deductions for confidential settlements in sexual harassment or sex abuse cases. Related legal fees are also nondeductible, making the tax treatment of the legal fees here especially harsh.

Tax laws often have (to my mind anyhow) slick marketing names, some maybe even downright deceptive. Take the current "Inflation Reduction Act," for example. At the end of 2017, it was the Tax Cuts and Jobs Act, Pub. L. 115-97. Section 162 of the tax code generally lists business expenses that are tax deductible.

However, Section 162(q) now provides that:

"(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."

Currently, legal fees are generally seen as classic business expenses, assuming that there is some business connection. Of course, the overwhelming majority of legal settlement agreements have some type of confidentiality or nondisclosure provision. Thus, the fact that the law applies only to confidential settlements is not much of a qualifier. I have seen settlement agreements that no longer ask for confidentiality, but they are awfully rare.

Express Allocations

But can you allocate your way around these tax deduction restrictions? After all, most legal releases understandably cover a wide range of claims, known and unknown. A defendant paying money to resolve a case wants to know that all claims will be barred, so they throw in the kitchen sink. In an employment case, even if race, gender, or age discrimination claims were not explicitly made, they will surely be covered by the settlement agreement. That raises an interesting question.

Will *any* mention of sexual harassment claims make the settlement nondeductible? If it does, will it bar *any* tax deduction, even if the sexual harassment part of the case is minor? Plaintiff and defendant may want to agree on a particular tax allocation, attempting to limit the amount that is not deductible to the defendant. In a $1M settlement over numerous claims, could one allocate $50,000 to sexual harassment?

I've seen it done. Of course, this figure may or may not be appropriate depending on the facts. However, legal settlements are routinely divvied up between claims. There are always some tax considerations at play, and plaintiffs nearly always ask for some variety of favorable tax allocation. Now the defense has some tax motivations too, so there could be good reasons for the parties to address such allocations now.

To be clear, the IRS is never bound by an allocation in a settlement agreement. Even so, as a practical matter the IRS pays attention to allocations and often respects them. So does the Tax Court, if the dispute ever gets that far. That's why hammering out settlement agreement language is worth doing, even if it means frustration and delay.

The only time either side has a chance at cooperation is when the settlement agreement isn't yet signed. Explicit sexual harassment allocations are sometimes used where sexual harassment was the primary impetus of the case, and sometimes where the claims are primarily about something else.

For example, suppose that the parties allocate $50,000 of a $1M 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 also be allocated to sexual harassment too.

Yet defendants want complete releases. A release might cover the waterfront, but still state that the parties agree that no portion of the settlement is allocable to sexual harassment. These are worrisome tax changes, and they can complicate already difficult settlement discussions. Whoever you represent, get some tax advice and try to be prepared for the dynamics these issues may raise.

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

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

What about including a comprehensive 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, and there may be some analogies. It may also be analogous to cases in which punitive damages were requested in the complaint. When it comes settlement time, one or both parties may want to expressly state that no punitive damages are being paid.

And sometimes in employment cases, where the parties agree that all the wages have been fully paid, it can be okay not to treat any portion as wages. My own personal bias

is that having a portion of the money paid as wages is wise in any employment settlement. After all, the IRS expects it, and an explicit allocation to wages may help protect the other funds from recharacterization.

However, I have occasionally used language that the parties acknowledge and agree that all wages have been fully paid, and that no portion of the settlement payment is for wage or wage-related claims. Trying that format with sexual harassment or abuse might conceivably work. Including a complete release but having both parties agree that this is not a sexual harassment case may make sense.

However, it clearly will not if there are allegations of sexual harassment or sexual abuse. If there are, the tax deduction prohibition is clear, and it is right there in black and white in the Internal Revenue Code itself. It is not in a regulation, ruling or IRS Notice. The only way out may be either forgoing confidentiality entirely or allocating some express dollar amount to the sexual harassment or sexual abuse.

If the case is an employment case, as most sexual harassment cases are, an allocation might be more realistic. But be careful. The tax law in this area is still developing, and there will probably be contested tax cases in the future where defendants wrote off all or a large part of their sexual harassment settlements and legal fees and then try to defend it.

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