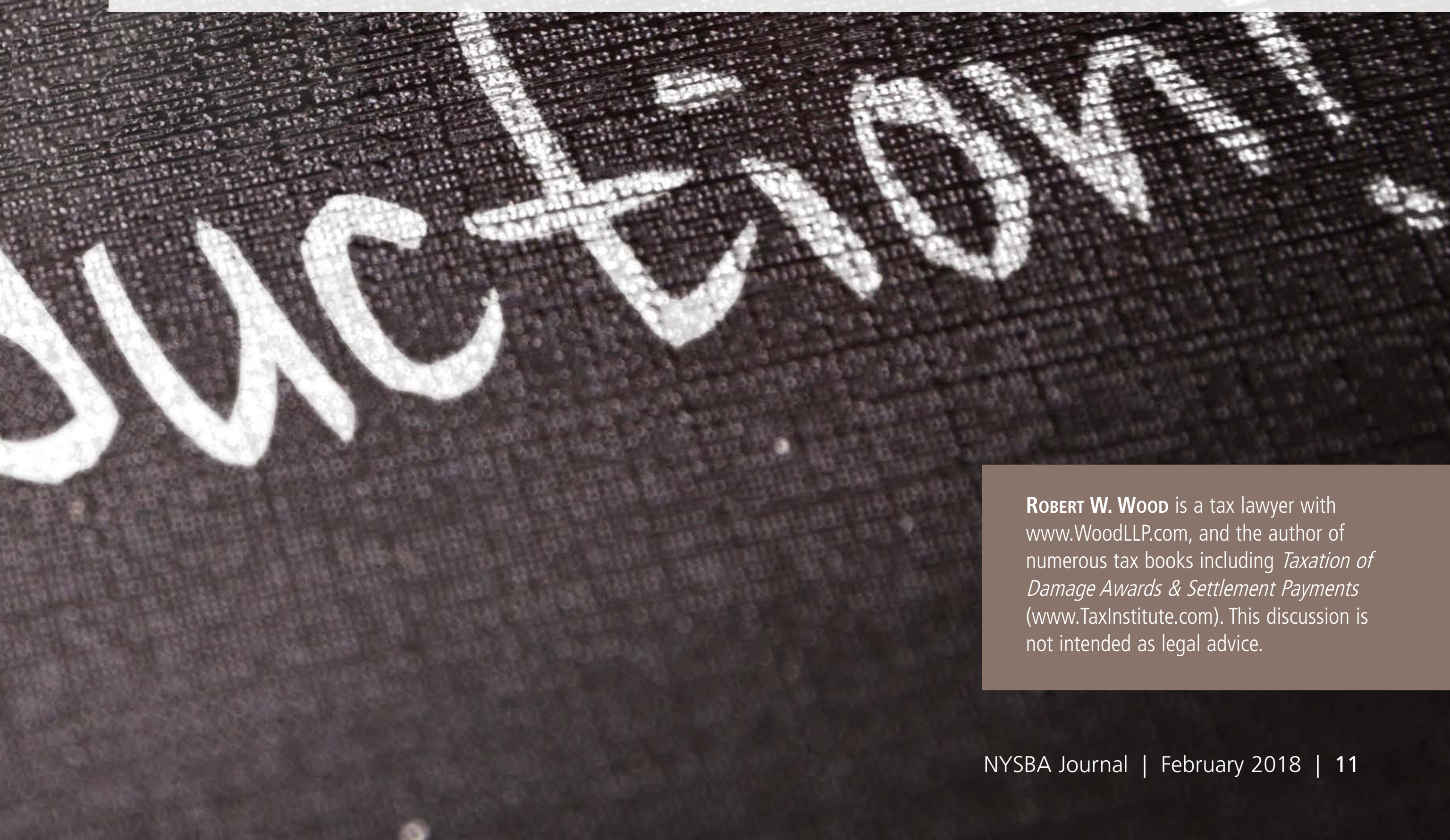

sexual harassment
Tax Ded

Tax Write-Offs in Sexual Harassment Cases After Harvey Weinstein

By Robert W. Wood

Harvey Weinstein, Kevin Spacey, Bill O'Reilly, and many other figures in the business and entertainment world have been accused of serious acts of sexual harassment. In a few cases, criminal investigations have reportedly been opened. In many cases, there have been significant business consequences, with 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 #MeToo. As 2017 drew to a close, *Time* magazine selected the "Silence Breakers" as its person of the year. They were all the women and men who publicly spoke about being victims of sexual harassment, assault or abuse, as a way to help others.[1]



Robert W. Wood is a tax lawyer with www.WoodLLP.com, and the author of numerous tax books including *Taxation of Damage Awards & Settlement Payments* (www.TaxInstitute.com). This discussion is not intended as legal advice.

With a major tax bill also unfolding in late 2017, perhaps it was inevitable that these two moments would collide. With tax reform being discussed, perhaps the tax law relating to deductions for sexual harassment settlements and related legal fees should be examined? Many people seemed to be shocked that for businesses legal settlements are nearly always tax deductible, as are legal fees.

In fact, except for legal fees that must be capitalized to an asset, legal fees are nearly universally deductible by businesses. Even legal fees related to clearly nondeductible conduct (such as a company negotiating with the SEC to pay a criminal fine) can still be deducted. The criminal fine might not be deductible.

But the related legal fees have always been fair game. In some cases, this can even be true with legal fees in criminal matters, and payments of restitution. Many people find it surprising that even 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 in the case of fines or penalties that have a remedial, rather than a punitive, purpose. Fines and penalties can have different purposes. That this kind of analysis goes on should not be surprising.

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 have passed.

However, with incredible speed, the recently passed tax bill includes what some have labeled a "Harvey Weinstein tax." It isn't a tax exactly, but it denies tax deductions, which is seen as a kind of tax. Legal fees and legal settlements in sexual harassment cases often end up as deductible business expenses.

New Era

The idea of 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 attorney fees, as well as the settlement payments. The language is simple.[2] Section 162 of the tax code generally lists business expenses that are tax deductible.

However, now new § 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. Up until now, legal fees are generally seen as classic business expenses, assuming that there is some business connection. Thus, the new law treats sexual harassment settlements and legal fees more harshly than nondeductible government fines (where legal fees could still be deducted).

Many people seemed to be shocked that for businesses legal settlements are nearly always tax deductible, as are legal fees.

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 this normal 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, since they might assume that some plaintiffs might want to go public. But some plaintiffs may not want publicity or scrutiny that might prejudice their employment or other aspects of their lives.

In any event, for some defendants, particularly where the lawsuit has already been the subject of press coverage, the lack of a confidentiality provision might seem to be worth the risk of disclosure. Apart from these obvious points, there have been other observations about the new tax that are worrisome. Some observers have pointed out that it is not crystal clear that the denial of legal fees is only in cases where a nondisclosure agreement is included.

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

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 present in the Senate version of the tax bill, and not in the earlier House version. Therefore, Congress referred the competing bills to a Conference Committee to determine which provisions of the House and Senate versions would survive.

The Conference Committee report goes provision-by-provision, describing the differences between the House and Senate versions and reporting which version of each provision survived. The Conference Committee Report describes new § 162(q) as disallowing any deduction "for any settlement, payout, or attorney fees related to sexual harassment or sexual abuse if such payments are subject to a nondisclosure agreement."[3]

Congress apparently *intended* for the new provision to only apply to legal fees paid in connection with 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 might prohibit legal fee deductions even where there is no express confidentiality clause. Defendants running the gauntlet of confidentiality will surely claim the deductions despite the ambiguity.

Plaintiffs' Legal Fees?

The target of the new law is surely 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 that 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 historically been all manner of tax jockeying and a deep rift regarding the tax treatment of legal fees in different Circuit Courts around the country.

Then, in 2005, the U.S. Supreme Court in *Commissioner v. Banks*[4] held that plaintiffs in contingent fee cases must generally recognize gross income equal to 100 percent of their recoveries. This is so even if the contingent fee lawyer subtracts the lawyer's 40 percent (or other) contingent fee before the plaintiff ever sees the money. Being treated as receiving 100 percent means that the plaintiff must figure a way to deduct the 40 percent fee.

The type of deduction has varied and 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, though, there is real concern that the legal fee deduction rules are going backwards. It may be fine to deny Harvey 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, promising an above-the-line deduction for legal fees in any employment-related claim. Yet the new Weinstein provision says that it trumps all others.

The new § 162(q) denies any deductions "under this chapter." Section 162 is located in Chapter 1 of Subtitle A, which extends all the way from § 1 through § 1400U-3. As a result, the new § 162(q) would appear to disallow deductions under §§ 62, 162, and 212 (as well as several other sections).

The above-the-line deduction for legal fees in employment cases is located in § 62. Plaintiffs might wonder if their legal fee deduction is also disallowed. One would hope that the IRS would view the *plaintiff's* legal fees as materially different from those of the defendant in this context.

Since 2004, the above-the-line deduction in employment cases has generally been non-controversial. In general, 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 presumably apply to *all* of the fees. Even very large figures on tax returns appear to generate few disputes between taxpayers and the IRS about the above-the-line deduction for attorney fees. Despite the somewhat worrisome wording of the new statute, perhaps plaintiffs and their tax preparers may assume that this non-deduction provision can *surely* not have been intended to apply to plaintiffs.

Surely Congress would not want a sexual harassment victim to pay tax on 100 percent of his or her recovery when 40 percent goes to his or her lawyer! Besides, a below-the-line deduction appears not to be available either. This is where the picture for plaintiffs arguably darkens even more materially.

Below the Line?

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

Remember, before the 2004 change, many employment-claim plaintiffs had to be content with such a deduction. In such a case, some of the fees were non-deductible on account of the 2 percent of gross income threshold. There were also phaseouts of deductions, depending on the size of the plaintiff's income. Worse still, there could be alternative minimum tax (AMT) repercussions.

> **The possibility that a plaintiff could be taxed on a gross recovery with no deduction for legal fees seems significant.**

In a few well publicized cases, plaintiffs with high legal fees actually lost money after taxes by winning their case.[5] 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.[6]

This is not a feature of the Weinstein tax, but of the other significant changes in the new tax law. With higher standard deductions, the law now eliminates these deductions until 2025. 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 that plaintiffs claimed before the above-the-line deduction was introduced in 2004 is found in § 212. That is in the same Chapter as the new § 162(q). As a result, the new § 162(q) would seem to also disallow below-the- line deductions under § 212.

This arguably suggests a broader tax problem. Outside of the employment context, there is a large problem for legal fees. Until 2025, plaintiffs who do not qualify for an above-the-line deduction for their legal fees evidently now must pay tax on 100 percent of their recoveries, not merely on their post-legal fee net. Only employment and certain whistleblower claims are covered by the above-the-line deduction.

One other possible deduction that might suggest itself would be a business expense deduction. Even before the above-the-line deduction for employment claims, some plaintiffs have argued that their lawsuit amounts to a business venture. A plaintiff doing business as a proprietor and filing Schedule C might claim a deduction there for legal fees related to the trade or business.[7]

However, this argument too seems obviated by the new law. Another possibility for legal fee deductions might be capital recoveries, where the legal fees can often be capitalized and offset against the gain. This does not appear to be impacted. Cases discussing the capitalization of legal fees generally mention § 263.[8] Section 263 is part of the same chapter of the tax code as § 162, so § 162 would appear to override § 263 *if* they conflict.

However, it is not clear that they do conflict. New § 162(q) only disallows "deductions." It is not clear whether capitalized expenses are "deductions" for purposes of new § 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, § 263 states that "[n]o deduction shall be allowed" for capitalized expenses, which would seem nonsensical if capitalized expenses were a type of deduction. Section 1.212-1(k) of the Treasury Regulations also uses language that implies that capitalized expenses are not "deductions." On the other hand, perhaps the new law will be read broadly enough to cover even this.

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 seems significant. This hardly seems to be a drafting error. Eliminating miscellaneous itemized deductions means that many plaintiffs (outside employment cases and certain whistleblower cases) may have *no legal fee deduction at all*. If this is correct, vast numbers of plaintiffs in many types of litigation apparently may now feel the full force of paying taxes on their gross recoveries, with no deduction for legal fees.

Express Allocations

Most legal releases understandably cover a wide range of claims, known and unknown. 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 surely 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. And there could be good reasons for the parties to talk turkey about such allocations now.

Of course, the IRS is never bound by an allocation in a settlement agreement. But the IRS does often pay 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 such explicit sexual harassment allocations. We may see aggressive allocations, where the sexual harassment may have been the primary impetus of the case. We may also see such allocations, presumably with nominal dollar amounts, even in cases where the claims are primarily about something else.

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.[9]

Suppose that 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, too.

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 agreeing to the latter. Defendants want complete releases, and surely excepting sexual harassment or abuse from a release would be unattractive to the defendant.

Thus, what about including the 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. Perhaps it will 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. Including a complete release but having both parties agree that this is not (primarily, or perhaps even remotely) a sexual harassment case may make sense.

Technical Corrections?

It is possible that Congress did not intend many of the problems that now seem apparent with this provision. It seems likely that Congress did not intend the scope of the denial of legal fees to be any different from the scope of the denial of legal settlement payments. It seems likely that Congress particularly did not mean to adversely impact plaintiffs who bring sexual harassment cases.

In that sense, surely plaintiffs should be permitted to deduct legal fees above the line. However, it is not 100 percent clear. Moreover, how successful plaintiffs and defendants will be with allocation techniques in this sensitive new area is also not clear.

Finally, there is an elephant in the room posed by a new lack of miscellaneous itemized deductions. This astounding change should presumably not impact plaintiffs in employment cases. It also should not impact 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.[10]

Standard deductions have been significantly increased. Yet for many types of cases involving significant recoveries and significant attorney fees, the lack of a miscellaneous itemized deduction could be catastrophic. There may be new efforts, therefore, to explore the exceptions to Supreme Court's 2005 holding in *Banks*.

The Supreme Court in *Banks* laid down the general rule that plaintiffs 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. Stay tuned. ■

1. *See* Edward Felsenthal, *The Choice*, Time (Dec. 6, 2017).
2. *See* Tax Cuts and Jobs Act, Pub. L. 115-97, § 13307.
3. H. Rept. 115-466 at 279.
4. 543 U.S. 426 (2005).
5. *See Spina v. Forest Preserve District of Cook County*, 207 F. Supp. 2d 764 (N.D. Ill. 2002).
6. Tax Cuts and Jobs Act, Pub. L. 115-97, § 11045.
7. *See Alexander v. Comm'r*, 72 F. 3d 938 (1st Cir. 1995).
8. *See Woodward v. Comm'r*, 397 U.S. 572, 575 (1970); *Dye v. United States*, 121 F.3d 1399, 1405 (10th Cir. 1997).
9. *See Robinson v. Comm'r*, 102 T.C. 116, 124 (T.C. 1994).
10. H. Rept. 115-466 at 166–67; *see also* Tax Cuts and Jobs Act, H.R. 1, 115th Cong. (2017), § 11078 (as amended by Senate).

"Upset at you for breaching the non-compete? Of course not."