

Taxing Chef Mario Batali's Sexual Harassment Settlement

By Robert W. Wood

Whenever money changes hands, there are tax issues, and that is certainly true with the legal settlement by celebrity Chef Mario Batali and his ex-partner. The duo are paying \$600,000 for claims of sexual harassment of employees at Batali's restaurants. Batali and TV food show judge Joe Bastianich's settlement payment is being divided among at least 20 workers according to New York Attorney General Letitia James who announced the deal.

Batali was accused of groping and forcibly kissing women, among other things. After a lengthy investigation that went on for years, authorities said that Batali and his management firm B&B "permitted an intolerable work environment" at New York's Babbo, Lupa, and Del Posto restaurants, the NY Attorney General said. The company is now called Pasta Resources.

The Attorney General said: "Batali and Bastianich permitted an intolerable work environment and allowed shameful behavior that is inappropriate in any setting. More than 20 employees were subjected to a hostile work environment in which female and male employees were sexually harassed by Batali, restaurant managers, and other coworkers." There were claims of unwanted sexual advances, inappropriate touching, and sexually explicit comments from managers and coworkers. "Several female employees were forcibly groped, hugged, and/or kissed by male colleagues," James' office said.

The taxes at play in this situation may seem surprising, on both sides of the equation. You might first think of the recipients, but let's first look at Batali and his former partner. The tax 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 controversially, the law seems to say that plaintiffs too cannot deduct their legal fees. The Weinstein tax is supposed to punish the defendant, not the plaintiff. We'll come back to the plaintiffs.

The prohibition on tax deductions is triggered by confidentiality and nondisclosure provisions. And since this settlement is public, it appears that Batali can write off the money as a business expense. As a practical matter, that means that it really only costs him about half that amount after taxes. Business face tax deduction restrictions when they are paying fines or penalties to the government. In this case, though, the money is earmarked for the victims, so the amount should be deductible.

How about the recipients, will the workers have to pay tax on the money they receive? The IRS would say yes, even though the sexual harassment might be a mixture of verbal or physical and might impact victims in a variety of ways. Indeed, getting tax free treatment in such cases can be tough, even though compensatory damages for personal physical injuries are tax free under Section 104 of the tax code.

It is one of the thornier issues in the tax law that trips up thousands of plaintiffs every year. The U.S. Tax Court, where most disputes between the IRS and taxpayers end up when they can't be resolved out of court, is littered with cases on this issue every year.

The problem is that exactly what is "physical" isn't clear. Where there is little or no physical contact, many sexual harassment victims have to pay taxes on their recoveries. Strangely enough, the order of events and how you describe them matters to the IRS. If you make claims for emotional distress, your damages are taxable.

On the other hand, if you claim that 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. If you are physically sick or physically injured, and your sickness or injury produces emotional distress, those emotional distress damages should be tax free. How about damages for PTSD?

Post-traumatic stress disorder claims from harassment are common now, and PTSD is arguably physical sickness on its own. So PTSD claims can help steer a recovery toward tax-free. Wording in the settlement agreement is important, and so is how IRS Forms 1099 are handled. Some of the line-drawing comes from a footnote in the legislative history to the tax code adding the 'physical' requirement.

The footnote buried in the legislative history says that "emotional distress" includes physical symptoms, such as insomnia, headaches, and stomach disorders, which may result from such emotional distress. See H. Conf. Rept. 104-737, at 301 n. 56 (1996). Plainly, if you are a plaintiff, 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.

If you have to pay tax on a recovery, there's a potential tax double whammy. You might assume that if you have a contingent fee lawyer, at least the lawyer's fees are not income to you. However, 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.

In 2004, Congress enacted a tax deduction for legal fees in employment cases, and many harassment cases arise in employment. However, starting in 2018, if a sexual harassment (or sex abuse) settlement is confidential, the defendant cannot deduct the legal fees or the settlement amount. However, the law unintentionally seems to also prevent plaintiffs from being able to deduct their own legal fees. 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 that bill has still not passed.

Fortunately, the IRS has said in an FAQ that sexual harassment victims in employment cases can write off their fees. However, outside the context of employment, there are still problems. In any of these circumstances, tax advice before a settlement is documented can save headaches later. Sometimes a relatively small change in wording can make a big tax difference. The IRS isn't bound by the parties' tax characterization, but it is often respected if reasonable. And 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 reported tax case, stress at work produced a heart attack, physical sickness that qualified for tax free treatment. In another, stressful conditions made a worker's pre-existing multiple sclerosis worse, and that too was considered tax-free physical sickness. It pays to consider this and other rules about how settlement awards are taxed before signing a settlement agreement.

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