

Taxing Sexual Abuse and Harassment Settlements

By Robert W. Wood

Are there still tax issues in sexual abuse and sexual harassment cases? You bet. Whether arising from clergy sex abuse, athlete sex abuse, scouting sex abuse or in other contexts, settlements for abuse have become numbingly familiar. Many sexual harassment cases may have facts that are less graphic than abuse cases, but they can still be quite difficult. Sexual harassment might be verbal, physical or both, and it may impact victims in a variety of ways.

There is no one-size-fits-all solution to the tax issues in this context. The tax treatment of litigation damages varies, 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. We'll come back to that central issue, but let's first look at the *defendant's* taxes. If the defendant is in business, isn't paying for lawsuits always a deductible business expense?

Not always. If a sexual harassment settlement is *confidential*, the defendant cannot deduct legal fees or the settlement amount itself. This denial of tax deductions started in 2018, and it is often called the Weinstein tax. Although it's target is harassers, it also seems to prevent *plaintiffs* from deducting their *own* legal fees. The "Repeal the Trump Tax Hike on Victims of Sexual Harassment Act of 2018" was quickly introduced in 2018 to correct this glitch, to make clear that the plaintiffs *can* deduct their legal fees. But the bill has *still* not been passed.

Fortunately, the IRS posted an FAQ on its website saying that the Weinstein tax does *not* preclude *plaintiffs* from deducting their attorney's fees related to the settlement of sexual harassment claims even if there is a nondisclosure agreement, provided that the fees are otherwise deductible. But are they "otherwise deductible?" That turns out to be a thorny issue. If the harassment or abuse occurs in *employment*, then the fees should be deductible, assuming that they are paid in the same year as the settlement, as occurs with contingent fees.

But what if the harassment or abuse occurs outside of the employment relationship? Amazingly, there may be no tax deduction for the plaintiff's legal fees, and that could mean paying tax on 100%, even though 40% goes to the lawyer. Most legal settlement agreements have some type of confidentiality or nondisclosure provision. What about the plaintiff's *net* recovery in the case, the money he or she gets to keep?

Under the tax code, damages for personal physical injuries or physical sickness are tax free. Damages for emotional injuries are not. Yet if you have emotional injuries *triggered* by physical ones, the damages for the emotional injuries are also tax-free. What constitutes personal physical injuries or physical sickness is not defined, but the IRS likes to see observable bodily harm such as bruises or broken bones.

Yet if you are sexually assaulted or abused, you may not have these outward signs. The interactions between physical and emotional injuries and sicknesses are starting to be explored, but there are frequent tax disputes between plaintiffs and the IRS. Fortunately, some plaintiffs in

employment suits have prevailed in Tax Court in having some or all of their settlements classified as tax-free. In one case, stress at work produced a heart attack. In another, stressful conditions exacerbated the worker's pre-existing multiple sclerosis, which was clearly a nontaxable physical sickness recovery.

However, the way in which sexual abuse and sexual harassment recoveries are taxed remains cloudy. As a result, for many victims, the award of cash comes with tax worries. Can the IRS tax this? The answer is nuanced, adding more angst to the victim's experience. If you've been through an ordeal and have eventually collected a settlement or judgment, the last thing you want is uncertainty about taxes. You do not want to pay taxes if you don't have to, but you also don't want to face claims by the IRS or state tax authorities several years later.

Especially for sexual abuse cases, the law should be clarified to make clear that these recoveries should be treated as nontaxable. However, until that happens, at least the IRS has issued one piece of non-precedential guidance that a clergy sex abuse settlement was tax-free. The IRS said this even though the abuse occurred years before, and even though only emotional injuries could be shown. The IRS *assumed* that some of it was physical enough at the time to trigger continuing emotional injuries years later. In that ruling, the IRS allowed the exclusion from income for the settlement *without* proof of physical harm.

Yet it's not clear if part of the IRS rationale was that the victim was a minor and that many years had elapsed by the settlement. In a sexual abuse case, to try to maximize your chances of smooth sailing, consider these steps. And the same kind of rationale can apply in sexual harassment cases, where the "is it physical enough" issue can be even tougher. Victims who end up with post-traumatic stress disorder can argue that this alone should be considered physical enough for tax-free treatment, but the law remains less than clear on this point.

Therefore, if you have not yet signed a release or settlement agreement, ask for the payment to be described as for your personal physical injuries, physical sickness and emotional distress therefrom. That does not bind the IRS, but it can help. When you can, mention the primary event, i.e., that you allege you were sexually assaulted or abused. Ask that no IRS Form 1099 be issued to report the payment. After all, payments of damages that are tax-free should not be reported on these forms.

If you do not have a firm commitment in the settlement agreement that no Form 1099 will be issued, you might be issued a Form 1099 and have to report or explain it. Every year I see large numbers of IRS Forms 1099 that plaintiffs did not expect. If possible, get tax advice *before* your settlement is documented, including when mediating your dispute. The IRS isn't bound by the parties' tax characterization, but how lawsuit settlements are taxed often hinges on settlement agreement wording, and the IRS often respects it.

Minimizing taxes is a goal of any plaintiff or claimant. Intuitively, that is about the plaintiff's net recovery after legal fees and costs. But in some cases, if the plaintiff does have to pay tax, there can be a double whammy. Because of quirky tax

deduction rules, if a recovery is taxable, some plaintiffs may not be able to deduct all of the legal fees. Be careful out there.

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