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The Effect of the Tax Cuts and Jobs Act on Employer Settlements of Sexual Harassment Claims

The new tax law enacted on December 22, 2017 contains a little-publicized provision that appears to be a response to the recent wave of sexual misconduct allegations spanning the private and public sectors and the accompanying public concern regarding confidentiality provisions in agreements settling such claims. Previously, employers generally could deduct as business expenses all settlement payments arising out of a business matter and related attorneys' fees, no matter if the settlement agreements contained confidentiality provisions. A short provision of the Tax Cuts and Jobs Act now prohibits such deductions if related to a sexual harassment or sexual abuse settlement that is subject to a nondisclosure agreement. This change to the prior law could have a large impact on how sexual harassment and sexual abuse claims are settled going forward.

The New Law

The new provision, Section 162(q), modifies Section 162 of the Internal Revenue Code, which allows for deductions for ordinary and necessary trade or business expenses. It provides that “[n]o 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.” This provision applies to amounts paid or incurred after December 22, 2017.

Section 162(q) does not prohibit nondisclosure agreements (“NDAs”) in sexual harassment or sexual abuse settlements. Rather, the new provision only eliminates a tax deduction in a sexual harassment or sexual abuse settlement if the settlement or payment is subject to an NDA. The deductibility of sexual harassment or sexual abuse settlement expenses *not* subject to an NDA, and the associated attorneys’ fees, as well as the expenses and attorneys’ fees associated with other kinds of settlements, are unaffected by this provision.¹

While seemingly enacted to protect alleged victims of sexual harassment by deterring employers from seeking confidentiality provisions when settling such claims, the provision appears to apply to all NDAs, whether they bar disclosures by the employer, the employee, or both.

¹ Deductions are generally permitted under §162(a) for settlement payments for litigation (and attorneys’ fees) if the litigation is connected to a taxpayer’s trade or business. Rev. Rul. 80-211, 1980-C.B. 57.

Open Questions

The sparse provision, and the conference report issued by the committee responsible for reconciling the House and Senate versions of the legislation, provide little guidance on exactly how the new provision will be applied in a myriad of circumstances.

Section 162(q) only affects the deductibility of settlement amounts and attorneys' fees that are "related to" sexual harassment or sexual abuse. It is unclear how broadly this "related to" language will be interpreted, which leaves open many questions for employers settling sexual harassment or sexual abuse claims.

Multiple Claims. The new provision does not address the possibility that employees may allege other claims along with their sexual harassment allegations. Alleged victims of sexual harassment or abuse often assert a variety of additional claims—such as gender or race discrimination claims—against their employers. It is unclear whether, in such situations, employers may enter into two separate settlement agreements—one with an NDA to resolve the non-sexual harassment claims, and another without an NDA to resolve the sexual harassment claims—and claim a deduction for the settlement paid for the non-sexual harassment claims. It is also unclear whether employers could potentially include NDAs in both settlements, while allocating a smaller amount to the (nondeductible) sexual harassment settlement to mitigate the tax effect of the nondeductible settlement.

General Releases. Another question left open by Section 162(q) is whether an employer's receipt of a broad general release of all claims (which would include claims of sexual harassment) when settling claims unrelated to sexual harassment or abuse would trigger the new law, if such settlements include an NDA.

Attorneys' Fees. Section 162(q) is unclear as to the deductibility of the attorneys' fees an employer pays in the defense of a sexual harassment or sexual abuse claim prior to settlement. The provision does not specifically address whether attorneys' fees related to investigating and responding to a complaint of sexual harassment or sexual abuse should be treated differently from the fees related to negotiating and drafting the settlement agreement.

Impact and Takeaway

While Section 162(q) provides clear disincentives for settling sexual harassment or abuse claims subject to an NDA, employers may decide, based on their own particular circumstance, that an NDA is more important to them than the ability to claim a tax deduction for the settlement payment and attorneys' fees. Employers may also be faced with a difficult decision if an *employee* requests an NDA during settlement negotiations, knowing that it would make the settlement nondeductible.

Given the uncertainty of how the IRS will interpret the words “related to” in the statute, we encourage employers to work with their counsel at the earliest stage possible and consider their options in structuring settlements of sexual harassment or abuse claims.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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