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Confidential Sexual Harassment Settlements No Longer Tax Deductible

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The tax law signed by President Trump on December 22, 2017, does not only change tax brackets and rates—it also reflects changes brought in the aftermath of many highly publicized sexual harassment scandals. Effective upon signing, the new tax law has eliminated businesses' ability to deduct the costs to settle allegations of sexual harassment or sexual abuse when the settlement requires confidentiality, which is a standard settlement term.

Specifically, the new law adds sub-section (q) to Internal Revenue Code Section 162, which allows businesses to deduct certain ordinary and necessary expenses paid or incurred as part of running the business. Section 162(q) states that "No deduction shall be allowed ... 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 language was added to the tax law in response to the "Me Too" movement—the recent wave of sexual misconduct claims against politicians, media figures, and business executives, and reports that many of the accused bad actors and/or their employers had previously entered into confidential settlement agreements with other harassment claimants. Many believe that non-disclosure agreements played a role in allowing alleged harassers to keep their jobs and continue to mistreat co-workers.

There are still some unanswered questions. The new law does not define key terms in the limitation on deductibility of settlements, there are no congressional documents casting light on legislative intent, and Treasury Department or IRS interpretative guidance is not expected for months.

What is clear, however, is that the new provision will complicate settlement negotiations in harassment cases. Employers will have to choose between (1) non-deductibility of a payment to settle a sexual harassment administrative charge or lawsuit (and related legal fees), increasing the cost of settlement, and (2) preventing public disclosure of embarrassing allegations and the terms of settlement. Employers value non-disclosure (and related non-disparagement) requirements in settlement documents because they help limit similar claims by others, but often both the employer and employee want confidentiality.

Note that the new provision applies to settlement and attorney's fee payments made after December 22, 2017, even if a settlement was reached before that date, and to settlements involving recurring payments, some of which are to be made after December 22.

It may be possible to structure settlements in cases that involve multiple claims, some relating to sexual misconduct and others relating to additional issues, so that part of the payment to the charging party or plaintiff and related legal fees are confidential and still deductible.

The new tax law provision serves as an important reminder of two facts: (1) there are an increasing number of limitations and requirements relating to the content of agreements to settle and release employment law claims; and (2) employers can help prevent sexual harassment claims in the first place by, among other things, fostering an atmosphere of professionalism, having good anti-discrimination, harassment, and retaliation policies in place, and providing effective training.

We will discuss confidentiality and other timely topics related to sexual harassment claims and settlements in the "Me Too" era at our upcoming round of Quarterly Breakfast Briefings. You can register for one of the briefings here. Also, let us know if you have particular issues you would like to hear addressed at the breakfast briefings.
