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New Tax Law **Limits Deductibility of Harassment Settlements:** Where Will the Law of Unintended Consequences Take Us?

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On December 20, Congress passed a comprehensive tax reform bill (the Act) that the President signed into law on December 22. There is one provision of the Act that is of interest to employment litigators and their clients. New §162(q) of the Internal Revenue Code of 1986 eliminates the deductibility of amounts paid in connection with settlement of sexual harassment and sexual abuse claims if the settlement agreement requires nondisclosure on the part of the employee.

By way of background, a taxpayer generally is allowed a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business. I.R.C. §162(a). Settlement payments made to claimants in connection with employment-related disputes are, thus, treated as deductible business expenses by employers, including related attorney fees. Similarly, plaintiffs who sustain attorney fees in connection with settlements of employment disputes may deduct such fees. Section 162(q) eliminates those deductions in cases of settlement of sexual harassment and abuse claims that condition the settlement on non-disclosure.

The provision's language is remarkably brief. Section 162(q) reads in full:

> (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.

The legislative history of §162(q) does not provide much guidance as to its interpretation. The provision was proposed as an amendment to the Senate bill in November by Sen. Robert Menendez, a Democrat from New Jersey. The conference report history for the Senate amendment merely restates the text of the provision: "Under the provision, no

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deduction is allowed for any settlement, payout, or attorney fees related to sexual harassment or sexual abuse if such payments are subject to a nondisclosure agreement."

Section 162(q) leaves several questions unanswered that will need to be resolved by the courts and the Internal Revenue Service.

First, what is a claim "related to" "sexual harassment" or "sexual abuse"? The Act does not define any of these terms. Admittedly, sexual abuse claims are subject to less ambiguity. But how broadly should employers interpret "sexual harassment" claims, let alone claims "related to" sexual harassment?

Second, assume that the claim being settled is genuinely and unambiguously a sexual harassment claim, but the claimant has raised other claims as well and the settlement agreement includes a release of any and all claims the employee may have had against the employer, including but not limited to sex-based claims. The settlement payment is consideration for the release of all claims, not just the sex-based claims. This is a common situation. Can the settlement payment be allocated between the harassment-based claim and other claims being settled? That way, at least part of the payment—if such quantification and allocation is permissible under the Act—may be deductible. This approach brings its own complications, however, including determining how much of the settlement should be allocated to the sexual harassment or abuse claims.

Third, what attorney fees are "related to such a settlement or payment," and, thus, non-deductible? The provision does not distinguish between the claimant's and the employer's attorney fees. Moreover, is it only the fees related to negotiating a settlement, drafting an agreement, and executing payment? May parties deduct fees incurred in investigating the underlying claims, engaging in litigation and evaluating the settlement value of a case? This could be a significant area to recoup some of the deductibility otherwise denied by §162(q) in the event a confidential settlement is preferred.

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The obvious intent of the provision is to provide a strong disincentive to settlements of harassment claims that include confidentiality provisions. Nevertheless, it could well have unintended consequences. Some plaintiffs welcome confidentiality provisions, because they themselves have no interest in publicity about their claims. Moreover, plaintiffs certainly would recognize that an employer may be more willing to pay a higher amount in settlement if the amounts paid are deductible. The provision may ultimately result in fewer settlements, or lower settlement amounts, for plaintiffs. It also may incentivize employee creativity in asserting claims—for example, by not asserting harassment but instead asserting other claims that could continue to be settled confidentially without adverse tax consequences. It thus may actually result in fewer sex harassment claims being brought.

A final consideration is relevant to claimants. The non-deductibility of attorney fees in confidential settlements ironically may be more significant to claimants than employers in light of the Act's reduction of the marginal tax rate for corporations from 35 percent to 21 percent; individuals' tax rates extend up to 37 percent. In 2005, the Supreme Court held that attorney fees are taxable income to plaintiffs. *Banks* v. *Comm'r*, 543 U.S. 426 (2005). But the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (Oct. 22, 2004), allowed plaintiffs to take deductions for attorneys' fee payments in discrimination cases. Thus, another unintended consequence of §162(q)—again, which was intended to remove sex harassment settlements from a shroud of secrecy—may be to incentive plaintiff-employees to characterize sex harassment claims as disparate treatment sex discrimination claims separate from harassment, in order to preserve the deductibility of their attorney fees.