CLIENT ALERTS

To Disclose or Not to Disclose - That is the Question: Sexual Harassment Settlements & the New Tax Act

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The Tax Cuts and Jobs Act (the new Tax Act) may make sexual harassment settlements more expensive for employers. Prior to tax reform, the Tax Code had permitted companies to take a business deduction for the costs of obtaining sexual harassment settlement agreements. The new act prohibits that deduction if sexual harassment or sexual abuse settlements include non-disclosure provisions.

Section 162 of the federal Tax Code enumerates deductions for ordinary and necessary business expenses "paid or incurred during the taxable year" by a trade or business. Section 13307 of the new Tax Act amends that section by adding an entirely new sub-section (q) prohibiting the taking of a business deduction 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." The immediately effective provision applies to "amounts paid or incurred" after the new Tax Act's date of enactment.

In an emailed statement to the *New York Times*, Senator Bob Menendez of New Jersey explained that he had proposed the amendment because he believed that "most Americans would be outraged to know that they are subsidizing sexual predators in the tax code." High-profile and costly settlements for misconduct by Bill O'Reilly and Harvey Weinstein reportedly contained non-disclosure and confidentiality provisions.[1]

Companies have deducted the expenses of sexual (and other) harassment settlements, including attorneys' fees associated with such settlements. For a variety of reasons (including concern for retaliation against complainants and witnesses), harassment settlement agreements often contain non-disclosure provisions binding all parties to confidentiality.

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Although the Tax Code excludes business deductions for personal expenses paid by companies on behalf of corporate officers (e.g., expenses of a CEO's divorce settlement), companies have deducted costs of settlements involving potential individual defendants (including attorneys' fees) when the released parties include alleged harassers, including CEOs, corporate officers, members of senior management, and other employees.[2]

The unarticulated premise of the tax reform? The assumption that non-disclosure provisions can allow sexual harassers to continue their unlawful conduct for years. In a Thompson Reuters interview, EEOC Commissioner Chai Feldblum warned that the Equal Employment Opportunity Commission anticipates an increase in sex-based harassment charges in a post-Weinstein world. She also warned that the EEOC will highly scrutinize harassment settlements for provisions that violate the law, including and especially non-disclosure and waiver of claims provisions.

The new Tax Act provision also raises additional questions, given its potential interpretation by the IRS or by courts. For example, if a settlement agreement settles more claims than a sexual harassment claim, does the prohibition against the deduction apply only to the amount paid to settle the sexual harassment claim? Does a non-disclosure provision sufficiently narrow in scope trigger the prohibition?

Employers thus face a choice when negotiating these settlements. Not including a non-disclosure provision in a sexual harassment settlement agreement may effectively reduce the cost of a settlement by continuing to allow a tax deduction. At the new corporate tax rate in the Tax Act, for ease of example, a company that does not include non-disclosure provisions in a $1 million dollar settlement agreement (including the amount of the payment and the amount of the attorneys' fees reimbursed to the complainant and his/her attorney) could potentially take a reduction of $210,000 in federal income tax. Despite this incentive, a company may well decide to forego the deduction out of concerns for (among others): 1) the effect allowing disclosure of the settlement could have on its business; 2) the "due process" and privacy concerns that the EEOC guidelines raise to protect all employees participating in a sexual harassment investigation; and 3) the confidentiality and non-retaliation provisions of its harassment policy and procedure. This new provision in the Tax Code places employers on the horns of a dilemma that requires careful consideration in consultation with counsel.

For further information, please contact the authors of this bulletin or your Butzel Long Labor & Employment attorney.

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[1] See: https://www.nytimes.com/2017/12/16/us/politics/tax-bill-harassment-settlements.html.

[2] As part of such settlements, companies may also pay the attorneys' fees of the settling complainant. In doing so, companies reflect such attorneys' fees on Form 1099s issued to the settling individual, even if separate checks are written to the individual and a law firm. An individual complainant who treats attorneys' fees as a trade or business expense (such as a consultant or other professional) would typically have deducted such fees under former Section 162. Depending on tax advice received, an individual employee may also have taken an itemized deduction for such fees. Given its breadth, new Section 162(q) may result in an unintended consequence: the inability of the complainant to deduct such fees if a settlement agreement contains a non-disclosure clause.