

Employers Beware: Tax Law Change Eliminates Tax Deductions Relating to Certain Settlements

by Melissa Raphan and Katina M. Peterson

The #MeToo movement has had far-reaching implications and appears to have influenced the new federal tax law. The legislation contains a provision that has received little attention but that may have serious, unintended consequences for employers. New Internal Revenue Code Section 162(q) will require employers whose settlements of sexual harassment claims include nondisclosure provisions to navigate carefully to preserve the deductibility of settlement related payments. Although transparency has been a hallmark of the #MeToo movement, this provision may prove challenging for employers and employees who wish to maintain the confidentiality of certain settlements.

With certain exceptions, Section 162 of the Internal Revenue Code allows employers to deduct ordinary and necessary expenses paid or incurred in carrying on a trade or business. Under this provision, employers have historically been allowed to deduct payments made and costs incurred in settling employment-related claims, including claims relating to sexual harassment. The recently enacted tax legislation will significantly change these rules.

Public Law No. 115-97, originally titled the Tax Cuts and Jobs Act of 2017 (actual title “an Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018”) (the “Tax Act”) includes a provision that denies a tax deduction for expenses relating to certain settlements.

Section 13307 of the Tax Act states:

“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.”

As summarized in the conference committee report, “Under the provision, no 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.”

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The provision applies to amounts paid or incurred after December 22, 2017, the date of enactment.

The provision's broad language creates a number of troubling uncertainties and potential problems for both employers and claimants. Significantly, the statutory language fails to define any portion of the all-important phrase "any settlement or payment related to sexual harassment or sexual abuse." How will "sexual harassment" and "sexual abuse" be defined? If a sexual harassment claim is part of a multi-claim suit, are any settlement payments made to resolve the case "related to" a sexual harassment claim? What if release and confidentiality language included in the settlement agreement apply to claims of sexual harassment and abuse even if such claims have not actually been made? What if the parties are subject to a court order containing nondisclosure requirements? All of these questions are open issues and will need to be carefully evaluated by employers and their advisors.

It is also concerning that the provision explicitly applies to deductions "under this chapter," which in effect refers to all of the income tax provisions in the Internal Revenue Code. Read literally, the provision would deny a deduction for attorney's fees that claimants could otherwise potentially be entitled to under other applicable income tax provisions of the Code. Even if this is not the provision's intent, it is difficult to read the statutory language any other way and the conference committee report is unhelpful.

Takeaways for now:

1. In light of this provision (which will be codified as new Section 162(q) of the Internal Revenue Code), careful analysis, planning, and drafting relating to any settlements that could potentially fall under its terms will be imperative in order for employers to realize anticipated tax benefits.
2. Such planning will include carefully defining claims, making clear allocations of payments in the settlement agreement, and considering multiple settlement agreements for multi-claim matters.
3. Employers should pay close attention to this provision given that clarification could be forthcoming.