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Harvey Weinstein Tax May Hit Both Plaintiffs and Defendants

By: Robert W. Wood | Feb 14, 2018

IN BRIEF

- The so-called Weinstein tax will deny tax deductions for settlement payments and attorney's fees in sexual harassment cases if there is a nondisclosure agreement.
- It is unclear from the language of the statute, however, whether the denial of legal fees is only in cases where nondisclosure is included.
- And what about plaintiff's legal fees in sexual harassment cases subject to a nondisclosure agreement?

Harvey Weinstein, Kevin Spacey, Bill O'Reilly, and many other figures in the business and entertainment world have been accused of serious acts of sexual harassment. The torrent that was unleashed came to be known on social media as the #MeToo movement. As 2017 drew to a close, *Time Magazine* selected the "Silence Breakers" as its person of the year. See Edward Felsenthal, *The Choice*, Time (Dec. 6, 2017).

With tax reform under discussion, many people seem shocked that for businesses, legal settlements and legal fees are nearly always tax deductible. Even legal fees related to clearly nondeductible conduct (such as a company negotiating with the SEC to pay a criminal fine) can still be deducted. In general, only fines and penalties paid to the government are not deductible.

The recently passed tax bill includes what some have labeled a Harvey Weinstein tax. The idea of the new provision is to deny tax deductions for settlement payments in sexual harassment or abuse cases if there is a nondisclosure agreement. Notably, this "no deduction" rule applies to attorney's fees as well as settlement payments. The language is simple. See Tax Cuts and Jobs Act, Pub. L. 115-97, § 13307.

Section 162 of the tax code generally lists business expenses that are tax deductible; however, new section 162(q) provides:

> (q) PAYMENTS RELATED TO SEXUAL HARASSMENT AND SEXUAL ABUSE. —No deduction shall be allowed under this chapter for—
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> > (1) any settlement or payment related to sexual harassment or sexual abuse if such settlement or payment is subject to a nondisclosure agreement, or
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> > (2) attorney's fees related to such a settlement or payment.

Most legal settlement agreements have some type of confidentiality or nondisclosure provision. There has been recent speculation that sexual harassment settlements may now start breaking this normal confidentiality mold.

Some observers have pointed out that it is not crystal clear that the denial of legal fees is only in cases where a nondisclosure agreement is included. The nondisclosure is clearly the trigger for the denial of the deductibility of the settlement monies, but the legal fees are not so clear. It is possible (although I would hope unlikely) that the IRS might read the law as a denial of a tax deduction for legal fees related to sexual harassment or abuse, even *without* a nondisclosure agreement.

Moreover, what about legal fees paid by the *plaintiff* in a sexual harassment case in which a confidential settlement is reached? It is shocking to think that they might not be deductible. The tax treatment of legal fees a plaintiff pays to reach a recovery, often on a contingent-fee basis, has been troubled for decades.

In 2005, the U.S. Supreme Court in *Commissioner v. Banks*, 543 U.S. 426 (2005), held that plaintiffs in contingent-fee cases must generally recognize gross income equal to 100 percent of their recoveries. This means that the plaintiff must figure a way to deduct the 40-percent fee. Plaintiffs were relieved when a few months before the *Banks* decision, Congress provided an above-the-line deduction for legal fees in employment cases.

Since that 2004 statutory change, plaintiffs in employment cases have been taxed on their net recoveries, not their gross. Now, though, there is real concern that the legal-fee deduction rules are going backwards. It may be fine to deny Harvey Weinstein and Miramax any tax deduction for settlements and legal fees, but how about the plaintiffs?

On its face, the new law would seem to prevent *any* deduction for legal fees in this context. One answer to this surely unintended result might be to revisit the 2004 change that ushered in the above-the-line deduction for employment cases. That language is still in the tax code, promising an above-the-line deduction for legal fees in any employment-related claim, yet the new Weinstein provision says that it trumps all others, including the above-the-line deduction. One would hope that the IRS would view the *plaintiff's* legal fees as materially different from those of the defendant in this context, but we do not yet know. Despite the somewhat worrisome wording of the new statute, plaintiffs and their tax preparers might well assume that this nondeduction provision can *surely* not have been intended to apply to plaintiffs. Surely Congress would not want a sexual harassment victim to pay tax on 100 percent of his or her recovery when 40 percent goes to the lawyer!

BELOW THE LINE?

One might think that even if the IRS were to read the Weinstein provision as applying to defendants *and* to plaintiffs, there might be a fallback position. Before the 2004 change, many employment-claim plaintiffs had to be content with a below-the-line deduction. In such a case, some of the fees were nondeductible on account of the two percent of gross income threshold. Miscellaneous itemized deductions were not deductible except to the extent they exceeded two percent of adjusted gross income.

There were also phase outs of deductions, depending on the size of the plaintiff's income. Worse still, there could be alternative minimum tax (AMT) repercussions. However, now the below-the-line deduction seems to be gone, too, at least until 2026. Tax Cuts and Jobs Act, Pub. L. 115-97, § 11045.

This is not a feature of the Weinstein tax, but of the other significant changes in the new tax law. With higher standard deductions, the law now eliminates miscellaneous itemized deductions. Thus, for the sexual harassment plaintiff, the choice would appear to be either an above-the-line deduction or nothing. This suggests a broader tax problem. Outside of the employment context, there is a large problem for legal fees. Plaintiffs who do not qualify for an above-the-line deduction for legal fees evidently now must pay tax on 100 percent of their recoveries, not merely on their post-legal fee net. Only employment and certain whistleblower claims are covered by the above-the-line deduction.

SEXUAL HARASSMENT ALLOCATIONS

Will *any* mention of sexual harassment claims trigger the Weinstein provision? If it does, will it bar *any* tax deduction, even if the sexual harassment part of the case is minor? Plaintiff and defendant may want to expressly agree on a particular tax allocation of the settlement in an attempt to head off the application of the Weinstein tax.

In a $1M settlement over numerous claims, could one allocate $50,000 to sexual harassment? This figure may or may not be appropriate on the facts; however, legal settlements are routinely divvied up between claims. There could be good reasons for the parties to address such allocations now. The IRS is never bound by an allocation in a settlement agreement, but the IRS often pays attention to allocations and respects them. I expect that we will start seeing such explicit sexual harassment allocations. We may see them where the sexual harassment was the primary impetus of the case, and where the claims are primarily about something else. Suppose that the parties allocate $50,000 of a $1M settlement to sexual harassment. That amounts to five percent of the gross settlement. If $400,000 is for legal fees, five percent of those fees ($20,000) should presumably be allocated to sexual harassment, too.

One other possible answer might be for the parties to expressly state that there was *no* sexual harassment, and that the parties are not releasing any such claims, but defendants typically want complete releases. Thus, what about including the complete release, but stating that the parties agree that no portion of the settlement amount is allocable to sexual harassment? This may make sense in some cases.

These are big and worrisome tax changes, and they may complicate already difficult settlement discussions. Whoever you represent, get some tax advice and try to be prepared for the new dynamics that these issues may raise. Finally, when it comes to attorney's fees for plaintiffs, this may be a sea change.

For many types of cases involving significant recoveries and significant attorney's fees, the lack of a miscellaneous itemized deduction could be catastrophic. There may be new efforts, therefore, to explore the exceptions to the Supreme Court's 2005 holding in *Banks*, which laid down the general rule that plaintiffs have gross income on contingent legal fees. The court alluded to various contexts in which this general 100-percent gross income rule might not apply. We should expect taxpayers to more aggressively try to avoid being tagged with gross income on their legal fees.