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### Ironically, Weinstein Tax On Sexual Harassment Settlements May Hurt Plaintiffs Too

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. As the #MeToo movement gained strength, many people seem shocked that settlements and legal fees are nearly always tax deductible by businesses. So the recently passed tax bill includes a Harvey Weinstein tax that denies deductions in confidential sexual harassment or abuse settlements. Notably, this "no deduction" rule applies to the lawyers' fees, as well as the

settlement payments. New Section 162(q) of the tax code provides:



**“(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.”

Most legal settlement agreements have some type of confidentiality or nondisclosure provision. However, some commentators have suggested 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. That would hurt plaintiffs. Even worse, could legal fees paid by the *plaintiff* in a sexual harassment case be covered if there is a confidentiality provision? It surely was not intended, but the wording could cover plaintiff's legal fees too.

That isn't the only tax worry either. Plaintiffs who use contingent fee lawyers are treated for tax purposes as receiving 100%, of if their lawyer takes 40% off the top. So ruled the U.S. Supreme Court in *Commissioner v. Banks*, 543 U.S. 426 (2005). That means the plaintiff must figure a way to deduct the 40 percent fee. In 2004, Congress provided an above the line deduction for legal fees in employment cases. Since then, plaintiffs in employment cases have been taxed on their net recoveries, not their gross.

Surely Congress would not want a sexual harassment victim to pay tax on 100 percent of her recovery when 40 percent goes to her lawyer! But we do not yet know how this will be read by the IRS. Before the 2004 change, many employment plaintiffs had to be content a below the line deduction, which face limitations. But with higher standard deductions, the law eliminates these deductions. Thus, for the sexual harassment plaintiff, the choice may be an above the line deduction or nothing. Outside of employment cases, plaintiffs who do not qualify for an above the line deduction for legal fees may now 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.

It is also worrisome to ask if *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 agree on a particular tax allocation, attempting to head off the application of the Weinstein tax. In a \$1M settlement over numerous claims, could one allocate \$10,000 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 respects them, and we may start seeing explicit sexual harassment allocations. We may see them where 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 5 percent of the gross settlement. If \$400,000 is for legal fees, 5 percent of those fees (\$20,000) should presumably be allocated to sexual

harassment too. Perhaps a complete release might state that the parties agree that *no* portion of the settlement is allocable to sexual harassment?

These are big and worrisome tax changes, and they may complicate already difficult settlement discussions. For many types of cases involving significant recoveries and significant attorney fees, the lack of a miscellaneous itemized deduction could be catastrophic. There may be new efforts, therefore, to explore the boundaries of the Supreme Court's 2005 holding in *Banks*. 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. It is a troubling new tax world, and it could well hurt plaintiffs materially.

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