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Sexual Harassment Tax Law That Double-Taxes Victims Needs Fixing

The “Repeal the Trump Tax Hike on Victims of Sexual Harassment Act of 2018” has not yet been passed, and it is not clear that it will be passed. But it certainly *should* be passed. Most observers looking at the big tax reform law that passed at the end of 2017 note the potential confusion--or worse--caused by the so-called Harvey Weinstein provision. The provision was meant to stop *defendants* in sexual harassment cases from being able to deduct their legal fees and their settlement payments where they require confidentiality from their

accusers in legal settlement agreements.



But the law *actually* reads that the *accusers too* cannot deduct their legal fees. That means if a plaintiff recovers \$500,000 but must pay her lawyer 40%, the full \$500,000 is taxable income. It means that the victim is paying tax on money she never receives. And if the legal fees and

costs combined climb to say 50%? That means paying taxes on twice the money

you collect. That sure sounds like double taxation. 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."

It doesn't say *whose* legal fees can't be deducted, so it means *everyone's*. Of course, virtually all legal settlement agreements have some type of confidentiality or nondisclosure provision. It is true in virtually any kind of legal case, and perhaps especially so in sexual harassment cases. The basic tax rules for legal fees surprises many people. Plaintiffs who use contingent fee lawyers are treated for tax purposes as receiving 100% of the settlement amount, even 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. Yet a glitch in the tax law seems to mean that the plaintiffs--the very people the new law was presumably meant to help protect--cannot deduct their legal fees either. There is a movement to amend the law to correct this ridiculous and unjust result.

But sexual harassment victims who must settle in the meantime may be worried. In the topsy-turvy world of Congress, it is not clear that the law will pass. Even if it does eventually, it is not clear that will be anytime soon. Any mention of sexual harassment in a legal case could trigger the law. It could bar *any* tax deduction, even if the sexual harassment part of the case is minor. Plaintiff and defendant may agree on a particular tax allocation, perhaps allocating only a small amount to sexual harassment. However, the IRS is never bound by an allocation in a settlement agreement.

Hopefully the Repeal the Trump Tax Hike on Victims of Sexual Harassment Act of 2018 will be passed, and passed swiftly. Of course, there are many other parts of the new tax law that require technical corrections or other fixes too. But this one should be corrected without delay.

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.