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Decoding the Tax Cuts and Jobs Act – Part I: Obscure Provision in New Tax Law Denies Deductions for Sexual Harassment Settlements Subject to Nondisclosure Agreements

By Larry Brant and Steven Nofziger on 1.4.18 | Posted in Legislation, Tax Planning

As indicated at the end of 2017, I intend to provide our readers with an in-depth review of the Tax Cuts and Jobs Act ("TCJA"). With the help of two of my colleagues, Steven Nofziger and Miriam Korngold, we will do this in a series of bite-size blog posts. Our goal is to not only review the technical elements of the new law, but to offer practical insights that will be helpful to tax practitioners and their clients.

Many of the provisions of the TCJA have already received significant attention by the media. Rather than start our multi-part series with any of those provisions, we decided to commence the journey with a discussion about a rather obscure provision of the new law. This provision, while it may not have received any media attention, could be a huge trap for the unwary. It also highlights several aspects of the new law that have received little discussion.

Do you recall recently reading about the sexual harassment and/or abuse scandals involving many well-known employers, including Fox News, NBC News, CBS News and the Weinstein Company? The list of the persons accused of sexual harassment and/or abuse is staggering. The accused include: Rich Rodriguez, James Toback, Harvey Weinstein, Kevin Spacey, Ben Affleck, Mario Batali, Nick Carter, Louis C.K., Andy Dick, Richard Dreyfuss, Charles Dutoit, Gary Goddard, David Guillod, Dustin Hoffman, Reverend Jesse Jackson, John Lasseter, Matt Lauer, James Levine, Nelly, Charlie Rose, Steven Segal, Gene Simmons, Tom Sizemore, Oliver Stone and George Takei, among several others.

This past year has been a watershed for news about several high-profile persons in positions of authority being accused of sexual harassment and/or abuse. In some instances, the employers of those accused persons had previously settled claims against them for sexual harassment and/or abuse in the workplace. We likely had not heard anything about these prior claims because the settlements were subject to nondisclosure agreements.

Sexual Harassment Settlement Agreements Will Now Require a Closer Look

For years it has been a common practice for employers to settle employment-related lawsuits, requiring the claim and the resolution to be subject to confidentiality and nondisclosure. Such settlements are typically treated as a cost of doing business and any settlement payments are typically deducted by the employer-payor as an "ordinary and necessary" business expense under Internal Revenue Code ("Code") Section 162. Change is afoot, however!

The TCJA contains a provision that specifically denies a deduction for settlements subject to nondisclosure agreements that are paid in connection with sexual harassment and/or sexual abuse. TCJA Section 13307 amends Code Section 162(q) to read:

"(q) No deduction shall be allowed . . . 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."

This provision has received little, if any, press in light of the many changes made to the other provisions of the Code by the TCJA. The legislative history accompanying this provision indicates that it was added by the Senate. Further, the legislative history reflects that the new law is intended to deny deductions for both settlement payments and the related attorney fees in instances where: (i) the settlement involves sexual harassment and/or sexual abuse, and (ii) is subject to a nondisclosure agreement.

As indicated earlier, this blog post is the first in a series of posts addressing aspects of "tax reform" under the TCJA. Although this provision may seem like an unusual choice to lead with, it highlights several aspects of tax reform that have received little discussion.

First, it suggests that there are many other significant provisions buried within the TCJA that received little discussion or vetting during the relatively brief and mostly non-public process by which the law was enacted. Second, it highlights the need for regulatory guidance when the new tax law is enacted, in order to fully understand its meaning, scope and application.

Ambiguity Abounds

On the surface, one might think that this new provision is relatively clear and there will be little disagreement as to its general meaning, scope and application. However, digging deeper, you quickly notice that several terms, including "sexual harassment," "sexual abuse," and "nondisclosure agreement" are not defined anywhere in the provision. Since the statute is new, Treasury has not yet issued any regulatory guidance. Given the "all or nothing" aspect of the

deduction denial, and the potentially sizable payouts and attorney fees that will likely be incurred by employers and others relative to the numerous claims lurking out there, guidance beyond an "I know it when I see it standard" is desperately needed.

There are many unanswered questions. They include:

- Would a sexual harassment and/or abuse claim merely have to be asserted by a claimant, or does a formal lawsuit need to be filed for this provision to apply?
- If sexual harassment and/or abuse is among many claims being asserted by a claimant and a nondisclosure provision is included in the settlement agreement, is the entire settlement payment and all of the attorney fees incurred by the payor non-deductible or just the settlement payment and attorney fees specifically related to the sexual harassment and/or abuse claims?
- Could a taxpayer avoid the application of this provision if the nondisclosure provision is limited in application to the non-sexual harassment and/or abuse claims?
- Does a claim of sexual harassment and/or abuse need to meet a criminal law or tort law standard under applicable state law?
- What constitutes a nondisclosure agreement?
- Is a generic confidentiality provision sufficient, or is something more specific required to trigger the deduction denial?
- Would a settlement containing a non-disparagement provision, but not a confidentiality or nondisclosure provision, trigger the deduction denial?

How Taxpayers and Advisors Can Brace Themselves for This Change

Code Section 162(q) may be obscure in light of many of the provisions of the TCJA that impact millions of taxpayers, but it cannot be ignored. Taxpayers and their advisors need to be aware of it. Any settlement of claims involving sexual harassment and/or abuse needs to be carefully reviewed by a qualified tax advisor. Until regulatory guidance is issued, caution is advised. Some common sense guidelines include:

- All settlements involving any claim that includes a reference to sexual harassment and/or abuse should be reviewed by a qualified tax advisor;
- To ensure deductibility, employers should consider language be included in the written settlement agreement along the lines—notwithstanding anything herein to the contrary, this settlement is not subject to a "nondisclosure agreement" as that term is used in Code

Section 162(q); and

- Consider separately stating each and every claim and the amount of settlement consideration assigned to it in the written settlement agreement, thereby creating an argument that the settlement may be bifurcated among sexual harassment and/or abuse claims and any other claims.

Although this brief new provision contains what appear to be generally well-understood concepts, there are many aspects that require further guidance. Treasury and the IRS are almost certainly going to be overwhelmed with the need to issue guidance under the provisions of the TCJA for years to come.

Stay tuned for more installments of our thoughts on other aspects of the TCJA!

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