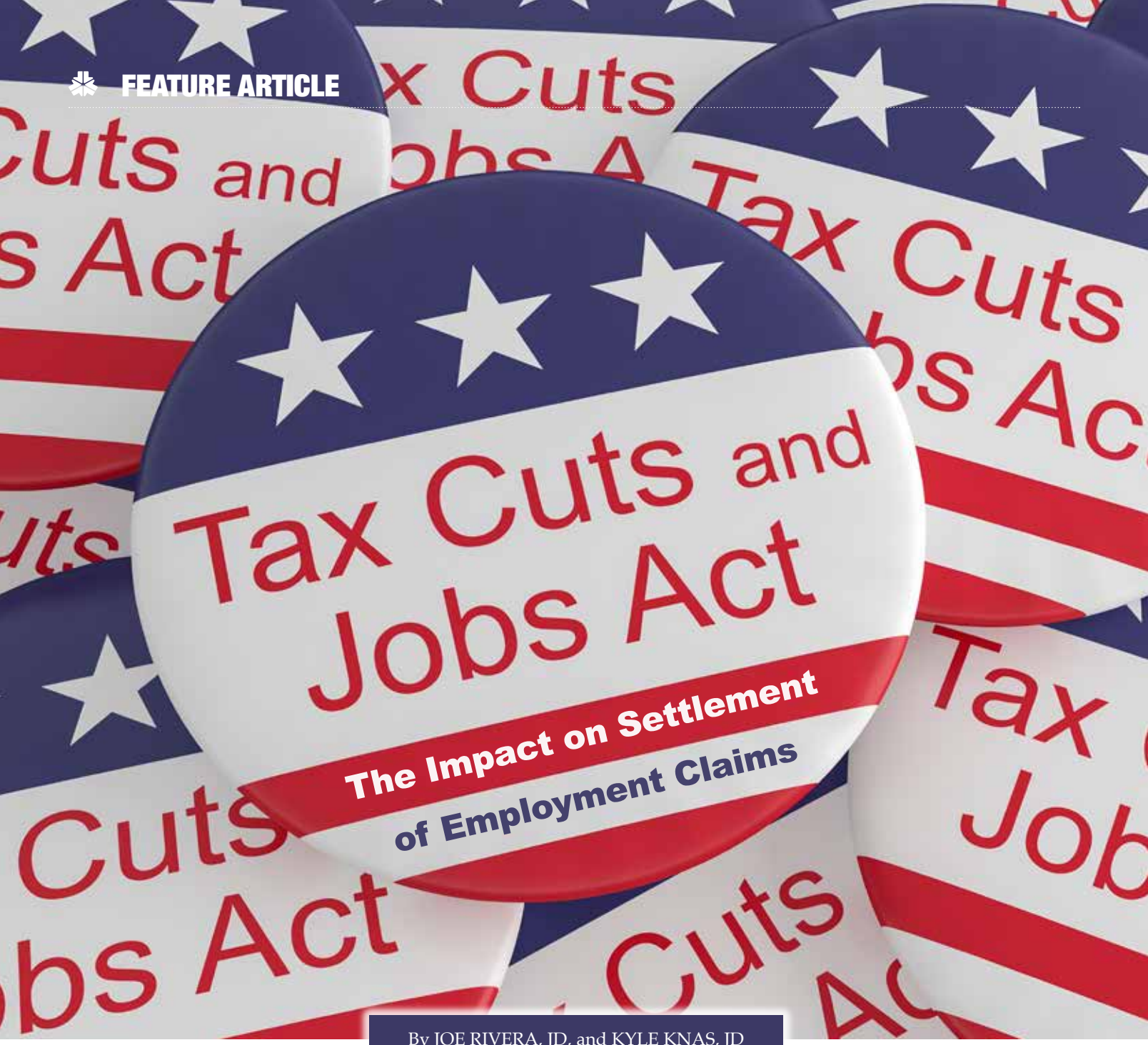

The Impact on Settlement of Employment Claims

By JOE RIVERA, JD, and KYLE KNAS, JD

The Tax Cuts and Jobs Act (the Act) passed by Congress and signed into law by President Donald Trump in December 2017 has been described as the most significant amendment to the federal tax laws since 1986. The Act has generated substantial interest among taxpayers who wish to understand how it will affect them. One such provision is the Act's amendment to IRC 162, which addresses confidential settlement agreements related to sexual harassment or sexual abuse claims.

History of Taxation in this Area

Historically, the taxation of a settlement in a sexual harassment claim was governed by IRC 61(a) and the dichotomy created by IRC 104(a)(2). The familiar language of IRC 61(a) states that gross income subject to taxation includes all income, from whatever source derived, with other sections of the code creating exceptions to this general rule. One such exception, IRC 104(a)(2), states:

> (a) In general. Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include – (2) the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness

This language has been interpreted to require that, to be excluded from taxation, damages or settlement funds must be (1) paid based on a tort or tort-type right and (2) paid "on account of *personal physical injuries or physical sickness." See Wells v. Comm'r,* T.C Memo 2010-5 (2010).

NON-PECUNIARY DAMAGES INCLUDE COMPENSATION FOR THINGS LIKE MENTAL ANGUISH AND EMOTIONAL PAIN.

Anti-discrimination statutes, such as Title VII of the Civil Rights Act of 1964 (as amended by the Civil Rights Act of 1991), which prohibits harassment or discrimination based on sex or membership in other protected classes, generally allows for recovery of compensatory damages, such as past lost wages or benefits and future lost wages and benefits. (See 42 USCS §§ 1981a, 2000e-5.) Because such damages are not "on account of personal physical injuries or physical sickness," they do not fall within the exception to taxable income created by IRC 104(a)(2) and thus are taxable.

Anti-discrimination laws like Title VII also allow recovery for what are known as "non-pecuniary" damages – damages that do relate to some underlying monetary obligation. Non-pecuniary damages include compensation for things like mental anguish and emotional pain. (See 42 USCS §§ 1981a, 2000e-5.)

Taxpayers have argued that funds paid in compensation for mental anguish or emotional pain suffered due to harassment or discrimination are not taxable, either because mental anguish or emotional pain are "physical injuries or physical sickness" or because mental anguish or emotional pain have caused "physical injuries or physical sickness." The Tax Court has rejected the former approach, concluding that emotional pain and mental anguish are not "physical injuries or physical sickness." (See *Wells v. Comm'r,* T.C Memo 2010-5 (2010); discussing the legislative history of IRC 104(a)(2)); also see *Blackwood v. Comm'r,* T.C. Memo 2012-190 (2012); noting legislative history cited insomnia, headaches and stomach disorders as common symptoms of emotional distress, the compensation for which should be taxed).

On the latter approach, there is some limited authority that if harassment or other hostility in the work environment causes physical manifestations beyond those typically associated with mental anguish or emotional pain, or exacerbates a physical injury or physical sickness, funds paid in compensation for such manifestations, injury or sickness are not taxable. So, for example, in *Domeny v. Comm'r,* T.C. Memo 2010-9 (2010), the taxpayer suffered from multiple sclerosis, a neurological disorder with symptoms including paralysis and jerking muscle tremors. The taxpayer claimed that a hostile work environment and related stress caused her MS to "flare up," with the taxpayer suffering symptoms like leg pain, difficulty walking, vertigo and fatigue. A settlement agreement was executed, which covered potential claims for disability harassment and discrimination.

A portion of the settlement proceeds was reported as wage compensation on Form W2 and a portion was reported on Form 1099-MISC as "non-employee compensation" for other aspects of the taxpayer's claim. The Tax Court held that the taxpayer demonstrated that the hostile work environment exacerbated the taxpayer's MS, a physical illness, resulting in physical manifestations beyond those normally associated with mental anguish or emotional pain, and thus the "non-employee compensation" was excludable from taxable income pursuant to IRC 104(a)(2).

Other issues that arise in the settlement of a harassment claim are the treatment of punitive damages or attorney's fees. Punitive damages are carved out of the exception created by IRC 104(a)(2) and are therefore taxable. (See IRS Pub. 4345.) This is true even if the punitive damages are received on account of physical injuries or physical sickness.

Anti-discrimination laws like Title VII also allow for recovery of attorney's fees. Generally, the tax treatment of attorney's fees is based on the tax treatment of the underlying claim in connection with which the fees were incurred. *Green v. Comm'r,* 2007 T.C. Memo. 2007-39 (2007).

Common-law tort claims can also be made in the employment context, particularly for sex-based harassment or assault. Common-law assault and/or battery causes of action clearly allow for recovery of compensatory damages for the physical injuries or physical sickness caused by assault or battery, as well as for emotional distress, mental anguish or other aspects of damage. *Gilliland v. Pon Lip Chew,* 401 S.W.2d 137, 139 (Tex. Civ. App. – El Paso 1966, no writ); *Stafford v. Steward*, 295 S.W.2d 665, 667 (Tex. Civ. App. – Eastland 1956, writ dism'd agr.). To the extent that funds are paid as compensation for physical injury or physical sickness caused by a common law assault, battery or similar claim, those funds can be excluded from taxable income under IRC 104(a)(2).

Of course, lawsuits generally involve multiple causes of action and multiple categories of damages. The Tax Court

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has held that when damages are paid in connection with a settlement agreement, it will first look to the language of the agreement to determine whether it expressly states that the damages compensate for "personal physical injuries or physical sickness" excludable from taxation under IRC 104(a)(2) or are instead taxable income. If the agreement is ambiguous or lacks express language specifying the purpose of the compensation, a court will then proceed to examine the intent of the payor, which is evaluated based on all the facts and circumstances of the case, including the pleadings in any lawsuit or other details of the litigation being settled. Domeny v. Comm'r, T.C. Memo 2010-9 (2010).

Parties to a settlement agreement that want to achieve desirable tax treatment should expressly address in the settlement documents the nature of the claims being settled, clearly identify any claims that are for physical injury or physical sickness, and specify an amount paid for each claim or cause of action so as to make it clear what portion of the overall settlement relates to claims for physical injury or physical sickness. Hansen v Comm'r, T.C. Memo 2009-87 (2009). (Although the taxpayer had sustained some bruises as result of incidents that gave rise to settlement, these injuries were not mentioned in agreement and thus all settlement funds were taxable.)

The Act and Taxation of Confidentiality Agreements

In today's world, it is not uncommon to hear news of an accusation that a celebrity, politician or otherwise high-profile person has engaged in sexual misconduct. #MeToo has been a highly public and powerful social media movement, which seeks to bring attention to the issues of sexual harassment and sexual assault.[1] Of particular concern to the movement is sexual harassment and sexual assault in the workplace.[2]

Apparently driven by the social context reflected by these phenomena, Congress included in the Act a provision specific to sexual harassment and sexual abuse claims. Specifically, section 162 of the Internal Revenue Code addresses confidentiality agreements pertaining to sexual harassment or sexual abuse settlements. This new code section is applicable to amounts paid or incurred after Dec. 22, 2017, meaning that settlements agreed prior to such date, but paid out afterward, are subject to this new law. Section 162(q) of the IRC, as added by the 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.

This new provision under Section 162(q) is drafted broadly and, like numerous other provisions in the Act, there is yet little guidance as to how the IRS will regulate and enforce the new law.[3] As with a great deal of the new Act, practitioners are awaiting Treasury Regulations or other interpretive guidance to provide more clarity to better advise clients as to the ramifications of the new law. Until regulations, publications, case law or other guidance become available, some areas of interest follow.

As discussed above, damages received under a settlement of a claim for harassment or discrimination are subject to the dichotomy created by IRC 104(a)(2), with compensation for physical injury or physical sickness generally excludable from gross income. (See IRC § 104(a)(2).) Compensation for workplace hostility or harassment that causes such a degree of stress that physical injury or physical sickness results is also excludable. (See *Domeny v. Commissioner,* T.C. Memo 2010-9.)

How will mental anguish or physical damages as the result of a sexual harassment or sexual abuse claim be treated? As drafted, the new law seems to disallow the deduction of any damages, regardless of the type, paid in settlement of a sexual harassment or sexual abuse claim, if the settlement is subject to a non-disclosure agreement. That is, IRC 162(q) can be read to override IRC 104(a)(2) and to make even funds paid in settlement of physical injury or physical sickness caused by sexual assault or sexual harassment subject to tax.

There is no guidance addressing this apparent conflict between IRC 104(a)(2) and IRC 162(q). To the extent that

[1] Edwards, Stephanie Zacharek, Eliana Dockterman, Haley Sweetland. "TIME Person of the Year 2017: The Silence Breakers." *Time*. Retrieved 2018-04-14.

[2] Smartt, Nicole. "Sexual Harassment in the Workplace in a #MeToo World." *Forbes*. Archived from the original on Jan. 16, 2018. Retrieved Jan. 16, 2018.

[3] One issue beyond the scope of this article presented by IRC 162(q) is its use of the phrase sexual "harassment" as opposed to sexual "discrimination." Sexual harassment is a form of sexual discrimination prohibited by Title VII of the Civil Rights Act of 1964 (as amended by the Civil Rights Act of 1991). *See Jones v. Flagship Int'l,* 793 F.2d 714, 719 (5th Cir. 1986). A cause of action for sexual harassment has specific elements, which are distinct from other forms of sexual discrimination. Given that the motivation for IRC 162(q) appears to be to disincentive confidentiality for settlements of sex-based harassment or abuse, particularly in the workplace, the question arises as to how the IRS would treat a settlement phrased in terms of sexual discrimination or a settlement where harassment is not at issue, but other forms of sex-based discrimination are.

the result of IRC 162(q) is to increase the tax burden on an employee settling a sexual assault or sexual harassment claim, employees and their attorneys will likely try to pass that burden back to employers, demanding a greater settlement payment to offset the tax effect, thereby increasing the cost of settling such claims.

This apparent conflict between IRC 104(a)(2) and IRC 162(q), and potential limitation of the former by the latter, must be assessed in the context of the practice of using global settlements. One benefit to an employer of entering into a settlement or severance agreement with an employee is achieving a final resolution of all claims, known or unknown, being made or that could be made by the employee.

Thus, it is a common practice to include global language in settlement and severance agreements covering all claims that might exist between the employer and employee, including claims for sexual harassment and tort claims (such as assault), even if those claims have not been made or are not really at issue. In light of IRC 162(q), this practice might be revisited, both by employees seeking favorable tax treatment of settlement funds and employers seeking to avoid paying to offset the employee's tax consequences or to maintain settlement agreements as confidential.

Particularly in today's environment, employers have justifiable concerns about the effect an accusation or settlement might have on the public's perception of the employer. However, IRC 162(q)'s language making funds paid to settle a sexual harassment or sexual abuse claim applies only when the settlement is subject to non-disclosure. In cases where the sexual harassment or sexual abuse aspects of the case are such that the employer believes that confidentiality is essential, the employer will likely have to be prepared to pay a higher settlement amount to offset the tax consequences to the employee of a confidential settlement of such claims.

In many cases, however, the concerns addressed by a non-disclosure or confidentiality agreement can be addressed through other provisions. So, employers seeking to avoid the complications and negative effects of IRC 162(q) could revisit the need for boilerplate confidentiality clauses and use other provisions to achieve similar protections.

A clause could be included specifying that the settlement and its terms are not to be filed in the court where any related lawsuit is pending, reducing the publicity of the settlement. Settlements or severance agreements should include recitals or stipulations that the settlement resolves disputed claims and that the settlement is made to avoid the costs and burdens of litigation and is not an admission of liability.

The settlement could also include a non-disparagement

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clause preventing the employee from making disparaging remarks related to claims of sexual harassment or sexual abuse. The parties could even negotiate an acceptable language for the employee to use in the event a public statement about the settlement is to be made.

In cases where sexual harassment or sexual abuse is not the focus, but the employer believes other aspects of the settlement should be kept confidential, the parties can negotiate and draft a settlement agreement following case law and guidance that already exists under IRC 104(a)(2). As noted above, the courts generally look to the settlement agreement to determine what claims were resolved and what portion of the settlement funds was paid for each in determining the taxability of the settlement funds.

Parties can follow this guidance in an effort to craft a settlement agreement whereby only a specific portion of the overall settlement is allocated to claims of sexual harassment or sex-related tort claims. In this way, the parties can attempt to isolate the sexual harassment or sex-related tort claims, thereby allowing other aspects of the claim to be subject to a non-disclosure or confidentiality provision, but still excluded from taxation to the extent allowed by IRC 104(a)(2).

Even this approach is not without risks given the breadth of the language of IRC 162(q). IRC 162(q) applies not just to payments to settle a claim for sexual harassment or sexual abuse, but also to a settlement "related to" such a claim. Even if provisions to settle a sexual harassment or sex-related tort claim are clearly segregated from provisions to settle other claims, the IRS could take the position that it is all part of an overall settlement and thus all other claims are related to the settlement of claims covered by IRC 162(q).

IRC 162(a) also addresses attorneys' fees. As noted above, whether attorneys fees recovered as part of a lawsuit or settlement are taxable normally depends on whether the damages to which the fees relate are taxable. A plain reading of the IRC 162(q) seems to suggest that both the employer's and employee's attorney's fees are non-deductible if related to the settlement of a sexual harassment or sexual abuse claim, even if the settlement of those claims is not subject to a non-disclosure or confidentiality agreement. Some commentators suggest that this textual reading was not the intent of Congress and that attorney's fees are only non-deductible if the settle is subject to a non-disclosure agreement.

Furthermore, there is a need for additional clarity on other issues pertaining to attorney's fees. Are the fees non-deductible for the claimant and the employer? Are fees still deductible for investigating, responding to, and litigating such claims? Until further IRS guidance is published, practitioners should take caution with the taxability of a settlement and particularly with regard to attorney's fees.

Difficult Choices for Handling Claims

As can be seen, the Act, including IRC 162(q), creates many questions. Practitioners are left to wait on further guidance, from the IRS or from the courts, on how IRC 162(q) will be interpreted and applied.

Particularly with regards to IRC 162(q), it appears that, although past authorities provide some guidance, employees with sexual harassment or sexual abuse claims and employers seeking to settle such claims are faced with difficult choices on how to handle such claims and draft settlement agreements

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