

Treatment of Settlements After Tax Act

Unfortunately, the news is full of a multitude of stories regarding sexual harassment. Companies are aggressively trying to control the damages associated with these claims, while the brave victims who come forward want to protect their privacy.

As part of the recently signed tax law, a new section was added to the Internal Revenue Code that prohibits companies from deducting costs related to sexual assault and sexual harassment settlements that are subject to nondisclosure agreements (NDA). Prior to the inclusion of this provision, the law permitted tax deductions for confidential settlement arrangements and attorneys' fees incurred in connection with these settlement arrangements. The prior law did not specifically address settlement arrangements containing claims of sexual harassment or sexual abuse.

Although it is not clear what the Congressional intent is with this provision, one could conclude that it was likely designed to attach a price tag to seeking an NDA. For an employer, loss of the tax deduction adds to the price of seeking a NDA. For a victim, the absence of the NDA results in no protection of their identity. This may cause the unintended consequence of, actually, discouraging victims from coming forward, as a victim may prefer to keep his or her claim confidential.

Several questions arise in the interpretation of this new law, including how settlements that include legal fees are to be treated. Under the new law, victims of sexual harassment may be required to pay taxes on the full amount of the settlement they receive, including amounts received for legal fees, if the settlement is subject to a nondisclosure agreement.

What Should an Employer Do?

- *Review all compensation, benefit plans, and restrictive covenant provisions to determine treatment in the event of termination for Cause* – An employer will have to take whatever action is needed in the proper handling of harassment claims, including termination of employment of an accused individual.
 - A careful examination of compensation and benefit plans should be completed to identify possible benefits that can be curtailed or eliminated in the event of an employee's termination for Cause. This can include, for example, elimination of severance benefits, cancelling of equity grants, removing exercise rights of vested awards, claw-back of prior incentives, and forfeiting non-qualified deferred compensation. Ceasing these benefits may help reduce the potential sting of a lost tax deduction for settlement payments to victims under a non-disclosure agreement and further enforce the position of not paying for bad behavior.

Treatment of Settlements After Tax Act

- The starting point for this review may be contained in company policies and, if applicable, employment contracts. The employment agreement should specify what, if any, further compensation or benefits the employee is entitled to if the employment contract is terminated for Cause. In addition, if the employee is subject to any restrictive covenants, such as non-piracy and/or non-compete agreements, the employment agreement should clearly specify whether early termination extinguishes such obligations or, in the case of termination for Cause, is treated differently.
- At will employment is employment in which an employer or an employee may generally terminate the employment relationship at the will of either party, for any reason or for no reason at all. Under these circumstances defining what is a termination for Cause, within policies, may help defend against claims of terminating employment for an unlawful, discriminatory reason. These policies can also detail benefit and compensation forfeiture upon termination for Cause.

Additional guidance is expected on this new provision to answer certain questions. Pending clarifications, all parties should address this new law in a conservative and cautious manner.

[Please share your thoughts!](#)

Elliot N. Dinkin

President/CEO

412.394.9997

elliottd@cowdenassociates.com

My blogs consider a variety of topics including: compensation, benefits, retirement, management, sales and marketing. In addition to my blog, I also actively utilize Twitter, ([@ElliotDofCowden](#)). Feel free to [Follow my blog today!](#)