On December 22, President Trump signed a significant tax bill (originally named the Tax Cuts and Jobs Act but later renamed to comply with Senate rules) that includes a provision impacting settlement of employment-related claims. In the fast-paced process of drafting the sweeping tax legislation, Senator Bob Menendez (D-NJ) offered an amendment during the Senate Finance Committee markup intended to address corporate settlements involving claims of sexual harassment and sexual abuse. The Menendez amendment survived the drafting process and made its way into the final legislation.

Effective immediately, the new Internal Revenue Code Section 162(q) provides:

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 new limitation applies to any payments made on or after December 22, 2017. Existing agreements may be adversely affected if they contemplate payments extending beyond that date. The provision also denies deductions for any related attorney’s fees, whether paid to the company’s or the plaintiff’s counsel.

Employers should consider the implications for any employment-related settlement. The statutory language provides no definition for the terms “sexual harassment” or “sexual abuse,” nor does the language address whether any particular payment would be “related to” such claims within the meaning of the new provision. The conference report adds little clarity, noting only that the prohibition on deductions applies broadly to “any settlement, payout, or attorney fees … if such payments are subject to a nondisclosure agreement.”

Under Section 162 of the tax code, companies are permitted to deduct ordinary and necessary expenses of conducting business, with certain exceptions. Employers have relied on this deduction in making payments to employees under settlement agreements that release employment-related claims, as well as in deducting the costs of counsel defending such claims. Employers also use employment releases as a matter of course in any situation where an employee is being paid severance pay, such as reductions in force and negotiated separations.

It is common practice in employment-related settlement agreements to include both a broad release of claims as well as a confidentiality (nondisclosure) clause. The release typically applies to all claims the employee is permitted to release privately, including claims based on sex discrimination under Title VII of the Civil Rights Act (and similar state and local laws). Properly drafted, the
release and confidentiality language in every settlement agreement would apply to claims of sexual harassment or sexual abuse **whether or not the employee actually made such claims**. The potential breadth of the new rule raises some concerns because application of the new rule seemingly does not require any obvious connection between the settlement and any particular underlying claim.

Settlement of employment-related claims often involves analysis of the underlying tax treatment of payments and related reporting obligations. Employers will now need to consider these additional deduction issues in evaluating the terms and cost impact of any settlement.

In light of Section 162(q), employers should review their standard employment settlement agreement templates, as well as agreements negotiated with individual employees, and any settlement agreements that were not fully paid prior to December 22nd. Depending on the circumstances of each individual case, employers may consider modifications to the breadth of the release, the breadth of the nondisclosure provisions, and/or to the addition of representations or new remedies.

Employers reviewing their practices also should keep in mind the existing statutory and regulatory guidance that impacts settlements, such as those limiting releases under existing EEOC rules and those impacting confidentiality provisions under the Dodd-Frank Act or the Defend Trade Secrets Act of 2016. Employment and tax counsel can guide employers to release language applying desirable protections without jeopardizing the deductibility of payments under these agreements.

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