

THE
NATIONAL LAW REVIEW

2018 Tax Reform Series: Change to Employer Deduction Rules

Monday, January 15, 2018

This is the sixth article in our series covering the various tax and employee benefits-related changes contained in the [Tax Cuts and Jobs Act](#) signed by the President on December 22, 2017.

One surprising change made by the Act, summarized below, is the elimination of the employer deduction for certain settlement payments made in the employer-employee context.

General Rule

Payments made in settlement of claims or suits arising out of the employer-employee relationship are tax deductible by an employer unless the payment is specifically listed as nondeductible in the Internal Revenue Code ("[Code](#)").

Prior to the Act, Section 162 of the Code provided that only the following types of payments were nondeductible:

- Any punitive fine or similar penalty paid to a government for the violation of any law.
- Any illegal payment, bribe, kickback, or rebate when made under any of the circumstances or to or by any of the persons described in the Code.
- A portion of treble damage payments under the antitrust laws.

Limitations on Deductions Added by the Act

The Act adds two limitations to the tax deductibility of payments that can apply in the employer-employee context. In particular, the Act adds the following types of payments as nondeductible:

1. Any settlement or payment related to sexual harassment or sexual abuse and attorney fees related to such settlement or payment ***IF*** the settlement is subject to a nondisclosure agreement.
2. Any amount paid at the direction of a governmental entity in connection with the violation of any law or the investigation or inquiry by the governmental entity into a potential violation of law – ***OTHER THAN*** amounts paid as restitution for damages or paid to come into compliance with the law.

Both changes are effective for payments made after December 22, 2017.

Issues to Consider Regarding Nondeductibility of Sexual Abuse or Harassment Claims

- The changes made by the Act apply only to the deductibility of the payments by the employer. The Act does not change the plaintiff's/claimant's tax treatment of the payments.
- As neither the Act nor the Conference Report provide any indication as to how to answer the following questions, we will need further guidance from the IRS to answer such questions:
 - Does nondeductibility apply if the sexual abuse or harassment claim is meritless or frivolous?
 - If a claimant/plaintiff includes claims other than sexual harassment or sexual abuse, can the settlement amount be allocated among the nondeductible sexual harassment or abuse claims and the deductible other claims?
 - If the settlement amount is allocated, on what basis can the allocation be made?

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- For example, the basis for allocating a settlement amount between W-2 wages subject to withholding taxes and Form 1099 taxable income can be problematic. Both the courts and the IRS have stated that the allocation made by the parties in a settlement agreement can be ignored if the allocation does not reflect the economic substance of the claims.

Employer Takeaway

If a claimant/plaintiff includes claims other than sexual harassment or sexual abuse, we suggest that the settlement agreement designate the portion of the settlement amount (either as a percentage or a dollar amount) being allocated to the sexual harassment or abuse claims. The purpose is to provide the basis for taking the position that the portion of the payment made for the other claims is tax deductible.

If a settlement payment is made at the direction of a governmental entity in connection with the violation of any law or the investigation or inquiry by the governmental entity into a potential violation of law, the law, as revised by the Act, retains the distinction between nondeductible punitive fines and deductible compensatory penalties. The employer should consult with counsel to determine the deductibility of such payment.

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