

Client Alert

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Congress Enhances Deductibility of Attorney's Fees and Costs for Discrimination Plaintiffs — Which May Moderate Settlement Costs for Employers

Tucked away among the 600-plus pages of a bill just passed by Congress dealing with a wide variety of trade and tax benefits and loopholes (named with characteristic election-year modesty the American Jobs Creation Act of 2004) is a provision that may give some assistance to employers in settling discrimination and related claims. Specifically, Section 703 of the Act, titled Civil Rights Tax Relief, enhances the ability of successful plaintiffs in discrimination cases to take a full deduction on their federal income tax returns for the attorney's fees and costs they incurred, including fees and costs paid for them by the employer as part of a judgment or settlement. As a result, attorney's fees and costs paid by an employer will not result in any income tax to the employee, which may help to moderate the cost of settlements.

This provision applies to any payments made after the President signs the Act into law, which is expected to occur shortly, with respect to judgments or settlements occurring after that date.

In recent years, several federal courts of appeals, as well as the U.S. Tax Court, have held that the amount of the employee's attorney's fees and costs paid by the employer, whether in a settlement or as part of a judgment after trial, and whether based on hourly

rates or a percentage of the settlement or judgment pursuant to a contingency fee arrangement, constitutes taxable income to the employee. Because of limitations on the ability of individuals to deduct these expenses (limitations that become increasingly severe as the taxpayer's income level rises), the tax impact of the employer's payment of the employee's attorney's fees and costs could be significant, resulting in increased pressure on employers to pay more in settlement of discrimination claims, especially at the higher end. At the lower end, individuals who did not itemize deductions on their returns could not deduct any fees paid to an attorney. The new law will neutralize the tax impact of the attorney's fees, giving the employee a tax deduction exactly equal to the amount of the imputed income.

The Act amends the Internal Revenue Code of 1986, as amended (the "Code") to allow a taxpayer to deduct attorney's fees and court costs paid by, or on behalf of, the taxpayer in connection with discrimination or whistleblower claims under federal and state laws, up to the amount of income received on account of the claim. The Act applies to claims under Title VII, the National Labor Relations Act, the Fair Labor Standards Act, the Age Discrimination in Employment Act, the Rehabilitation Act, ERISA, the Employee Polygraph Protection Act, the WARN Act, the Family and Medical Leave Act, USERRA (relating to the employment and reemployment rights of members of the uniformed services), the Americans with Disabilities Act, any federal whistleblower law (such as Sarbanes-Oxley and OSHA), and any federal, state or local law or common law "providing for the enforcement of civil rights" or "regulating any aspect of the employment relationship." The Act applies to fees paid pursuant to a fee arrangement between the plaintiff and plaintiff's attorney or to fees awarded by the court pursuant to fee award provisions in the various statutes.

Limitations Under Current Law on Deductibility of Attorney's Fees and Costs

Under existing law (before the amendment), all amounts received by judgment or settlement of claims for employment discrimination or similar employment claims constitute taxable income to the employee (only payments for claims of physical sickness or injury are excluded from taxation; damages for back pay, front pay, emotional distress, pain, suffering, humiliation and the like obtained in connection with an employment discrimination or whistleblower claim are taxable). Although deductions are allowed for the expenses incurred to obtain this income (such as the payment of attorney's fees and costs), there are, as noted above, significant limitations on the ability of individuals to take tax deductions for these items.

Currently, taxpayers may deduct attorney's fees and costs as a miscellaneous itemized deduction (if they itemize), only to the extent the sum of all miscellaneous itemized deductions exceeds two percent of the individual's adjusted gross income for the year. In addition, the total amount of miscellaneous itemized deductions is phased out as adjusted gross income rises. Further, the deduction for attorney's fees and costs is eliminated for persons subject to the alternative minimum tax ("AMT"). The receipt of a large settlement or award in a discrimination case can be sufficient to trigger application of the AMT, resulting in a dramatic increase in tax liability. In some cases, the amount paid to the attorney can exceed the award to the plaintiff, and the employee's tax liability, based on the imputed income from the payment to the attorney and the limitations in the Code, could exceed the amount of the judgment or settlement actually received by the employee.

To remedy this situation, the Act changes the attorney's fees deduction from a miscellaneous itemized deduction to an "above-the-line" deduction, effectively eliminating application of the AMT as well as the limitations applicable to miscellaneous itemized deductions. Under the new law, amounts received by judgment or settlement with respect to employment discrimination and similar employment claims are still taxable income to the recipient, but the employee obtains a full deduction for attorney's fees and costs, effectively rendering those items non-taxable.

The New Deduction for Attorney's Fees May Affect Pending Supreme Court Cases

There is currently a split among the circuit courts of appeal over whether the amount paid directly to the plaintiff's attorney should be included as taxable income to the plaintiff. The Commissioner of Internal Revenue has concluded, and the majority of circuits have held, that the entire amount of the judgment or settlement, including the portion paid to the attorney (whether as a contingency fee

or a court award under a fee-shifting statute), constitutes gross income to the employee.

The United States Supreme Court recently granted *certiorari* in two cases to resolve the question of whether the amount paid as contingent attorney's fees must be included in gross income. *Banaitis v. Comm'r*, 340 F.3d 1074 (9th Cir. 2003), *cert. granted*, 2004 U.S. LEXIS 2385 (Mar. 29, 2004); *Banks v. Comm'r*, 345 F.3d 373 (6th Cir. 2003), *cert. granted*, 2004 U.S. LEXIS 2384 (Mar. 29, 2004). Although these cases specifically concern payments of contingency fees to attorneys, it is assumed that the Supreme Court's ruling also will govern the taxability of attorney's fees paid pursuant to a fee-shifting provision in employment law cases. The enactment of the Civil Rights Tax Relief provision, however, will render the Supreme Court's determination largely academic with regard to fees paid in employment-related cases, as it effectively excludes all such fees from the plaintiff's income by permitting them to be deducted in full, to the extent they have been included in income.

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