

CLIENT ALERTS

EPSTEIN BECKER & GREEN, P.C.

Resurgens Plaza
945 East Paces Ferry Road
Suite 2700
Atlanta, Georgia 30326-1380
404.923.9000

150 North Michigan Avenue
Suite 420
Chicago, Illinois 60601-7553
312.499.1400

Lincoln Plaza
500 N. Akard Street
Suite 2700
Dallas, Texas 75201-3306
214.397.4300

Wells Fargo Plaza
1000 Louisiana
Suite 5400
Houston, Texas 77002-5013
713.750.3100

1875 Century Park East
Suite 500
Los Angeles, California 90067-2506
310.556.8861

Wachovia Financial Center
200 South Biscayne Boulevard
Suite 2100
Miami, Florida 33131
305.982.1520

Two Gateway Center
12th Floor
Newark, New Jersey 07102-5003
973.642.1900

250 Park Avenue
New York, New York 10177-1211
212.351.4500

One California Street
26th Floor
San Francisco, California 94111-5427
415.398.3500

One Landmark Square
Suite 1800
Stamford, Connecticut 06901-2681
203.348.3737

1227 25th Street, N.W.
Suite 700
Washington, D.C. 20037-1175
202.861.0900

U.S. Supreme Court Rules That Contingent Fee Portion of Lawsuit Settlements and Judgments Is Taxable to the Client

On January 24, 2005, the United States Supreme Court ruled that attorneys' fees paid from a settlement or award pursuant to a contingent fee agreement are includible in a litigant's gross income for federal tax purposes. By a vote of 8-0 (Chief Justice Rehnquist abstained), the Court followed the long-standing principle that a taxpayer cannot exclude an economic gain from gross income by assigning the gain in advance to another party. Though the recently enacted American Jobs Creation Act (AJCA) (discussed below) may limit the future effect of this decision, the present impact is an important one as employers and employees must now determine the tax implications of settlements and awards occurring throughout most of 2004.

The Cases

In reaching the decision in two consolidated cases – *Commissioner of Internal Revenue v. Banks*, No. 03-892, and *Commissioner of Internal Revenue v. Banaitis*, No. 03-907 – the Court resolved a split between the lower courts. The Court of Appeals for the Fifth, Sixth and Eleventh Circuits adhered to the view that the contingent fee portion of a litigation recovery is not included in the plaintiff's gross income. The Ninth Circuit held that the portion paid to the attorney as a contingent fee is excluded from the plaintiff's gross income if state law gives the plaintiff's attorney a special property interest in the fee, but not otherwise. In contrast, the Second, Third, Fourth, Seventh, Tenth and Federal Circuits sided with the Internal Revenue Service in finding that the entire litigation recovery, including the portion paid to an attorney as a contingent fee, is income to plaintiff. The Supreme Court based its decision on the "anticipatory assignment of income" doctrine, which states that one who earns or has control of income cannot avoid being taxed on that income even if he assigned it to another.

The American Jobs Creation Act

The impact of the Court's decision is somewhat muted, however, by congressional enactment of the civil rights tax relief provision (Section 703) of the AJCA, signed into law on October 22, 2004. Section 703 provides

CLIENT ALERTS

for an above-the-line deduction for attorneys' fees and costs paid by or on behalf of a plaintiff in specifically enumerated unlawful discrimination lawsuits. [See *October 29, 2004 Client Alert*, "Civil Rights Tax Relief Benefits Both Sides of the Fence," prepared by Gayla C. Crain and Emily Taylor, available at http://www.ebglaw.com/article_1056.pdf]. The plain effect of the law will be to permit plaintiffs to avoid taxation of the entire amount of recovery that typically includes attorneys' fees by way of a contingent fee arrangement or fee-shifting statutes.

Notably, however, Section 703 only applies to such fees and costs for any settlement or judgment occurring *after* October 22, 2004. Indeed, the Court noted that Section 703 likely would have pertained to the employment-related cases at issue, but because the law is not retroactive, it did not apply (plaintiffs settled their respective cases well before the enactment of the AJCA). The Court also articulated that it was not ruling on the tax implications of other federal laws that provide attorneys' fees, some of which exceed the award the plaintiff receives (e.g., where plaintiff seeks injunctive relief, cases involving statutory cap on recoveries).

The Questions That Remain

Several issues relating to the tax treatment of certain settlements and awards for the 2004 year – as well as in the future – remain unresolved as a result of the Court's decision and passage of the AJCA. As a preliminary matter, the Court opted not to consider whether the assignment of income doctrine should apply where the anti-discrimination law at issue contains a fee-shifting provision (i.e., where the court is allowed to require the employer to pay the plaintiff's attorney fees if the plaintiff prevails). The Court determined that it need not address such a scenario since the fees paid in *Banks* were made pursuant to a contingent fee arrangement and not awarded by a court. Therefore, an employee who *before* the effective date of AJCA won an award (or procured settlement) including provisions for the payment of attorney's fees under a fee-shifting statute may still argue that attorneys' fees are not income to such employee.

Additionally, employers must be mindful that, while Section 703 of the AJCA applies to a broad group of employment claims, certain claims brought by an employee may not be covered, such as defamation that is not in the context of employment, contract and invasion of privacy claims, ERISA cases other than those under Section 510 of ERISA, products liability, personal injury and securities law. Furthermore, there is some question whether Section 703 of the AJCA applies to settlements reached before a suit is filed or to payment or settlement of a claim before an administrative agency. Thus, whether a claim falls within the ambit of the AJCA is of critical import, as the old double taxation rule likely increased the settlement cost for employers because plaintiff employees focused on the net payment rather than the "settlement amount." Many employers there simply increased the settlement amount to provide the employee with a net that matched the proposed settlement.

Employers are therefore encouraged to seek legal advice when determining possible tax consequences arising from any employee settlement or award that occurred both before and after October 22, 2004 in light of the uncertainties resulting from the Supreme Court's decision and passage of the AJCA.

* * *



CLIENT ALERTS

Please feel free to contact **James P. Flynn** in the firm's **Newark** office at 973/639-8285 if you have any questions or comments. Mr. Flynn's email address is jflynn@ebglaw.com. **Patrick Lucignani**, an associate in the Labor and Employment Department, assisted in the preparation of this Alert.

This document has been provided for informational purposes only and is not intended and should not be construed to constitute legal advice. Please consult your attorneys in connection with any fact-specific situation under federal law and the applicable state or local laws that may impose additional obligations on you and your company.

© 2005 Epstein Becker & Green, P.C.

