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Our Employment and Labor Practice has decades of experience in litigating virtually all types of employment and traditional labor claims before federal and state courts and agencies, ranging from single-plaintiff cases to complex class actions. We also provide comprehensive counseling to our clients on a wide variety of employment and labor issues.

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New Law Gives Favorable Federal Income Tax Treatment To Attorney Fee Awards In Civil Rights Cases

On October 22, 2004, President Bush signed into law the American Jobs Creation Act of 2004 (the "Act"), sweeping legislation that makes extensive changes to the Internal Revenue Code of 1986 (the "Code"). Section 703 of the Act, entitled "Civil Rights Tax Relief," makes a significant change in the law with respect to the federal income tax treatment of amounts paid by civil rights plaintiffs (or paid on their behalf) in attorneys' fees and court costs and, as a result, has important implications for settlements in civil rights cases.

Currently, most of the federal Circuit Courts and the U.S. Tax Court have agreed with the Internal Revenue Service that civil rights plaintiffs must include in their federal taxable incomes not only amounts they receive personally as part of a judgment or settlement (unless the amounts result from a claim for personal physical injury or physical sickness) but also amounts either paid directly to their counsel or paid to the plaintiffs but designated and paid as attorneys' fees and court costs in settlement documents. (A minority of the circuits has ruled that such amounts are not includable. The Supreme Court is expected to resolve this split this term in two cases that were argued before the Court on November 1, 2004.) Under the majority view, if a plaintiff obtains a \$100,000 settlement of a discrimination claim, \$60,000 of which either is paid by the settling defendant directly to plaintiff's counsel or is designated as such in the settlement papers, the plaintiff must include the entire \$100,000 in his/her federal taxable income. Prior to the passage of the Act, the plaintiff would be entitled to deduct the amount actually paid to the attorney (\$60,000 in this example) as a miscellaneous itemized deduction on his/her federal income tax form.

These pre-Act rules had two adverse consequences for civil rights plaintiffs. First, amounts treated as a miscellaneous itemized deduction were deductible only to the extent that they exceeded 2% of the taxpayer's "adjusted gross income." In addition, the amounts deductible as miscellaneous itemized deductions were subject to further limitations for high income taxpayers. Thus, under the pre-Act law, attorneys' fees could not be deducted on a dollar-for-dollar basis with the amount that had to be reported as income. Second, and equally important, amounts deducted as miscellaneous itemized deductions were excluded from the calculation of the alternative minimum tax. As a result, on occasion civil rights plaintiffs have been required to pay the alternative min-

imum tax solely as a result of the income they were required to report for the attorneys' fees received by them or their counsel.

This pre-Act law had the effect of complicating (and, for defendants, increasing the costs of) settlement negotiations of civil rights cases, with plaintiffs demanding higher settlements to offset the consequences of being forced to pay taxes on amounts paid by them or others on their behalf to their attorneys.

The Act, which amends Section 62 of the Code, eliminates these unfavorable tax consequences by giving a civil rights plaintiff an "above-the-line" deduction from gross income in an amount equal to the amount paid by the plaintiff, or on his/her behalf by the defendant, to the plaintiff's lawyer for attorney fees and court costs as part of a judgment or settlement. Thus, while such amounts still must be reported by plaintiffs as income on their federal income tax returns (subject to the outcome of the pending Supreme Court case), plaintiffs will now receive an offsetting dollar-for-dollar deduction from gross income that should eliminate any tax consequences of the fee payments.

The amount of the new deduction allowed under the Act is limited to the amount includable in the plaintiff's gross income for the taxable year as a result of the judgment or settlement. The Act applies to fees and costs paid after the date of the Act's passage, October 22, 2004, with respect to any settlements or judgments occurring after such date. It applies to judgments and settlements obtained on a wide variety of employment-related claims, including claims brought under:

- Federal equal employment opportunity statutes, such as Title VII of the Civil Rights Act of 1964, the Age Discrimination in Employment Act, the Americans with Disabilities Act, the Rehabilitation Act, 42 U.S.C.

§ 198, and Title IX of the Education Amendments of 1972;

- The Fair Labor Standards Act, including the Equal Pay Act;
- The Family and Medical Leave Act;
- The National Labor Relations Act;
- Section 510 of the Employee Retirement Income Security Act;
- The Worker Adjustment and Retraining Notification Act;
- Federal whistleblower protection provisions; and
- Any federal, state, or local law, including common law, providing for the enforcement of civil rights or regulating any aspect of the employment relationship.

As a result of this last catch-all category, the Act would appear to apply in the case of virtually every type of claim arising from the employment relationship.

Groups representing both employers and employees supported this portion of the Act. From the employers' perspective, the Act should simplify settlement negotiations and may make settlements less costly because parties should no longer have to consider the tax consequences to the plaintiff of settlement proceeds paid to, or destined for, plaintiff's counsel.

State income tax laws may differ from the new federal provisions. Accordingly, employers should consult with their tax counsel concerning the application of both state and federal tax laws to specific settlement terms.

Information on other provisions of the American Jobs Creation Act of 2004 is available at the Sidley Austin Brown & Wood LLP website at www.sidley.com.

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