

# Labor Law Bulletin

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Labor and employment law trends of interest to our clients and other friends.

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## SUPREME COURT DECIDES TO INCLUDE ATTORNEY'S FEES IN PLAINTIFF'S GROSS INCOME

On January 24, 2005, the U.S. Supreme Court decided whether the portion of a judgment or settlement paid to a plaintiff's attorney under a contingent fee agreement is income to the plaintiff. The Court held that the entire recovery should be included in the plaintiff's gross income. *Commissioner of Internal Revenue v. Banks*, No. 03-892.

Prior to the decision, the federal courts had reached different results on this issue. In those jurisdictions where the fee payment constituted income to the plaintiff, the practical effect was to drive up the cost of settlement since the plaintiff had a tax liability for the monies he received to discharge his claim as well as for the monies he received to pay his attorney since such attorney fees were often not deductible in whole or in part.

The Supreme Court decided that money paid to a litigant's attorney arises from the claim and that the litigant controls the claim. As a result, the money paid to the litigant's attorney is includible in the litigant's gross income even when paid directly to the attorney.

In light of legislation that took effect last year, this decision has limited application. Under the American Jobs Creation Act of 2004 ("AJCA"), a taxpayer may deduct from gross income attorney's fees and court costs paid in connection with "any action" involving a claim of "unlawful discrimination," which includes a number of specific federal statutes and any federal, state, or local law regulating any aspect of the employment relationship or prohibiting the discharge of an employee, to the extent the recovery is includible in the taxpayer's gross income for the year. Because the AJCA allows an above-the-line deduction as opposed to an itemized deduction, the deduction is also allowed in computing the plaintiff's alternative minimum tax liability. This AJCA provision is effective for fees and costs paid after Oct. 22, 2004 with respect to any judgment or settlement occurring after that date. There is some question whether the AJCA provision applies to settlements reached before a suit is filed or to payment or settlement of a claim before an administrative agency.

The Supreme Court's decision makes clear that the portion of a settlement of an employment claim allocable to the claimant's attorney's fees should be reported as income to the claimant. Whether or not the claimant can then offset that inclusion through a deduction under the AJCA depends on the date the settlement was reached and, possibly, the procedural posture of the claim at the time of settlement.

If you have any questions regarding this decision or a related issue, please contact Bruce Alper, Dan Sherlock, or another Vedder Price attorney.

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