



*November 19, 2004*

### **Tax Benefit Granted to Wrongful Discrimination Plaintiffs**

In the recently-enacted American Jobs Creation Act of 2004 (P.L.108-357), a new subsection was added to the Internal Revenue Code for the purpose of ensuring that plaintiffs who win awards or settlements in certain civil rights cases and other lawsuits do not pay income tax on the part of the recovery paid to attorneys.

The new legislation provides an "above-the-line" deduction (instead of a "miscellaneous deduction") for attorneys' fees and costs paid by a plaintiff in connection with any action involving a claim of unlawful discrimination, including age discrimination, certain claims against the Federal Government, or a private cause of action under the Medicare Secondary Payer statute. The effect of this provision is that plaintiffs involved in these claims will be able to offset the legal fees against the total recovery, and will be taxed only on the net recovery – thereby avoiding the limitations otherwise imposed on miscellaneous itemized deductions. The provision also allows for a full deduction of such expenses and costs for purposes of the alternative minimum tax (AMT).

**What does this mean to you?** It means that you can expect plaintiffs' claims to be framed as being one of the described types so as to ensure that the plaintiffs can take advantage of this new tax rule.

What this new provision doesn't do, however, is change the taxability of the payments made to the plaintiffs. Nor does it change your withholding and reporting obligations with respect to such payments – those obligations remain the same as before. For example, if an employer settles a claim for back wages by issuing a check payable jointly to both the employee and his or her attorney, and delivers the check to the attorney, as under prior law the employer is required to issue a Form 1099 to the attorney for the amount of the check (net of income and FICA tax withholding) and is also required to issue a Form W-2 to the employee for the gross settlement amount.

For more information about this issue, please contact a member of the Labor and Employment Practice Group in one of our offices.

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