

CLIENT ALERT

Employment, Labor & Immigration

April 2004

Volume V No. 12

U.S. Supreme Court To Address Tax Treatment of Attorneys' Fees and Disparate Impact In Age Discrimination Cases

The United States Supreme Court will consider three employment cases in its term beginning next October, addressing two of life's certainties, taxes and aging. In *Commissioner of Internal Revenue v. Banks* and *Commissioner of Internal Revenue v. Banaitis*, the Supreme Court will decide whether, under Section 61(f) of the Internal Revenue Code, an employee's income from proceeds of litigation includes the portion of his damages recovery that is paid directly to an attorney pursuant to a contingent fee agreement. In *Smith v. City of Jackson, Miss.*, the Court will resolve the conflict among the Courts of Appeals over whether the Age Discrimination in Employment Act of 1967 ("ADEA") provides employees 40 years of age or older with a cause of action when their employer implements a facially neutral policy that has a "disparate impact."

Taxation of Attorneys' Fees

Joseph Banks worked as an educational consultant with the California Department of Education ("CDOE") from 1972 to 1986, at which time he was terminated. Banks filed a civil action against the CDOE for wrongful termination in violation of federal and California anti-discrimination laws. During the trial, the parties agreed to a settlement on condition that the entire settlement amount was "characterized in the settlement agreement as compensation for personal injury damages." Banks paid his counsel, pursuant to their contingency fee agreement. He did not include any portion of the settlement proceeds as gross

income on his 1990 federal income tax return. Following the IRS' issuance of a Notice of Deficiency, the matter proceeded to trial. The tax court ruled against Banks determining: (1) the entire settlement constituted taxable income because no portion of the settlement amount was attributable to a claim of personal injury; and (2) the monies Banks had paid to his counsel were not excludable from income. Banks appealed.

The Sixth Circuit Court of Appeals reversed. In doing so, it concluded that the tax court erred in determining that the \$150,000 Banks paid to counsel were not excludable from income.

In a separate case, Sigitas Banaitis, a former vice-president and loan officer of the Bank of California, brought suit against his former employer and another banking institution alleging wrongful termination, as well as intentional and willful interference with his employment agreement and economic business expectations. Following a jury award in favor of Banaitis, the parties entered into a settlement agreement, part of which required the defendants to issue a check directly to Banaitis' attorney. Like Banks, Banaitis excluded from his gross income the full settlement amount. The IRS disagreed, and issued a Notice of Deficiency. Banaitis promptly filed a petition with the state tax court seeking a redetermination of the deficiency. The tax court issued findings in favor of the IRS, from which Banaitis appealed.

The Ninth Circuit Court of Appeals reversed the tax court's ruling, holding that amounts paid to Banaitis' attorney pursuant to the contingent fee agreement were not includable in Banaitis' gross income.

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The Court's upcoming decisions in these cases, which will resolve whether or not contingent attorneys' fees are taxable to the client, are likely to have a significant impact on future settlement negotiations.

Disparate Impact Under ADEA

Police officers and public safety dispatchers, all over the age of 40 years, collectively brought suit against the City of Jackson, Mississippi and its police department, alleging violations of ADEA. They claimed that they were treated unfairly under a new pay scale, which they contended had the effect of offering them smaller wage increases than employees younger than 40 years of age. Under the plan which was implemented on October 1, 1998, those officers and dispatchers with five or fewer years of tenure with the department received proportionately greater raises than officers and dispatchers with more than five years of tenure.

The plaintiff officers claimed both disparate treatment and disparate impact. Under their disparate

impact theory, the officers alleged that the implementation of the plan by the City defendants gave rise to liability because the plan resulted in pay increases to officers under 40 years of age that were "four standard deviations" higher than the raises received by officers over 40. Despite plaintiffs' statistical evidence, the District Court granted the defendants' motion for summary judgment, holding that the officers' disparate impact claim was not cognizable under the ADEA. The officers appealed.

The Fifth Circuit Court of Appeals affirmed, holding that ADEA was not intended to remedy age disparate effects that arise from the application of employment plans or practices that are not based on age. Fundamental to the Fifth Circuit's decision was the ADEA's express exception permitting an employer's conduct based on "reasonable factors other than age - an exception absent from Title VII - and the inapplicability to the ADEA context of the policy justifications identified by the Supreme Court [in *Griggs v. Duke Power Company*]

for recognizing a disparate impact cause of action in the Title VII context." In this regard, the Fifth Circuit explained that, "[f]acially, the exception appears to serve as a safe harbor for employers who can demonstrate that they based their employment action on a reasonable non-age factor, even if the decision leads to an age-disparate result."

The Court's decision in *Smith v. City of Jackson, Miss.* will determine whether employers may be susceptible to liability under ADEA for similar pay scale or related plans, which are themselves neutral, but have the effect of treating older employees less favorably than younger employees.

We send these Alerts to our clients and friends to provide information on recent developments in the law. The Alerts, however, should not be relied on for legal advice in any particular matter.

IMMIGRATION NEWSFLASH

On April 2, 2004, Rep. Lamar Smith, a former Chairman of the House Subcommittee on Immigration and a key Member on immigration matters, introduced a bill that would provide for an exemption from the H-1B cap for up to 20,000 applicants possessing Master's or Ph.D. degrees from U.S. universities. The overall H-1B cap would remain at its current level of 65,000. The legislation reinstates the education and training fee of \$1,000 and proposes an anti-fraud fee of \$500 that would be paid by the employer at the time of the initial application.

In addition, the legislation includes some L-1B visa language that would prevent issuance of L-1B visas to employees who would be supervised and controlled by an employer who is not affiliated with the petitioning employer and/or placed with an unaffiliated employer to provide labor that does not involve the specialized knowledge specific to the petitioning employer. It would also require all L-1 applicants to have worked with the employer abroad for one year, rather than six months.

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