

## **SUPREME COURT RULES FULL COURT AWARDS TAXABLE; NO EXCLUSION FOR PORTION ALLOCATED TO LEGAL FEES**

- *Erwin J. Shustak, Esq., senior partner*  
*Shustak Jalil & Heller, P.C., California and New York*

Last month the U.S. Supreme Court, in a unanimous ruling, decided a case that will have huge financial consequences to litigants who recover awards from securities firms or other defendants under a contingent fee agreement.

In a typical securities arbitration or litigation case undertaken on a contingent fee basis, the attorneys' fees can range between 25 and 40% of the total amount recovered by settlement, award or verdict. Often, in the case of a settlement, the attorneys' fee portion is paid directly to the attorney. Claimants typically have reported as income only the net, after legal fee amount of the recovery they actually receive.

Before the Supreme Court's decision, the federal appeals courts were split on whether the full amount of the recovery-or just the net portion actually received by the client was taxable. The case arose from two appeals by the Justice Department seeking to overturn decisions by the federal appeals courts in San Francisco and Cincinnati. **Those federal courts had rejected the Internal Revenue Service's position that all gain is taxable to the claimant or plaintiff who earned it, regardless of how much of the settlement, award or verdict actually went to the client after the attorney took his or her contingent fee.**

Before the two cases were argued last fall, Congress changed the tax law in favor a special sub-class of lawsuit or arbitration-winning plaintiffs. **Under that law, The American Jobs Creation Act of 2004, taxpayers can deduct legal fees and court costs "in connection with any action involving a claim of unlawful discrimination".** The law broadly defines "discrimination" to include many types of employment disputes. The law, however, is not retroactive and applies only to prevailing parties in employment dispute litigations or

arbitrations. It does not, for example, apply to arbitrations or litigations against broker-dealers or their affiliates or representatives arising out of customer initiated claims. In one of the cases decided by the Court, *Revenue v. Banks, No. 03-892*, the plaintiff settled an employment discrimination claim for \$464,000, of which \$150,000 went to his attorney under their contingent fee agreement. In the other case, *Commissioner v. Banaitis, No. 03-907*, a former Vice-President of the Bank of California prevailed on a jury verdict of \$4.9 of compensatory and punitive damages. The defendant also paid \$3.9 directly to the plaintiff's attorneys. The Supreme Court held that in both cases, the amount of legal fees paid to the attorneys was to be included in the amount of taxable income to be reported by the prevailing plaintiffs despite the fact that the legal fees went directly to the attorneys.

While legal fees generally can be deducted as miscellaneous itemized deductions, **large awards make the prevailing party subject to the alternative minimum tax**, which eliminates miscellaneous itemized deductions. Under the new act, however, and only in those cases involving discrimination claims, legal fees may be deducted regardless of the applicability of the alternative minimum tax.

**The implications are considerable for plaintiffs in non-discrimination cases.** Take, for example, the typical customer vs. brokerage firm dispute. Assume a customer obtains a \$600,000 award or settlement under a contingent fee agreement that gives the attorney one-third of the fee. The customer receives only \$400,000 but is taxed on the full \$600,000. Assume the amount of the settlement puts the customer in the top tax bracket and, between Federal and State taxes; the effective rate on the \$600,000 is 50%. The customer pays \$300,000 in tax; \$150,000 in legal fees and is left with \$150,000 of a \$600,000 award after tax. In other words, for every additional dollar the customer would have received, the after tax, after legal fee net to the customer is only 25 cents.

**We have two suggestions.** First, the impact of the taxability of the full award must be considered and explained to the client before any settlement is considered. Second, if at all

possible, assert a claim for discrimination. **In that way, there is at least an argument that some or all of the settlement is taxed only after legal fees are deducted.**

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**SHUSTAK JALIL & HELLER, A Professional Corporation**

Erwin J. Shustak, Esq., Senior Partner  
Shustak Jalil & Heller, New York and California  
619.696.9500  
[shustak@shufirm.com](mailto:shustak@shufirm.com)

[www.shufirm.com](http://www.shufirm.com)

**California Office**

401 West "A" Street, Suite 2330, San Diego, CA 92101  
tel: 619.696.9500  
fax: 619.615.5290

**New York Office**

400 Park Avenue, 14th Floor, New York, NY 10022  
tel: 212.688.5900  
fax: 212.688.6151