Anderson Kill & Olick, P.C.
EMPLOYMENT
Law Insider
Spring 2005 www.andersonkill.com

Recent Tax Developments Relating to Employment Law

By Phillip England and John J. Hess

Congress tightens rules on nonqualified deferred compensation plans. The American Jobs Creation Act of 2004 ("AJCA") added section 409A to the Internal Revenue Code. This section makes significant changes to the tax rules for virtually all nonqualified deferred compensation arrangements. Failure to follow these rules could cause the deferred compensation to be included in the participant's gross income at the time he becomes vested in the deferred compensation (i.e. it is no longer subject to forfeiture) rather than at the time he will actually be paid such benefits. The new rules are generally effective for amounts deferred on or after January 1, 2005. Plans established prior to January 1, 2005 that are operated in accordance with the new law have until December 31, 2005 to be amended.

These new rules generally apply to any agreement or arrangement (even if covering one individual) that provides for the deferral of compensation. Qualified plans (i.e. a qualified profit sharing plan) and certain designated welfare benefit plans are exempted from the new rules. The IRS has provided that, until further notice, plans or arrangements which pay benefits within 2½ months after the close of the year in which such benefits vest will not be subject to the new rules. Section 409A imposes three requirements which must be satisfied.

First, deferred compensation generally cannot be distributed any earlier than (i) separation from service; (ii) disability; (iii) death; (iv) a specified time or fixed schedule; (v) a change in ownership or control of the employer; or (vi) the occurrence of an unforeseeable emergency. Second, there are restrictions with respect to both the timing of a participant's initial deferral election as well as the designation of the time and form of distributions. The initial election to defer compensation for services performed during a taxable year must generally be made no later than the close of the preceding taxable year. However, the deferral election with respect to "performance-based" compensation (i.e., a bonus) can be made up to 6 months before the end of the performance period. Third, the time and form of distributions must be designated at the time of the initial deferral election. However, the new rules allow for changes that further delay or change the form of

Litigation Corner

Presenting The Employer's Case In Court: Tips From The Trenches

By Dona Kahn

You can easily lose your case in court if you don't take certain steps immediately upon being confronted with a complaint from an employee.

1. Before you even file an Answer, marshal all the facts by talking to everyone remotely involved. Facts must be understood in order to be persuasive to a jury. Identify any inconsistencies and try to resolve them by using what you learn from one person to refresh the recollection of another.
2. Examine all known relevant documents to show to all potential witnesses and again resolve any conflicts if possible.
3. Apply the applicable law to the facts and solicit the facts you need from the employer and from the plaintiff at his or her deposition for summary judgment or for use at trial. In a case involving an allegation of religious discrimination in failing to accommodate a Seventh Day Adventist's observation of the Sabbath, the applicable law was reviewed before going to the client to learn the facts. The law in the Circuit in which the case was filed provided that an employer did not have to accommodate the employee's religious beliefs if: a) it would affect the safety and efficiency of the operations, and b) payment of

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payment if certain requirements are met:

Section 409A also imposes limitations on (i) funding nonqualified deferred compensation with assets located outside the U.S. or (ii) restricting assets to the payment of deferred compensation if there is an adverse change in the employer's financial health. The new law will require that all nonqualified deferred compensation (deferred on or after January 1, 2005) must be reported on IRS Form W-2 or Form 1099 even though such deferred compensation is not yet taxable.

Severe tax consequences will occur if the rules of section 409A are violated: First, all vested nonqualified deferred compensation (including prior years deferrals) of an affected participant (plus earnings on such compensation) must generally be immediately included in gross income. Second, there will be imposed an additional tax equal to 20% of such deferred compensation. Third, an interest charge will be imposed.

Therefore, it is imperative that an employer's nonqualified deferred compensation plans or arrangements be reviewed by its outside benefits advisor and appropriate human resources person and, if necessary, these persons should draft procedures so that such plans will be brought into operational compliance with the new law as soon as possible. In addition, any required written plan amendments must be adopted prior to 2006.

U.S. Supreme Court settles the tax treatment of contingent legal fees. On December 24, 2005 the U. S. Supreme Court unanimously decided in *Commissioner v. Banks* that when a litigant's recovery constitutes income to the recipient, the litigant's income also includes the portion of the recovery paid to an attorney as a contingent fee. There had been a split of authority on this issue.

The Court agreed with the IRS that a contingent-fee agreement is akin to an "anticipatory assignment" of income since the litigant, in most instances, retains control over the cause of action derived from the plaintiff's legal injury. If an assignor of a right to income (the plaintiff) retains "dominion and control" over the property that produces the income (the cause of action) then the full amount of the judgment or settlement is included in his income, including the attorney's contingent fee. Although the plaintiff can generally deduct his attorney's fees as an itemized deduction, this may produce less of a tax benefit than if the attorney's fee was entirely excluded from the plaintiff's gross income. The Court rejected the idea that the relationship between attorney and client was like a business partnership (or joint venture) for tax purposes.

However, a tax provision of AJCA (in effect) excludes attorney's fees and court costs from gross income of a successful plaintiff if these fees and costs were incurred in connection with an action involving a claim of unlawful discrimination. Therefore, it is important for plaintiff's counsel in settling a discrimination suit to provide in the agreement that, for tax purposes, the plaintiff will be deemed to be the "prevailing party." While employers may object to such a characterization, the parties may narrowly provide that the plaintiff shall be deemed to be the prevailing party solely for the purposes of AJCA and that there shall be no other admission of liability. In other cases, plaintiff's counsel must determine the after-tax effect of a settlement offer in a contingent fee arrangement in light of the Supreme Court's decision in Banks. ■

Wage and Hour Update

By Bennett Pine

In the last edition of the "Employment Law Insider," our lead article summarized the U.S. Department of Labor's new, comprehensive regulations regarding the rules for overtime and "exempt" status for white collar employees, effective August 23, 2004. In a pair of Opinion Letters issued on January 7, 2005, the Department of Labor provided two interpretations of the Fair Labor Standards Act which serve to clarify and implement those rules.

Paralegals Generally not Exempt as Professionals

In the first Opinion Letter, the Wage-Hour division determined that paralegals employed by a law firm did not qualify as "exempt" from overtime under the "learned professions" exemption, even if they possess a four-year degree, a paralegal certificate, have taken continuing legal education courses, and have extensive experience.

According to the Department of Labor, paralegals and legal assistants generally do not qualify as exempt learned professionals because an advanced

specialized course of study and academic degree is generally not a standard prerequisite for entrance into the field. The Department of Labor suggested, however, that the exemption *would* be available for certain paralegals who do possess and utilize an advanced specialized degree in another field, e.g., where a law firm hires an engineer to provide expert advice, and to otherwise assist, on product liability or intellectual property matters.

OK to Dock Partial Day Absences from Exempt Employees' Leave Banks, But Not Their Salary

In a second Opinion Letter, the Department of Labor stated that where an "exempt" employee is paid on a salary basis, it is permissible to deduct absences of less than a full day due to personal reasons, accident or illness from an employee's Paid Time Off ("PTO") Bank, (including vacation, sick and disability entitlements), without jeopardizing the employee's exempt, salaried basis. On the other hand, "docking" an otherwise exempt employee's salary when the employee is absent for less than a full day (i.e., hourly computation or one half day of salary) is inconsistent with the requirement that the employee be paid on a "salaried" basis, could jeopardize the employee's "exempt" status and, as a result, entitle him/her to overtime. ■

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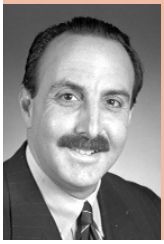

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overtime was required. With this in mind, management was asked if accommodation would have an adverse impact on the operations and if overtime was available. The answer was that such a defense was only available the first time the employee asked for the accommodation and not any other week for the three years thereafter being claimed. To prove entitlement to three years of back pay, Plaintiff would have had to establish he had the requisite seniority for each of the weeks, which he clearly would not have been able to do for all the weeks. Accordingly, a stipulation was sought and obtained from opposing counsel to limit the inquiry at trial to the first time and if it was found that the refusal to accommodate that day was discriminatory, the employer would waive any defense to each of the Fridays for the remainder of the three years. The full three years back pay was the carrot held out for the stipulation. It worked and the Judge precluded any questioning about any week except the first and ruled in favor of the defendant.

4. Prepare motions in limine, i.e., motions filed before trial, to exclude certain evidence on the grounds that it is either hearsay, irrelevant, or otherwise inadmissible. If the employer prevails, the case is very limited and the jury doesn't hear potentially damaging evidence. If the motions are denied, it becomes an issue for appeal.
5. Pick a theme very early in the preparation of your defense so you can prepare witnesses and depose the plaintiff with your theme consistently in mind. The theme I chose in a case involving the demotion of a female anchor on a network 11:00 p.m. news program who alleged sex and age discrimination, was to assert that it was the ratings and only the ratings which drove the decision. Consistent with the theme, the older male partner on the 11:00 p.m. news was told he would be demoted when his contract expired. Accordingly, by focusing on the ratings and not defending on the basis that the woman had other deficiencies and by also targeting the man, the female anchors claim for age and sex discrimination collapsed. The television station had initially wanted to hold off demoting the man, thinking he was needed to testify about how difficult it was to work with the woman. Needless to say, the case never went to trial.
6. Jurors always decide issues of discrimination on whether they perceive that the plaintiff was treated "fairly" or not. If they believe the treatment was unfair,

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they look for a "peg" to hang their hat on to find for the plaintiff. The job of the defense is to knock those pegs down. Once the peg is identified, it should be dealt with honestly and directly. In a case involving allegations of sexual harassment, when the "harasser" sent notes which some would characterize as offensive, we admitted to the inappropriateness of the notes, we didn't blame the provocative dress of the plaintiff for the notes, and we conceded that the fact that the plaintiff also sent inappropriate notes was no excuse. What we did do was shift the focus back to "fairness." Jurors don't like injustice and the theme in this case, which worked well enough to bring about a good settlement, was that the plaintiff's emotional distress was the result of personal issues related to her bitter divorce and custody fight, and it would not be fair to have the "harasser" take the blame for her distress. In essence, plaintiff tried to lay the blame for her emotional distress on defendant and our theme was "the blame lies elsewhere."

7. In summary, the employer's theory of the case is the legal and factual presentation of what happened, tested in the fire of credibility and put forth in a way that reflects the values of the community. Make sure everything you say and do is consistent with the theory from the time you receive the complaint until the closing to the jury. ■

Dona Kahn joined Anderson Kill & Olick, P.C. as "of counsel" in June 1990 and is Co-Chair of Anderson Kill's Employment and Labor Law Department. Ms. Kahn has extensive litigation experience in representing management in employment-related matters. Ms. Kahn lectures frequently on employment and discrimination law issues as well as trial practices. She can be reached at (212) 278-1812 or dkahn@andersonkill.com.

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Mark Your Calendar

Employment and Benefits Issues Seminar for Not-For-Profit Organizations

Date: May 4, 2005
Time: 4:00 - 6:00 p.m. (cocktail hour from 6:00 - 7:00 p.m.)

Radio City Suites of Rockefeller Center, 64th Floor
30 Rockefeller Plaza
New York, New York

Topics to be discussed include:
- Avoiding Liability When Downsizing
- Employment Practices Liability Insurance
- Executive Compensation and Benefits
- Claims of Discrimination, including Sexual Harassment, by Current and Terminated Employees

This free seminar is worth 1.5 credit hours of NY Continuing Legal Education. For more information or to register, please visit our website at www.andersonkill.com or contact Michele Elie at (212) 278-1318.

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