

# LEGAL NOTES

INFORMATION FOR OUR BUSINESS AND CORPORATE CLIENTS

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## DESIGN PROFESSIONALS ARE NOW VULNERABLE TO NEGLIGENCE CLAIMS BY CONTRACTORS

Pennsylvania law has historically limited design professionals' exposure to contractors' claims for purely economic losses. This doctrine, called the Economic Loss Rule, forbade contractors from suing architects in negligence. Unless the design professional contracted directly with the contractor, the contractor could not successfully sue the design professional.

Typically, this situation arises where a contractor submits a bid and wins the construction contracts. The owner, in soliciting the bids, required all bidders to use its architect's drawings and specifications. During construction, the contractor encounters difficulty which requires that the project be completed at a significantly higher cost. The contractor contends that using the architect's specifications caused the cost overrun. Since the contractor did not contract directly with the architect, it could not sue the architect for breach of contract. Because the Economic Loss Rule prevented the contractor from suing in tort, it had no remedy against the architect.

### Protection Recently Eliminated

In January 2005, the Pennsylvania Supreme Court eliminated this protection for design professionals. Overturning years of case law, the Pennsylvania Supreme Court decided that the Economic Loss Rule no longer protected design professionals for negligent misrepresentation claims. Design professionals could now be sued in tort by a contractor, which relied upon its plans, drawings, specifications, etc. and sus-

tained purely economic loss.

The case, entitled *Bilt-Rite v. The Architectural Studio*, involved the construction of a new school. In soliciting bids, the school district contracted with The Architectural Studio (TAS) to prepare plans, drawings and specifications which were submitted to the contractors for the competitive bidding process. *Bilt-Rite* was awarded the contract as the lowest responsible bidder. In submitting its bid, *Bilt-Rite* utilized TAS's work product.

Once construction began, *Bilt-Rite* discovered that additional work had to be done resulting in substantially increased construction costs. *Bilt-Rite* attributed these cost overruns to TAS's specifications which it alleged were false and misleading.

*Bilt-Rite* sued TAS in negligence and sought reimbursement for the cost overruns. At trial, had the Judge dismissed TAS' complaint, the Superior Court upheld the trial court's ruling. However, the Pennsylvania Supreme Court reversed, holding that the Economic Loss Rule no longer protected design professionals from these types of lawsuits.

The Supreme Court based its decision on five factors. First, a design professional is well aware that its design will be utilized by others. Second, the design professionals play such an important role in the planning process that there is no reason to exempt the design professional from the consequences of its negligence. Third, the design professional will only be held responsible for the foreseeable risk of harm. Fourth, establishing the duty between the design professional and the contractor is not unreasonable. Fifth, establishing the duty serves the public interest.

Clearly, the Supreme Court ignored the basic contractual relationships that function to allocate risk during construction. Two dissenting judges criticized the opinion, finding that the new rule will introduce chaos into the myriad of contractual remedies which govern any construction project. It will also impact insurance costs.

### Designers Should Check All Contracts

Pennsylvania is not alone in eliminating this shield for design professionals. Now that the new cause of action exists,

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# CONTINGENT FEE COMMERCIAL LITIGATION PLAINTIFFS AND DEFENDANTS BEWARE!

**R**ecent U.S. Supreme Court rulings impact both lawyers and their clients with respect to contingent fee arrangements. There are a number of things of which both plaintiffs and defendants should be aware.

The Court ruled that, for federal income tax purposes, fees paid to the plaintiff's attorney under non-personal injury contingent fee arrangements are taxable income to the plaintiff.

Additionally, plaintiffs who have received taxable recoveries in some cases may not be permitted to take an offsetting deduction for the fees paid to their attorney.

The Court held that the amounts payable to the attorney constitute gross income to the plaintiffs under the Internal Revenue Code, which defines gross income as "income from whatever source derived." Under the Code, an individual cannot exclude an economic gain from gross income by assigning that income to another person in advance, which is also known as an "anticipatory assignment of income." According to the Court, a contingent fee arrangement constitutes an anticipatory assignment of income, which is disallowed under current law, and therefore this amount should be included in plaintiff's gross income.

For discrimination claims and other alleged civil rights violations, the Court's holding has already been reversed by the American Jobs Creation Act of 2004, which is effective for fees and costs paid after October 22, 2004.

These rulings do not apply to personal injury matters. Recoveries from personal injury lawsuits continue to be excluded from gross income. However, the case does impact commercial litigation matters and underlying claims for breach of contract where there is no apparent allegation of dis-

crimination or civil rights violations.

## The Effect on Tax Deductions.

Individuals who have received taxable recoveries in contingent fee litigation treat the deduction of attorney fees as miscellaneous itemized deductions, which are subject to several limitations.

Miscellaneous itemized deductions are only deductible to the extent that they exceed two percent of the taxpayer's adjusted gross income. In addition, for purposes of calculating the alternative minimum tax, no deductions are allowed for any miscellaneous itemized deduction. Therefore, individuals who have received a large taxable recovery, may be subject to the alternative minimum tax, without any reduction for the attorney's fees that have been paid according to the contingent fee arrangement.

Many analysts believe that since the attorney is reporting the income, and the client is unable to deduct the fee, the income is being taxed twice – once at the client level, and once at the attorney level. Whether a business can deduct a contingent fee payment depends on whether such payment is an "ordinary and necessary business expense."

## The Effect on Commercial Litigation and Possible Settlements

The American Jobs Creation Act of 2004, while resolving the uncertainty concerning the taxation among certain taxable recoveries, is not all conclusive.

For example, types of claims covered by the Act do not cover claims for recovery of

debts, breach of contract, consumer claims, and others. When pursuing litigation, a plaintiff must often determine whether it is more advantageous to have a contingent fee arrangement rather than an hourly fee arrangement. If the plaintiff is successful and recovers monetary damages, the contingent fee paid to the lawyer is often greater than if the plaintiff had just paid on an hourly basis. The purpose for the higher contingent fee is to reward the attorney for the risk of recovery. With the Court's recent decisions, this analysis becomes even more difficult.

The Court's decisions will also likely make settling cases more expensive because it means that the attorney's fee portion of a settlement is taxable income to the claimant regardless of whether the fees are paid to the claimant or the attorney. The Court's recent decisions add a layer of complexity in handling any type of contingent fee arrangement relating to a non-personal injury matter. Attorneys and clients will need to analyze whether the structure of a contingent fee arrangement benefits the client. In addition, attorneys will need to have more care in drafting the complaint, or settling the litigation, to fit within the safe harbors of the American Jobs Creation Act of 2004.

All in all, it is a good idea to fully discuss tax implications and other complexities of contingent fees arrangements with your attorney in the early stages of litigation.

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## DESIGN PROFESSIONALS ARE NOW VULNERABLE TO NEGLIGENCE CLAIMS BY CONTRACTORS

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design professionals can no longer rely upon the safeguards in their contracts with the owners to protect them from negligent misrepresentation suits by dissatisfied contractors. Great care must now be taken to establish contractual protections to try to shield the design professional from this new area of

exposure. All design professionals must take necessary steps to establish a pre-determined allocation of responsibility and risk, instead of leaving their potential risk and liability to the much more vague and less predictable stop-gap of the general common law.

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# THE 2004 TAX ACTS - THINGS YOU SHOULD KNOW!

In the fall of 2004, Congress passed two Tax Acts which impact individuals, businesses and investments. Congress first passed into law the Working Family Families Tax Relief Act of 2004 (the "Act") which mainly extends prior tax provisions that had already expired or were set to expire at the end of 2004. Congress shortly thereafter passed the American Jobs Creation Act of 2004 (the "2004 Act") which contains tax cuts aimed at manufacturers, multinational operations, agricultural businesses and energy companies and provides tax relief for small businesses, farmers, partnerships, and real estate investors. However, these tax cuts are offset by revenue raising provisions aimed at both individuals and businesses. The summary below highlights various provisions of these acts which may have an impact on your or your business.

## Child Tax Credit

The Act provides a uniform definition of a child and maintains the child credit at \$1,000 per child through 2010.

## Marriage Penalty Relief Through 2010

This provision preserves the income level subject to the 10% percent bracket for married taxpayers filing jointly and gives full marriage penalty relief in the standard deduction by setting the basic standard deduction for joint filers to twice that of single taxpayers. It increases the income level in the 15% percent bracket for married couples filing joint returns to twice that of single taxpayers.

## Alternative Minimum Tax

The Act continues the existing Alternative Minimum Tax exemptions of: \$58,000 for married couples filing jointly; \$22,500 for married individuals filing separately; \$40,250 for single individuals and \$33,750 for estates and trusts. These exemption amounts will continue throughout 2005 and are scheduled to expire in 2006 when they will revert to the 2000 level.

## Export And Domestic Production Incentives

Congress repealed the exclusion of "extra territorial income," (gross income that is attributable to foreign trading gross receipts) from gross income and phases out certain related benefits through 2006.

## Deduction for Manufacturing Activity

The 2004 Act creates a manufacturer's deduction to replace the exclusion of "extra territorial income" noted above. The new deduction is equal to a percentage of the income earned from manufacturing undertaken in the United States. This deduction will be phased in gradually beginning in 2005 and fully phased in by 2010, when the deduction will be equal to 9% of the lesser of (a) qualified production activities income for the year, or (b) taxable income for the year. The fully phased-in deduction should effectively reduce the corporate income rate for C Corporations three percentage points, from a top rate of 35% to 32%.

The deduction is not based on exports but

on domestic manufacturing and will provide a greater benefit than the old exclusion since it applies to all qualifying US manufacturers, whether or not they export. Congress defines the term manufacturers very broadly so many domestic producers may qualify for the new deduction.

## Depreciation

The 2004 Act offers several provisions affecting depreciation and cost recovery, including but not limited to, extending the \$100,000 limitation of small business expenses through 2007. It creates a new 15-year recovery period using straight line depreciation for qualified leasehold improvements to non-residential real property and qualified restaurant property placed in service after the date of enactment and before January 1, 2006.

## S Corporation Reform

The 2004 Act simplifies the rules regarding the qualification of an S Corporation by increasing the limit on the number of shareholders from 75 to 100 members and by expanding the definition of family members. Additionally, the 2004 Act also makes it easier for certain S Corporation shareholders to use suspended losses and passive activity losses and provides relief for inadvertent S Corporation terminations and invalid S Corporation elections.

## State Tax Deduction

The 2004 Act allows individual taxpayers to make an election to deduct state and local sales and use tax rather than state and local income taxes. Taxpayers will be permitted to deduct either actual expenditures (provided such expenditures can be properly documented) or to deduct the amounts listed on the IRS provided tables using the IRS provided tables.

## Deduction for Attorneys Fees and Costs from "Unlawful Discrimination" Suit

The 2004 Act allows an above the line deduction for lawyer contingent fees paid directly to attorneys out of a judgment or settlement in an unlawful discrimination suit for any deductible attorneys fees and costs paid by or on behalf of the taxpayer.

The deduction is limited to the amount includable in the taxpayer's gross income for the year stemming from the judgment or settlement, whether it is a lump sum or periodic payment.

## Non-Qualified Deferred Compensation Plans

Major changes have been made to the rules governing the validity of a deferral election in a non-qualified compensation plan for any deferral of compensation in 2005 or later. Vested deferred compensation balances as of December 31, 2004 are not subject to these new restrictions so long as the plan is not significantly amended after October 3, 2004.

## Charitable Contributions of Vehicles

The Deduction for charitable contributions of qualified vehicles (automobiles, boats and airplanes) has been limited. The amount of the deduction for qualified vehicles with a value exceeding \$500.00 depends upon the use of the vehicle by the charitable organization. If the charitable organization sells the vehicle without having made any significant use or improvement, the deduction is limited to the gross proceed received from the sale. There are also new substantiation requirements for contributions of vehicles with a claimed value in excess of \$500.00. These limitations apply to contributions made after December 31, 2004.

## Enhanced Foreign Tax Credits

The foreign tax credit carryover provisions are now extended to allow a one year carry back and a 10-year carry forward of the credit. Previously, the credit was limited to a five-year carry forward. In addition, the 2004 Act simplified the rules for utilizing foreign tax credits, making it more likely that taxpayers will receive dollar for dollar federal tax reductions for the foreign taxes that they are required to pay.

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# RECENT SUPREME COURT DECISION MAY INCREASE EMPLOYEE AGE DISCRIMINATION LAWSUITS

In a recent Supreme Court case, *Smith v. Jackson, Mississippi*, the justices ruled that older employees can prevail in age discrimination claims against their employers without proving that the employers intended to discriminate against them.

In this landmark decision, the Supreme Court held that members of the workforce in the 40+ age group can now win age discrimination cases by showing that the acts committed or plans implemented by their employers have the effect of discriminating against older employees. Previously, some courts took the position that older employees could win age discrimination cases only if they proved that their employers intentionally or deliberately discriminated against them, a hurdle that is tough to overcome. Advocates for the rights of older employees characterize this new decision as a "major boost for the fight to eliminate age discrimination in the workforce."

## Employers Still Have Strong Defense

Although the *Smith* case opened the door for older employees to sue their employers for acts that effectively discriminate against them, the decision was not a complete loss for employers. The law affords employers a strong defense to these claims which older employees will have a tough time overcoming.

As the Supreme Court notes, employers can take actions or implement plans that adversely impact older employees if the actions are based on reasonable factors other than age. In other words, unless an aggrieved employee can trump the

employer's showing that the action or plan was based on a legitimate or sound concern, it is unlikely that he will prevail. Interestingly, the *Smith* case is prime example of the strength of this defense. In that case, the City of Jackson, Mississippi stated a purpose for its actions which the plaintiffs in that case could not prove violated the law.

In October 1998, the City of Jackson, Mississippi revised its pay plan for police officers and police dispatchers. Under the plan, officers with less than five years service received proportionately greater raises than those with more seniority. Because most of the officers on the force who were over the age of 40 had more than five years experience, this group was adversely affected by the plan.

Specifically, under the plan, although the senior officers received more money than their younger counterparts, the percentage of their increases was smaller when compared to their salaries. Consequently, a group of older officers filed suit claiming, among other things, that because their salary increases were proportionately smaller, the City was, effectively, discriminating against them on the basis of age.

In response to the claims, the City argued that the primary objective of the

plan was not to harm the older police officers. Rather, it was simply to boost the recruitment of police officers by increasing the salaries of junior officers to the level of comparable positions in the market.

The officer's claims were dismissed in the federal district court and the federal appeals court and they appealed to the Supreme Court. The Supreme Court determined that the rationale for the plan, increasing pay at the starting level to help recruit new officers, was based on factors other than age and was "unquestionably reasonable". The Court upheld the dismissal of the officers' claims.

## Increase in Lawsuits Possible, Review Your Policies

Although the decision did not benefit the *Smith* plaintiffs, it may, nevertheless, lead to an increase in lawsuits attacking company compensation and benefit plans and policies. In that regard, employers should review their policies and plans with their attorneys to address any possible adverse impact the plans have on employees in the 40+ age group. We encourage our clients to begin this process with us immediately.

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## DO YOU HAVE A LIVING WILL?

In light of the recent Terri Schiavo case, all clients should have, and periodically review, an Advanced Healthcare directive – often called a "Living Will." Along with a Power of Attorney and Last Will and Testament, this document is a critical element of every estate plan.

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## REAL ESTATE TAX APPEALS

If you own property in Philadelphia and want to dispute your current tax assessment, or a proposed increase for 2006, you must file an appeal by the later of October 3, 2005 or 30 days after the notice of increase (earlier in suburban counties).

*Please contact either David Fineman, Esq.  
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