The Court Versus The Code –

Recent Tax Code Amendment Addresses Pending Issue At Supreme Court

By Heather White Martin and Deborah L. McNeely

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The Internal Revenue Code (IRC) excludes from gross income any amounts received on account of personal *physical* injuries.[1] Employment discrimination claims rarely involve physical injury, so monetary damages received from these claims are almost always taxable income.[2] Or are they? The question that has plagued the courts for years is to what extent the award is taxable to the plaintiff. For example, if a plaintiff receives a $1 million damages award and pays his attorney 40 percent under a contingent fee agreement, is the plaintiff taxed on the entire $1 million or his $600,000 net award?[3] The United States Supreme Court recently heard oral arguments on this precise issue, but a recent amendment to the IRC may render the issue moot.

Contingent Fee Tax Implications. In a majority of jurisdictions, the entire $1 million must be claimed as gross income, and the plaintiff may then take whatever deductions are available.[4] The attorney fees cannot be deducted, however, if the plaintiff is subject to the alternative minimum tax (AMT).[5] The result is a double tax on the fee portion of the award—the plaintiff pays taxes on the entire $1 million award and the attorney pays taxes on his $400,000 fee. A second, and perhaps more surprising, result is that as the percentage of the contingent fee increases, the plaintiff's tax liability may realistically exceed 100 percent, requiring the plaintiff to pay more in taxes than his actual net award.

Same Means, Different Ends. The majority view arises from the First, Second, Third, Fourth, Seventh, Tenth and Federal Circuits.[6] Its rationale is that although individual state law may provide the attorney with a lien on the award to ensure his fees are recouped, his is merely a security interest of sorts, insufficient to constitute ownership.[7] Under this view, the attorney has no "ownership" interest in the fee despite state-specific attorney lien law, and if the attorney does not "own" the fee portion of the award, it must still belong to the plaintiff.[8] Therefore, the fee portion of the award is simply gross income to the plaintiff and no deduction is allowed.

In contrast, as early as 1959, a minority of circuits began relying on the same attorney lien theory to conclude that the fee portion of the plaintiff's award is *not* to be taxed to the plaintiff.[9] Although these circuits have since abandoned reliance on the state-specific theory, the circuits continue to reach the same conclusion — fee portions of an award are not taxed to the plaintiff.[10] Most recently, the Sixth Circuit in *Banks v. Commissioner*[11] determined that regardless of the state-specific law the fee portion of a claim is "not already earned, vested, or even relatively certain to be paid" to the plaintiff.[12] Rather, the fees are "merely an intangible, contingent expectancy, dependent upon the attorney's skills to realize any value from it."[13] In other words, the plaintiff has no guarantee of funds at the time he assigns a portion to the attorney, so the fee portion of any award need not be taxed to the plaintiff.[14] While both the majority and minority views now ignore state-specific attorney lien laws, they continue to reach opposite conclusions. To make matters more interesting, the Ninth Circuit has taken yet a third approach, which brings us *back* to reliance on state-specific attorney lien laws. In *Banaitis v. Commissioner*,[15] the Ninth Circuit reasoned that if state law provides an attorney with greater interest in the fee than he would have had under a

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contingent fee contract, then the plaintiff lacks sufficient control over the potential award for the funds to constitute income to the plaintiff.[16] Thus the Ninth Circuit reached the same conclusion as the minority in that the fee portion of the award is not taxable as gross income to the plaintiff.[17]

The Commissioner of Internal Revenue appealed to the Supreme Court in both *Banks* and *Banaitis*. Though each Circuit held that the fee portion of the award should be excluded from plaintiff's gross income, their underlying rationales differed.[18] Interestingly, before the Court scheduled oral argument in the cases there was added to the mix a tax code amendment addressing this very issue.

Internal Revenue Code — Clearing the Muddy Water? On October 22, 2004, President Bush signed into law H.R. 4520. Section 703 of the bill eliminates the double tax on attorney fees by amending IRC Section 62 to provide a deduction "for attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination" as now defined therein.[19] The amendment effectively eliminates the double tax calamity by removing from the plaintiff's gross income the fee portion of damages awards in unlawful discrimination claims. Of course, and unfortunately, the attorney still has to pay taxes on his earned fees.[20]

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By eliminating the double tax, the IRC amendment also eliminates the need for the Supreme Court to choose the appropriate means to that end, because the amendment codifies the end result reached in both *Banks* and *Banaitis*. The amendment does not apply to *Banks* and *Banaitis*, however, because their actual damages awards long pre-dated the IRC amendment. Nevertheless, the Respondents brought the import of the amendment before the Supreme Court by contending in their briefs to the Court that the Court's decision in the appeal will have little or no effect on future tax disputes because the new IRC amendment will apply.[21] They further suggested that the presence of the amendment may warrant dismissal of both cases "on the ground that the writs of certiorari were improvidently granted."[22]

The long-awaited Court decision on this issue could easily result in a dismissal if the Court does in fact rely on the Congressional intent behind the IRC amendment as guidance in its decision.

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Thus, we may never know the "real" rationale for excluding the fee portion of a damages award from a plaintiff's gross income. Should the case be dismissed, Banks and Banaitis will maintain their winning positions, neither having to pay tax on the fee portion of their damages awards. Recipients of damages awarded subsequent to the IRC amendment will achieve the same result, but will do so through the newly crafted means of the IRC. Either way we see that the fee portion of a plaintiff's unlawful discrimination damages award should not be included in the plaintiff's gross income for purposes of determining tax liability. Now, only one question remains – will the Court dismiss or rule on the issue before it?

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[1] 26 U.S.C. § 104(a).

[2] 26 U.S.C. § 104(a).

[3] Net award or net recovery in this article means the plaintiff's pre-tax recovery after paying attorney fees and costs.

[4] 26 U.S.C. § 212(1) grants a deduction for the expense of producing or collecting income. Thus, when a judgment is deemed income to a plaintiff, the expense of producing that income (*i.e.*, the attorney's fee) can be deductible. *See also Raymond v. United States*, 355 F.3d 107, 115 (2d Cir. 2004).

[5] This is because attorney fees are considered a "miscellaneous itemized deduction," and a taxpayer subject to the AMT cannot use a miscellaneous itemized deduction to reduce his gross taxable income. *See* 26 U.S.C. § 56(b)(1)(A)(i).

[6] *See, e.g.*, *Alexander v. Internal Revenue Service*, 72 F.3d 938 (1st Cir. 1995); *Raymond v. United States*, 355 F.3d 107 (2d Cir. 2004); *O'Brien v. Commissioner*, 319 F.2d 532 (3d Cir. 1963); *Young v. Commissioner*, 240 F.3d 369 (4th Cir. 2001); *Kenseth v. Commissioner*, 259 F.3d 881 (7th Cir. 2001); *Hukkanen-Campell v. Commissioner*, 274 F.3d 1312 (10th Cir. 2001); and *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995).

[7] *Raymond*, 355 F.3d at 110.

[8] *Id.*

[9] *See, e.g.*, *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959); *Estate of Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000).

[10] *Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir. 2000); *Foster v. United States*, 249 F.3d 1275 (11th Cir. 2001).

[11] 345 F.3d 373 (6th Cir. 2003).

[12] *Banks*, 345 F.3d at 110.

[13] *Id.*

[14] *Id.*

[15] 340 F.3d 1074 (9th Cir. 2003).

[16] *Id.* at 1081.

[17] *Id.*

[18] Coincidentally, the two cases appealed to the Supreme Court each represent the minority "conclusion" with regard to taxation of attorney fees.

[19] H.R. 4520, Section 703. The definition of "unlawful discrimination" is quite expansive, covering numerous provisions of Federal, State, and local law, as well as common law claims.

[20] Prior to this IRC amendment, a plaintiff's attorney arguably had an obligation to advise his client that excessive tax liability could be incurred with regard to the fee portion of the plaintiff's potential damages award in an unlawful discrimination claim. *See* Gregg D. Polsky, *The Contingent Attorney's Fee Tax Trap: Ethical, Fiduciary Duty, and Malpractice Implications*, 23 VA. TAX REVIEW 615 (Winter 2004). The attorney's obligation is now greatly diminished thanks to the IRC amendment and its expansive definition of "unlawful discrimination." However, the attorney should advise his client if there is any indication that the definition does not include the client's claim, and the client should consult a tax professional accordingly.

[21] Joint Supplemental Brief for Respondents, filed in the Supreme Court of the United States, October 2004.

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