NOTE: This article was referenced in the June 2005 *In Brief* in the article entitled, "Taxes on Attorney Fees." It is a more detailed explanation of the issues discussed in that article. Our thanks to Philip N. Jones, *Duffy Kekel LLP,* and Joseph Wetzel, *Wetzel DeFrang & Sandor,* for providing this article.

RECENT DEVELOPMENTS IN TAXATION OF COURT COSTS AND ATTORNEY FEES FOR INDIVIDUALS

There is some good news and some bad news about the income tax treatment of legal fees. These new tax developments apply to tax treatment of legal fees and court costs paid by the non-business taxpayers in specific types of cases. They do not apply to legal fees and court costs paid or incurred by businesses and do not apply to most personal injury cases.

First, the good news. Last fall, Congress passed the American Jobs Creation Act of 2004 (Act) (P.L. 108-311). The Act adds a rule to the Internal Revenue Code. The new rule provides that, to the extent attorneys' fees and court costs are includable in income, those fees and costs will be deductible - thus offsetting the income. To qualify for the tax treatment of this new IRC subsection, the client must be an individual and the cause of action must fall within those specified by the new legislation.

Next, the bad news. The US Supreme Court recently reversed a 9th circuit case and held that, as a general rule, when a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee. The decision came in two consolidated cases, *Banks* and *Banaitis*, 543 U.S. ___, 125 S.Ct. 826, 95 AFTR2d 2005-659 (2005). The *Banaitis* case originated in Oregon.

Attorneys who advise clients regarding settlements and judgments in cases that do not fall within the Act should make certain that their clients receive advice on the tax aspects of the awards, including the legal fees.

Tax Aspects of the American Jobs Creation Act

The American Jobs Creation Act (Act) , H.R. 4520, provides an above-the-line deduction for attorneys fees (contingent and other legal fees) incurred in specifically enumerated causes of action. The Act is effective only for those attorneys fees paid after October 22, 2004, the date of enactment, with respect to any judgment or settlement occurring after that date of enactment.

If your client receives legal fees in any of the covered actions, the legal fees must be included in the client's income, but the client will have a full deduction, essentially a wash, under the new deduction provision which is not subject to percentage limitations or to the alternative minimum tax. Congress accomplished this by adding the new provision to 26 USC 62(a) which details the kinds of deductions that are not subject to itemized deduction limitations and are not subject to the alternative minimum tax. Accordingly, your client will simply report the recovery of legal fees as the client's income and then

wash out that inclusion with this new full deduction. The Act covers many causes of action including many related to civil rights, employment, and discrimination. It also covers actions involving claims against the government under 31 USC Ch.37, claims for damages under the Social Security Act (42 USC 1395y), claims under the Civil Rights Act of 1991 (2 USC 1202), claims under the Congressional Accountability Act of 1995 (2 USC 1311,ff), claims under the National Labor Relations Act (29 USC 151,ff), claims under the Fair Labor Standards Act of 1938 (29 USC 201, ff), claims under the Age Discrimination in Employment Act of 1967 (29 USC 623 or 633), claims under the Rehabilitation Act of 1973 (29 USC 791 or794), claims under the Employee Retirement Income Security Act 1974 (29 USC 1140), claims under the Education Amendments of 1972 (20 USC 1681, ff), claims under the Employee Polygraph Protection Act of 1988 (29 USC 2001, ff), claims under the Worker Adjustment and Retraining Notification Act (29 USC 2102, ff), claims under the Family and Medical Leave Act of 1993 (29 USC 2615), claims relating to the protection of members of the uniformed armed services (38 USC 43); civil rights actions under 42 USC 1981, 1983, or 1985, claims under the Civil Rights Act of 1964 (42 USC 2000e), claims under the Fair Housing Act (42 USC 3604, ff), claims under the Americans with Disabilities Act of 1990 (42 USC 12112), and any claim under the federal whistleblower law.

The Act doesn't apply to any cause of action that is not specifically named in the Act. Some of the causes of action that are not listed include defamation, intentional infliction of emotional distress, breach of contract, unfair competition, securities laws, antitrust, patent, trademark, or copyright laws. If your client's cause of action isn't specifically enumerated in the Act, the rules discussed in the next portion of this article apply.

Tax Treatment of Legal Fees that Don't Fall Within the Act

When a litigant's recovery constitutes taxable income and the cause of action does not fall within the Act, the taxation of the attorney's fees as gross income becomes very important because the attorney's fees are not deductible for alternative minimum tax (AMT) purposes. If the portion of the judgment paid to the attorney is excludable from the gross income of the taxpayer, the need for a deduction is eliminated. In *Banks* and *Banaitis*, the Supreme Court ruled that attorneys' fees are not excludable. Therefore, if your client is an individual whose recovery constitutes taxable income and whose cause of action does not fall within the Act, the attorney fee portion of the recovery is taxable income. Depending on your client's financial situation (engaged in business or not), your client may be required to include the fee as income without a commensurate deduction.

Background. For most businesses, attorneys' fees are an ordinary and necessary business deduction for income tax purposes. For individuals, however, attorneys' fees are usually a "miscellaneous itemized deduction." Such deductions are allowed only to the

extent they exceed 2% of adjusted gross income. In the year in which a taxpayer receives a large judgment, that 2% floor serves as a very significant impediment to a deduction. The situation is even worse under the AMT, which is a separate "parallel" tax. It is reported and calculated on the income tax return of the individual taxpayer, and the taxpayer must pay the greater of the regular tax or the alternative minimum tax. Miscellaneous itemized deductions, however, are not allowed for purposes of the alternative minimum tax. When a deduction is allowed for income tax purposes, but denied for AMT purposes, the income tax deduction becomes ineffective, and the individual is taxed on the income that would have otherwise been protected by the deduction. In general, the AMT rate is 26% of the first $175,000 of income and 28% of any amounts over $175,000, after an exemption amount. When that rate is applied to a substantial attorney's fee, the resulting tax can be very significant.

This issue is not present in most personal injury cases, because personal injury awards, either by settlement or by court judgment, are not taxable to the plaintiff, and no amount is included in the gross income of the taxpayer. For the same reason, the attorney's fees in a personal injury case are not deductible, nor is there any need to deduct the attorney's fees. (Tax issues may surface in some personal injury cases when large amounts of taxable income, such as interest or punitive damages, are present.) However, in other cases, such as defamation, intentional infliction of emotional distress, breach of contract, unfair competition, securities laws, antitrust, patent, trademark, or copyright laws the damages are often taxable to the plaintiff and are not deductible for AMT purposes.

The Implications. In a worst-case scenario, the position adopted by the Supreme Court in *Banks/Banaitis* could result in taxation being triggered in all of the following situations:

1. When attorney fees are paid pursuant to a contingent fee agreement, as in *Banks*/*Banaitis*.

2. When attorney fees are paid pursuant to a fee-shifting statute. The U.S. Code contains at least 119 fee-shifting statutes.

3. When attorney fees are paid pursuant to an hourly rate fee agreement.

4. When attorney fees are awarded by a court pursuant to a contractual clause requiring the losing party to pay the prevailing party's attorney fees.

5. When attorney fees are paid from a common fund in class action litigation.

6. When attorney fees are awarded to *pro bono* attorneys.

In several of these situations, a prevailing party could end up owing *more* in taxes than the party recovered in the litigation. Although a contingent fee agreement usually will not result in fees that exceed the award, under a fee-shifting statute the attorney fees could exceed the damages awarded to the prevailing plaintiff. Under a contractual attorney fee clause, a prevailing

defendant could leave the litigation without owing the plaintiff a cent but then be taxed on the attorney fees paid to the defendant's attorney. The same could happen if a *pro bono* attorney is awarded fees under a fee-shifting statute. In fact, that result could occur even if the fees did not exceed the recovery.

Unanswered Questions. After ruling that contingent attorney fees cannot be excluded from gross income, the Supreme Court listed the issues and theories that it was declining to comment upon, including:

1. Whether a contingent fee agreement established a Subchapter K partnership.

2. Whether the attorneys fees should be subtracted from the gross proceeds pursuant to §1001, §1012, and §1016.

3. Whether the attorneys fees are deductible reimbursed employee business expenses.

The court also declined to comment on the taxation of attorneys fees incurred by a relator under the *qui tam* provisions of the False Claims Act (31 U.S. C. §3729). Finally, the court declined to address the argument that the court's ruling in favor of the IRS was contrary to the purposes of the federal fee-shifting statutes, which were intended to make the plaintiff whole. As a result, taxpayers with fee-shifting cases might be able to pursue that argument.

Although the issue was considered by nearly all of the circuit courts of appeal, *Banks/Banaitis* Court didn't address many of the theories employed by the some of the circuit courts. As a result, the case provides little guidance for future or pending cases and many tax issues and case theories remain unsettled.

Where We Go From Here

If you represent a litigant whose recovery will constitute taxable income, the litigant should be advised of the tax consequences of the settlement paid to the litigant and the tax consequences of the sum paid to you. Clients who do not receive this tax advice in advance might suddenly turn litigious toward their own attorneys. In some cases, this advice might best be given before the client signs the fee agreement, or before the client consents to filing the case, particularly if the litigation might result in a tax liability in excess of the potential award.

Since courts often look to the pleadings to determine the taxation of settlements and judgments, when possible counsel should draft pleadings to bring their cases within the umbrella of the new legislation (the Act), which protect legal fees from taxation in certain discrimination, civil rights, and employment cases. For cases already pled, perhaps pleadings may be amended.

If a settlement agreement incorporates an agreement by the parties regarding the tax characterization of the payment, the IRS and the courts will often adhere to that characterization, although it is not binding on them. Similarly, neither the IRS nor the Tax Court is bound by the tax characterization of an award in a court ruling, although it presumably will

be given considerable weight.

For clients with causes of action that fall within the Act, the deduction must qualify as a trade or business deduction (26 USC 162), as a deduction for costs for production of income [26 USC 212(3)], or as a deduction for tax advice and planning [26 USC 212(3).] When constructing settlement agreements or judgments, it will be helpful if a qualifying activity is listed (trade or business, production of income, or tax planning).

For cases outside of the umbrella of the Act, a variety of approaches might help, but none are certain to prevail. If a federal fee-shifting statute is involved, any settlement agreement should recite that the attorney fees are being paid in lieu of statutorily-awarded fees, even though the effect of that recital is not yet known because the Supreme Court declined to address the issue. The result might vary from circuit to circuit based on the case law prior to *Banks/Banaitis.*

If all else fails, taxpayers should examine using some of the alternative theories not addressed by the Court. Those theories, and the effect of those theories, are among the many questions left unanswered by the Court.

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