



## TAXES ON ATTORNEY FEES

We have some good news and some bad news about the income tax treatment of attorney fees. Two new tax developments apply to the tax treatment of attorney fees and court costs paid or incurred by non-business taxpayers in specific types of cases. These developments do not apply to attorney 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 (the Act) (P.L. 108-311), which added a new rule to the Internal Revenue Code (IRC). The rule provides that, to the extent attorney fees and court costs are includable in the taxpayer's income, those fees and costs are 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. The Act names over 10 federal causes of action that qualify, most of which involve civil rights, employment, or discrimination. The Act applies to attorney fees paid after October 22, 2004, with respect to any judgment or settlement occurring after October 22, 2004.

The bad news is that the U.S. Supreme Court recently reversed a Ninth Circuit case and held that, as a general rule, when a litigant's recovery constitutes taxable 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, 160 L.Ed.2d 859 (2005). The *Banaitis* case

originated in Oregon.

Together, these two developments mean that individual litigants whose recovery constitutes taxable income, and whose cause of action does not fall within the Act, will be taxed on the recovery – including the portion paid to the attorney. Some examples of causes of action that do not fall within the Act and will result in taxation of the attorney fees under *Banks* and *Banaitis* are defamation; intentional infliction of emotional distress; breach of contract; unfair competition; and violations of securities, antitrust, patent, trademark, and copyright laws.

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 treatment of the awards, including the attorney fees.

For a more detailed explanation of these tax developments, visit [www.osbplf.org](http://www.osbplf.org), select Loss Prevention Material, then *In Brief* newsletter, then June 2005, and view the article, "Recent Developments in Taxation of Court Costs and Attorney Fees for Individuals," by Philip N. Jones, *Duffy Kekel LLP*, and Joseph Wetzel, *Wetzel, DeFrang & Sandor*.

*Our thanks to Philip N. Jones, Duffy Kekel LLP, and Joseph Wetzel, Wetzel, DeFrang & Sandor, for this tip and for the article posted on our Web site.*

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