

NONPHYSICAL PERSONAL INJURY SETTLEMENTS AND JUDGMENTS: AMENDING THE INTERNAL REVENUE CODE TO EXCLUDE ATTORNEY FEES¹

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INTRODUCTION

The U.S. Tax Court recently announced in *Kenseth v. Commissioner*,¹ that “Congress, not the Courts, is the final arbiter of how the tax burden is to be borne by taxpayers.”² Regardless of whether Congress, the Courts, or even the Internal Revenue Service ultimately holds the final responsibility for the allocation of tax burdens, a crucial shift is taking place with respect to the federal income tax treatment of attorney fees awarded in nonphysical personal injury settlements and judgments.

A real life example illustrates the harsh result of this shift. Don Lyons filed a Title VII sex discrimination complaint against his employer for retaliation. Lyons ultimately prevailed in the case and received a judgment of \$15,000 in punitive damages.³ Because punitive damages are taxable⁴ Lyons owed \$5467 in income tax on the award.⁵ Lyons received a net award of \$9533.⁶ Lyons’ attorney petitioned the court for \$170,000 in legal fees.⁷ If the court awarded only \$150,000 in attorney fees to Lyons as part of his judgment, Lyons would owe \$67,791 in tax on the attorney fee award, as if it were included in his gross income.⁸ Thus, Lyons’ award is devoured by taxes and he would actually pay the government \$58,236 for prevailing in a legitimate sex discrimination case against his employer.⁹ In short, because legal fees often constitute a significant portion of any civil settlement or judgment,¹⁰ a plaintiff who brings a civil action for

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1. 114 T.C. 399 (2000), *aff’d*, 259 F.3d 881 (7th Cir. 2001).

2. *Id.* at 415.

3. 146 CONG. REC. S7160-03, *S7162-64 (2000) (statement of Sen. Grassley) (discussing a letter sent by an attorney representing Lyons regarding the current dilemma created by the federal tax laws).

4. *See, e.g.*, *Stevan v. Comm’r*, 80 T.C.M. (CCH) 420 (2000) (holding that punitive damages are included in gross income and subject to federal income tax).

5. 146 CONG. REC. S7160-03, *S7163 (2000).

6. *Id.*

7. *Id.* at *S7164.

8. *Id.*

9. *Id.*

10. Whether a plaintiff pays his lawyer by the hour, by a fixed fee, or under a contingent fee arrangement, attorney fees are likely to be substantial. The most common type of fee arrangement for plaintiffs in civil litigation is the contingent fee. *See* Bruce L. Hay, *Contingent Fees and Agency Costs*, 25 J. LEGAL STUD. 503 (1996). “Contingency fees usually are calculated as a percentage of the amount recovered. Typically, contingency fees range between twenty-five and fifty percent,

nonphysical personal injuries must consider whether legal fees included in any settlement or judgment award can be excluded from his gross income.¹¹

Section 104(a)(2) of the Internal Revenue Code of 1986, as amended (the "Code"), allows a taxpayer to exclude from gross income "the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness."¹² Thus, attorney fees, included in a plaintiff's settlement or judgment award for physical injuries, are excluded from the plaintiff's gross income and therefore are not subject to federal personal income taxation.¹³ However, attorney fees included in a damage award for nonphysical injury (e.g., employment discrimination, sex discrimination, personal injury, breach of contract, and wrongful termination) are not necessarily excluded from the plaintiff's gross income and thus may be subject to federal personal income taxation. Moreover, there is no code section specifically allowing a deduction for legal fees, while Code sections 162 and 212 do allow the deduction of fees as business expenses or as production of income, respectfully.¹⁴

Currently, the federal circuit courts do not concur as to whether attorney fees (or interest thereon), which are included as part of a plaintiff's damages in a settlement or judgment for nonphysical injury, can be excluded from his gross income for federal income tax purposes. In light of this conflict, U.S. Tax Court decisions have varied widely, guided largely by the circuit to which an appeal from its decision would lie.

Plaintiffs who stand to receive damage awards through settlements or judgments should not be subject to the ambiguity and unpredictability of such a fundamental tax consequence created by the current conflict. The Internal Revenue Service's (the "Service") position has been consistent—attorney fees paid in an award are gross income to the plaintiff under the "fruit of the tree" doctrine.¹⁵ Under this doctrine, the taxpayer who "earns" or "derives" the

with the higher percentages awarded if the case progresses beyond the trial stage, and the lower percentages awarded if the case is settled before trial." Drew C. Phillips, *Billing Issue: Contingency Fees: Rules and Ethical Guidelines*, 11 GEO. J. LEGAL ETHICS 233, 233-34 (1998).

11. For purposes of consistency and neutrality, the male pronoun is used generically throughout to refer to plaintiff, and the female pronoun is used throughout to refer to plaintiff's attorney.

12. I.R.C. § 104(a)(2) (1994 & Supp. V 1999).

13. See, e.g., Priv. Ltr. Rul. 99-52-080 (Sept. 30, 1999) (holding that damages awarded in connection with a logging accident that caused plaintiff-taxpayer a "crushing, life-threatening injury resulting in the separation of three pelvic bones" were excludable from taxpayer's gross income).

14. I.R.C. §§ 162, 212 (1994 & Supp. V 1999).

15. In fact, the Service recently released a Market Segment Specialization Program audit guide that contains examination techniques for settlements and judgments.

In cases involving contingent fee arrangements, the gross award/settlement, without diminution for attorneys' fees or costs, should be included in the taxpayer's income. This treatment is in accord with IRC section 61 and the long established principle, "the

income is the taxpayer who will be taxed on that income. For plaintiffs who receive damage awards, this means that a significant portion of their recovery may be paid out in taxes on income that they never “actually” receive.

Courts in the Fifth,¹⁶ Sixth,¹⁷ and Eleventh¹⁸ Circuits have held that attorney fees included in a plaintiff’s damage award may be excluded from the plaintiff’s gross income for federal income tax purposes. These courts explain that attorney fees are excludable from a plaintiff’s gross income, in part, because the state law in those jurisdictions grants attorneys lien rights (or ownership rights) to income resulting from a settlement or judgment award. Thus, those courts have held that since the attorney had a “right” to the income, the plaintiff may exclude that portion of his award from his gross income. However, it is not clear that the state law is always dispositive in these cases.

Conversely, courts in the First,¹⁹ Ninth,²⁰ and Federal²¹ Circuits have held that attorney fees included in a plaintiff’s damage award should be included in the plaintiff’s gross income (though potentially deductible, depending on the plaintiff’s circumstances). These circuit courts explain that the income cannot be excluded from the plaintiff’s gross income because the plaintiff has “earned” that income and cannot assign it to someone else and avoid taxation.

Part I of this Note will identify the roots of this conflict by discussing the treatment of civil damage awards in the Code. Additionally, it will discuss and analyze the conflicting cases and recent U.S. Tax Court opinions that have applied the federal circuit holdings. Part II will set forth the reasons why the current circuit split must be resolved and discuss a number of possible resolutions to the conflict. Part III will posit that Congress should act immediately to amend Code section 104 to provide an additional exclusion for the settlement or judgment amounts plaintiffs receive due to nonphysical personal injury, which are attributable or attributed to attorney fees paid to facilitate the taxpayer’s lawsuit.

fruit of the tree” theory, that income is taxable to the person who earns it and cannot be assigned to someone else. . . . Examiners handling cases involving payments of attorneys’ fees in lawsuits in Alabama, Michigan, and Texas, however, should be aware that there is contrary authority based on an interpretation of applicable state law. . . . Until the issue is resolved, the Action on Decision in *Cotnam* [, which states that the Service will not follow the contrary authority,] should be followed and taxpayers should not be allowed to net the proceeds of the direct payment of attorneys’ fees in all cases arising under any law other than Alabama, Michigan, and Texas.

INTERNAL REVENUE SERVICE, DEP’T OF THE TREASURY, MARKET SEGMENT SPECIALIZATION PROGRAM (2001).

16. See *Cotnam v. Comm’r*, 263 F.2d 119, 125 (5th Cir. 1959).

17. See *Estate of Clarks v. United States*, 202 F.3d 854, 858 (6th Cir. 2000).

18. See *Davis v. Comm’r*, 210 F.3d 1346, 1347 (11th Cir. 2000).

19. See *Alexander v. Comm’r*, 72 F.3d 938, 944 (1st Cir. 1995).

20. See *Coady v. Comm’r*, 213 F.3d 1187, 1191 (9th Cir. 2000), *cert. denied*, 121 S. Ct. 1604 (2001).

21. See *Baylin v. United States*, 43 F.3d 1451, 1455 (Fed. Cir. 1995).

I. THE CODE'S TREATMENT OF DAMAGE AWARDS AND THE CONFLICT AMONG THE FEDERAL CIRCUITS

The Code imposes a tax on an individual's taxable income.²² Taxable income consists of a taxpayer's adjusted gross income ("AGI") minus either the taxpayer's standard deduction or the sum of the taxpayer's itemized deductions ("below the line" deductions).²³ AGI is derived from the taxpayer's gross income less the deductions allowed under Code section 62 ("above the line" deductions).²⁴ Gross income "means all income from whatever source derived."²⁵ Code sections 101 through 137 describe items specifically excluded from gross income.²⁶ Currently, Code section 104(a)(2) allows a taxpayer to exclude from gross income damages received on account of personal physical injuries or physical sickness.²⁷

Prior to 1992, courts interpreted Code section 104 to exclude damages from both physical and nonphysical injury to a person because the language of the statute did not distinguish between the two.²⁸ However, in *United States v. Burke*²⁹ and *Commissioner v. Schleier*,³⁰ the U.S. Supreme Court ruled that lost earnings damages resulting from employment discrimination were not excludable. In 1996, Congress amended Code section 104 to exclude from gross income only damages received "on account of personal physical injuries or physical sickness."³¹ Thus, damages arising from all nonphysical injury cases are not generally excluded from the plaintiff's gross income.³²

22. I.R.C. § 1 (1994 & Supp. V 1999).

23. *Id.* § 63.

24. *Id.* § 62. The expressions "below the line" and "above the line" are used by tax practitioners to refer to the deductions taken in arriving at AGI (i.e., above the line deductions) and those deductions taken in arriving at taxable income (i.e., below the line deductions). The "line" refers to Line 33 on Form 1040, U.S. Individual Income Tax Return.

25. *Id.* § 61 (1994).

26. *Id.* §§ 101-37 (1994 & Supp. V 1999).

27. *Id.* § 104(a)(2).

28. See generally Laura Sager & Stephen Cohen, *Discrimination Against Damages for Unlawful Discrimination: The Supreme Court, Congress, and the Income Tax*, 35 HARV. J. ON LEGIS. 447, 452-73 (1998) (arguing that attorney fees awarded in civil rights cases should be fully deductible or excluded from gross income). The original Code section 104(a)(2) excluded from gross income "damages . . . received . . . on account of personal injuries or sickness." I.R.C. § 104(a)(2) (1994 & Supp. V 1999). The exclusion was added to the Code in 1918. See ALANGUNN & LARRY D. WARD, CASES, TEXT AND PROBLEMS ON FEDERAL INCOME TAXATION 146 (3d ed. 1995).

29. 504 U.S. 229 (1992).

30. 515 U.S. 323 (1995).

31. I.R.C. § 104 (1994 & Supp. V 1999). Congress enacted the amendment as part of the Small Business Jobs Protection Act of 1996. *Id.*

32. See Laura Sager & Stephen Cohen, *How the Income Tax Undermines Civil Rights Law*,

Given that damages for nonphysical injuries are now taxable, determining how to treat legal fees in such cases is particularly important.³³ However, a conflict exists among the federal circuits as to whether attorney fees awarded in settlements or judgments for nonphysical injury can be excluded from gross income for federal income tax purposes.³⁴ Although attorney fees are not expressly excluded from gross income in the Code, some courts have held that attorney fees awarded in a settlement or judgment should not be included in a plaintiff taxpayer's gross income.³⁵ Other courts have applied the assignment of income doctrine³⁶ and held that plaintiffs cannot assign to their attorneys the portion of their recoveries awarded as attorney fees.³⁷ Although those courts allowed plaintiffs to deduct such legal fees as a miscellaneous itemized deduction, the result in too many cases is still less than fair, as illustrated by the result in Lyons' case.

A. Cases Where Courts Have Allowed Plaintiff to Exclude Legal Fees

Some federal circuits have allowed nonphysical injury plaintiffs to exclude attorney fees awarded in settlements or judgments from their gross income. In *Cotnam v. Commissioner*,³⁸ the Fifth Circuit held that the plaintiff's attorney fee award was not gross income because Alabama law granted the plaintiff's

73 S. CAL. L. REV. 1075, 1079 (2000).

33. *Id.* Incidentally, at least one estimate places the additional revenue raised by the 1996 amendment Code section 104 at \$230 million. Marcia Coyle, *U.S. Tax on Damages Under Fire*, NAT'L L.J., Aug. 9, 1999, at A1.

34. See generally ROBERT W. WOOD, TAXATION OF DAMAGE AWARDS AND SETTLEMENT PAYMENTS (2d ed. 1998); K. SPRIGGS, 1 REPRESENTING PLAINTIFFS IN TITLE VII ACTIONS, § 1.03 (2d. ed. 1998); Sheldon I. Banoff & Richard M. Lipton, *Whipsaw on Settlement Lawsuits: New Hope?*, 92 J. TAX'N 190 (2000); Susan Kalinka, *A.L. Clarks Est. and the Taxation of Contingent Fees Paid to an Attorney*, 78 TAXES 16 (2000); John H. Skarbnik, *New Tax Planning Needed for Employment-Related Damages*, 26 TAX'N FOR LAW. 39 (1997); William Winslow, *Tax Hell in Nonphysical Torts*, TRIAL, May 1999; Robert W. Wood, *The Plight of the Plaintiff: The Tax Treatment of Legal Fees*, TAX NOTES, at Nov. 16, 1998, 98 TNT 220-101; Jared A. Khokhar, *Tax Aspects of Settlements & Judgments*, 522-2d Tax Mgmt. (BNA) (2000).

35. *Davis v. Comm'r*, 210 F.3d 1346 (11th Cir. 2000); *Estate of Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000); *Cotnam v. Comm'r*, 263 F.2d 119 (5th Cir. 1959).

36. The assignment of income doctrine also known as the "fruit of the tree" doctrine was established in *Lucas v. Earl*, 281 U.S. 111, 115 (1930) (holding that the income tax is imposed on the income of those who earned it and thus, "no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.") (emphasis added); see also *Helvering v. Horst*, 311 U.S. 112 (1940).

37. *Coady v. Comm'r*, 213 F.3d 1187 (9th Cir. 2000), cert. denied, 121 S. Ct. 1604 (2001); *Alexander v. Comm'r*, 72 F.3d 938 (1st Cir. 1995); *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995).

38. 263 F.2d at 125.

attorneys a right to the fees.³⁹ Alabama Code provides that “attorneys at law shall have the same right and power over said suits, judgments and decrees, to enforce their liens, as their clients had or may have for the amount due thereon to them.”⁴⁰ The existence of the Alabama attorney lien statute led the *Cotnam* court to conclude that Cotnam never had rights to amounts subsequently paid to her attorneys. Rather, the attorneys were the sole owners of that right to income throughout the lawsuit.⁴¹

In *Estate of Clarks v. United States*,⁴² the Sixth Circuit was presented with the question of whether Clarks’ gross income included the full interest award or whether he could exclude from his gross income the portion paid to his attorney. Clarks’ attorneys were paid pursuant to a contingency fee agreement initiated prior to the lawsuit, but the court allowed him to exclude from his gross income the portion of post-judgment interest that was paid to his attorneys.⁴³ The court reasoned that the assignment of income doctrine did not apply.⁴⁴ Rather, the court followed the rule applied in *Cotnam* and held that the Michigan attorney lien law was similar to Alabama’s.⁴⁵

Similarly, the Eleventh Circuit dutifully followed *Cotnam* by allowing the plaintiff in *Davis v. Commissioner*⁴⁶ to exclude a portion of the punitive damage award that was paid to the plaintiff’s attorneys under a contingency fee arrangement.⁴⁷ Although the court reached a verdict favorable to the plaintiff, it acknowledged that it was bound by *Cotnam* because it was required to adopt as binding precedent all the decisions of the former Fifth Circuit that were made prior to September 30, 1981.⁴⁸

The case of *Foster v. United States* presented an analogous situation.⁴⁹

39. *Id.*

40. *Id.* (citing ALA. CODE § 46-64 (1940)).

41. *Id.*

42. 202 F.3d 854 (6th Cir. 2000).

43. *Id.* at 857-58.

44. *Id.*

45. *Id.* at 856. In Michigan, the law regarding attorney liens is not statutory but exists under common law. *Estate of Clarks v. United States*, 98-2 U.S. Tax Cas. (CCH) ¶ 50,868 (E.D. Mich. 1998) (citing *George v. Gelman*, 506 N.W.2d 583, 585 (Mich. 1993)). Nevertheless, the Sixth Circuit found that the common law attorney lien in *Estate of Clarks* operated in more or less the same way as the Alabama lien law in *Cotnam*. *Estate of Clarks*, 202 F.3d at 856.

46. 210 F.3d 1346 (11th Cir. 2000).

47. *Id.* at 1348.

48. Fifth Circuit cases decided prior to September 30, 1981, can only be overruled by an en banc court. *Id.* at 1347 n.4.

49. *Foster v. United States*, 106 F. Supp. 2d 1234, 1239 (N.D. Ala. 2000), *aff’d in part, rev’d in part*, 249 F. 3d 1275 (11th Cir. 2001); *see also* *Srivastava v. Comm’r*, 220 F.3d 353, 364-65 (5th Cir. 2000) (holding that a portion of the settlement award payable to taxpayer’s attorneys under a contingent fee arrangement was not included in taxpayer’s gross income because the court was bound by *Cotnam*), *reh’g denied* (Sept. 19, 2000); *Griffin v. Comm’r*, 81 T.C.M. (CCH) 972 (2001) (following *Cotnam* and holding that a portion of the settlement award payable to taxpayer’s

There, the U.S. district court in Alabama followed *Cotnam*, and stated that until the court of appeals or Supreme Court ruled otherwise, *Cotnam* controlled its decision. Nonetheless, the court noted that “there are serious and legitimate questions” as to whether the decision should be followed and “[s]trong arguments can be made . . . that *Cotnam* is not consonant with Supreme Court decisions like *Horst*”⁵⁰ Despite the *Foster* court’s rhetoric, nonphysical injury plaintiffs whose claims arise in the Fifth, Sixth, and Eleventh Circuits can exercise some confidence that attorney fees awarded in their settlements or judgments may be excluded from their gross income.⁵¹ Yet, since neither the U.S. Supreme Court nor Congress has resolved the issue, such plaintiff taxpayers must weigh the risk carefully and should be advised by their attorneys that the tax outcome is by no means certain.

B. Cases Where Attorney Fees are Included, but Deductible

A number of courts have held that under the assignment of income doctrine,⁵² a plaintiff cannot assign the attorney fee portion of a settlement or judgment award and subsequently exclude that amount from his gross income. These cases allow the plaintiff to deduct the amount paid in legal fees in arriving at taxable income.⁵³ Nonetheless, these deductions are subject to the two percent floor rule for miscellaneous itemized deductions.⁵⁴ Furthermore, the amount deducted, if over a certain amount, will be subject to the alternative minimum tax (the “AMT”), under which the itemized deductions are not allowed.⁵⁵ This was a serious problem for the AMT taxpayer because it effectively prevents the taxpayer from being able to escape paying taxes on an amount he never received.⁵⁶ Despite the potential for unfair results in nonphysical personal injury

attorneys under a contingent fee arrangement should be excluded from taxpayer’s gross income under the assignment of income doctrine).

50. *Foster*, 106 F. Supp. 2d at 1239. In *Helvering v. Horst*, the court, applying the “fruit of the tree” doctrine, held that a taxpayer, who gifted negotiable interest coupons to his son before the coupon due dates, could not avoid income tax on such interest because the person who earns the income must be taxed upon it. 311 U.S. 112, 120 (1940).

51. See Timothy R. Koski, *Contingent Fee Paid to Attorney Can Be Income to Client*, 65 PRAC. TAX STRAT. 166, 169 (2000) (stating that plaintiffs “in the Fifth, Sixth, and Eleventh Circuits have the best chance of success” with regard to Service scrutiny); see also Banoff & Lipton, *supra* note 34, at 191 (stating that *Estate of Clarks* “provides authority (at least for taxpayers not located in the First or Federal Circuits) for purposes of avoiding potential penalties” under Code sections 6662 and 6694 [the article was issued prior to the Ninth Circuit decisions that followed the First and Federal Circuit]).

52. See *supra* note 36.

53. See I.R.C. § 162 (1994 & Supp. V 1999) (deduction for business expenses); *id.* § 212 (deductions for expenses in producing income).

54. *Id.* § 67 (1994).

55. *Id.* § 55 (1994 & Supp. V 1999).

56. *Id.* § 68. The floor is adjusted annually, if necessary, for inflation. In 1999, the threshold

cases, courts have sided with the Service and held that plaintiff taxpayers cannot exclude the amounts paid out in legal fees to obtain their settlements or judgments in such cases.

In *Alexander v. Internal Revenue Service*,⁵⁷ the First Circuit decided a case in which a plaintiff did not attempt to exclude legal fees, but rather deducted the fees in arriving at what the plaintiff characterized as capital gain income from the settlement.⁵⁸ The court held that the portion of damages from plaintiff's breach of contract settlement that were expended for attorney fees could not be properly subtracted in arriving at capital gain because the claim resulted in ordinary income to the plaintiff.⁵⁹ More important, the court held that the plaintiff's legal fees did not qualify as a reimbursed employee business expense.⁶⁰ Thus, the plaintiff was forced to take the deduction below the line, and be subjected to the two percent miscellaneous itemized deduction floor.

Similarly, in *Baylin v. United States*,⁶¹ the Federal Circuit ruled that a portion of the plaintiff's condemnation award paid to attorneys should be included in the taxpayer's gross income despite plaintiff's lack of actual possession of the proceeds.⁶² In *Fredrickson v. Commissioner*,⁶³ the Ninth Circuit in an unpublished opinion, held that a portion of the plaintiff's sex discrimination settlement damages paid to her attorneys could not be treated as a reimbursed employee business expense.⁶⁴ Despite the fee-shifting provisions in Title VII that force defendants to pay a prevailing plaintiff's attorney fees, the plaintiff in *Fredrickson* was forced to pay tax on amounts received by his attorneys.⁶⁵ A number of U.S. Tax Court cases have followed these cases, usually noting that the attorney lien statutes cited in their controversies differ from the Alabama

was \$126,600. See Rev. Proc. 98-61, 1998-52 I.R.B. 18. One interesting application of the AMT involves the tax treatment of former President Clinton's legal defense fund which, if included in his gross income, would leave \$2.25 million subject to AMT. See Lee A. Sheppard, *News Analysis—A Look at the Clinton and Gore Tax Returns*, 87 TAX NOTES 472 (2000).

57. See *Alexander v. Comm'r*, 72 F.3d 938 (1st Cir. 1995).

58. *Id.* at 940-41.

59. *Id.* at 944.

60. *Id.* at 946. Plaintiff sought to characterize the legal fees as reimbursed employee business expenses to obtain an "above the line" deduction, which would allow the plaintiff to deduct the entire amount and avoid paying tax on the taxable amount of two percent if characterized as a miscellaneous itemized deduction (i.e., a "below the line" deduction). The court determined that the legal fees were "properly deducted 'below the line.'" *Id.*

61. 43 F.3d 1451 (Fed. Cir. 1995).

62. *Id.* at 1455.

63. 166 F.3d 342, 1998 U.S. App. LEXIS 31964 (9th Cir. Dec. 21, 1998).

64. *Id.* at *3.

65. *Id.*; see also *Coady v. Comm'r*, 213 F.3d 1187, 1190-91 (9th Cir. 2000) (holding that under Alaska law, a portion of damage award used to pay attorney fees, although deductible as a miscellaneous itemized deduction, was included in taxpayers' gross income), *cert. denied*, 121 S. Ct. 1604 (2001).

statute.⁶⁶

One recent U.S. Tax Court decision, *Kenseth v. Commissioner*,⁶⁷ addresses the controversy over whether attorney fee awards in nonphysical personal injury settlements and judgments should be excluded from gross income. *Kenseth* was decided by a divided court, further highlighting the larger circuit conflict by showing that not only are the federal circuits at odds, but the judges of the tax court are as well.⁶⁸ The *Kenseth* majority held that a portion of a plaintiff taxpayer's settlement award used to pay attorney fees under a contingent fee arrangement must be included in his gross income.⁶⁹ According to the court, *Kenseth* and other plaintiffs could deduct legal fees as a miscellaneous itemized deduction.⁷⁰ However, the court's majority, applying the "fruit of the tree" doctrine, refused to allow a full deduction or exclusion.⁷¹ This continuing conflict among the federal circuits and within the tax court is disparaging for taxpayers who suffer from nonphysical personal injuries. Such taxpayers not only incur potential reductions in their recovery, but also are forced to have their claims litigated in an environment where the tax consequences to the plaintiff-taxpayer are unpredictable. This conflict requires immediate resolution. Doing so will increase recovery for nonphysically injured plaintiffs, and alleviate uncertainty in the calculation of plaintiff's income, while encouraging predictability and consistency in tax court decisions.

66. See, e.g., *Kenseth v. Comm'r*, 114 T.C. 26, 36 (2000), *aff'd*, 259 F.3d 881 (7th Cir. 2001); *Hukkanen-Campbell v. Comm'r*, 79 T.C.M. (CCH) 2122, *15 (2000) (distinguishing a Missouri statute to find that a portion of the damage award used to pay attorney fees, although deductible as a miscellaneous itemized deduction, was included in taxpayers' gross income); *Benci-Woodward v. Comm'r*, 76 T.C.M. (CCH) 787, 790 (1998) (distinguishing a California statute to find that a portion of the settlement award used to pay attorney fees, although deductible as a miscellaneous itemized deduction, was included in taxpayers' gross income); *Sinyard v. Comm'r*, 76 T.C.M. (CCH) 654, 658 (1998) (distinguishing an Arizona statute to find that a portion of the settlement award used to pay attorney fees, although deductible as a miscellaneous itemized deduction, was included in taxpayers' gross income); *Estate of Gadlow v. Comm'r*, 50 T.C. 975 (1968) (distinguishing Pennsylvania and Alabama statutes); *Petersen v. Comm'r*, 38 T.C. 137 (1962) (distinguishing Nebraska and South Dakota statutes). *But see Kenseth*, 114 T.C. at 38 (Beghe, J., dissenting) (finding that the majority courts' use of "narrow" state law analysis was flawed and "broader" consideration of whether plaintiff has substantial control over the attorney fee income should be dispositive); *O'Brien v. Comm'r*, 38 T.C. 707 (1962) (noting in dictum that state law was not dispositive).

67. *Kenseth*, 114 T.C. at 26.

68. *Id.* at 38.

69. *Id.* at 29.

70. See *id.* at 38.

71. *Id.* at 34.

II. RATIONALE FOR RESOLVING THE ISSUE AND SUGGESTED RESOLUTIONS

A. Rationale for Resolving the Issue

The present conflict in the federal circuit courts over whether a nonphysical personal injury plaintiff can exclude the portion of his award attributable to legal fees should be resolved immediately. The conflict could be resolved by eliminating the miscellaneous itemized deduction effect and the AMT result (i.e., by allowing legal fees in nonphysical personal injury settlements and judgments to be fully deductible or excludable). However, one must initially examine why the conflict should be resolved.

A solution is needed for a variety of reasons. First, the AMT consequences to plaintiffs were unforeseen and unintended by Congress and thereby create an unjust result. Moreover, even if AMT were not problematic, forcing plaintiffs to deduct the attorney fees subject to the two percent miscellaneous itemized deduction floor still produces an unjust result.⁷² Second, full deductibility or exclusion would promote accuracy and fairness for the plaintiff in nonphysical personal injury cases.⁷³ Third, full deductibility or exclusion would promote consistency and predictability for nonphysical personal injury plaintiffs and their attorneys. Fourth, full deductibility or exclusion would preserve the fee-shifting provisions of federal anti-discrimination laws.⁷⁴ Finally, adopting a solution would put an end to the incessant litigation generated by the current conflict.

1. *The Code's AMT and Miscellaneous Itemized Deduction Provisions.*—The AMT and miscellaneous itemized deduction consequences to nonphysical personal injury plaintiffs were unforeseen and unintended by Congress and thereby, create an unjust result to plaintiffs with an income in excess of \$128,950 (including damage awards from settlements or judgments).⁷⁵ One commentator, who has written about the inequities created by the current federal circuit conflict, provides the following illustration:

[A]ssume that a plaintiff, . . . John, sues his employer for claims arising under state law as well as the Federal Age Discrimination in Employment Act. John enters into a settlement agreement this year for \$1 million, and the award is deposited in a trust account of John's attorney, Anne. Assume that 60 percent, or \$600,000, of the award is paid to John from the account in 2000, and the remaining \$400,000 is paid to Anne under a contingent-fee contract entered into between Anne

72. Deborah A. Geier, *Some Meandering Thoughts on Plaintiffs and Their Attorneys' Fees and Costs*, 87 TAXNOTES 531 (2000) (arguing that Congress should amend the Code immediately so that attorney fees directly connected to an included settlement or litigation recovery are deductible "above the line").

73. Sager & Cohen, *supra* note 32, at 1104.

74. *Id.*

75. Rev. Proc 99-42, 1999-46 I.R.B. 568. The original amount at which the AMT was triggered was \$100,000 but is indexed for inflation annually. *Id.*

and John before the initiation of the litigation.⁷⁶

Under this scenario, if John must include the full \$1 million in his gross income, John had to resort to a deduction to avoid taxation on the \$400,000 paid to his attorney. Code sections 162 or 212 allow John to make such a deduction. However, these deductions, allowed under Code section 67, are considered miscellaneous itemized deductions.⁷⁷ That is, the deduction is taken below the line and subject to a two percent floor up to which the income will at least be taxed.

This categorization has two consequences for John under the regular tax system and will very likely trigger the AMT. First, under the regular tax system, John's \$400,000 is deductible only to the extent that it, along with his other miscellaneous itemized deductions within the meaning of section 67, exceeds two percent of his adjusted gross income. Therefore, a rather modest portion of the fees, equal to two percent (or \$20,000), becomes immediately nondeductible (if we assume, for the sake of simplicity, that this is John's only miscellaneous itemized deduction). Second, because John's adjusted gross income would clearly exceed \$128,950 in 2000 because of the award, his itemized deductions, including his deduction for attorneys' fees, will be reduced under section 68 by up to a whopping eighty percent under the regular tax system.⁷⁸

Thus, the miscellaneous itemized deduction rules force John to forfeit a significant amount of his recovery to pay taxes on income that was transferred immediately to his attorney. Not only did John not enjoy the benefits of the \$400,000, but his \$600,000 recovery will be further reduced because of the miscellaneous itemized deduction rules. Moreover, the AMT takes an even deeper cut out of John's recovery.

[T]he biggest consequence for people like John is not under the regular tax system but rather under the [AMT] system. Under the [AMT], section 68 is ignored (good news), but all allowable miscellaneous itemized deductions, including the \$ 380,000 on our assumed facts that remains deductible after applying section 67 only, must be added back to his tax base under the [AMT] (bad news). In other words, taxpayers with significant miscellaneous itemized deductions will see some of them become nondeductible under the regular tax system and, worse yet, will usually trigger the [AMT], under which no miscellaneous itemized deductions are allowable. Under the [AMT], in short, John can deduct none of his \$ 400,000 in attorneys' fees. Even though the marginal tax rate that applies to his tax base under the [AMT] is lower than would apply under the regular tax system, John is worse off because of the inability to deduct his \$ 400,000 attorney fee.⁷⁹

76. Geier, *supra* note 72, at 533.

77. I.R.C. § 67 (1994).

78. *Id.*

79. Geier, *supra* note 72, at 533 (footnotes omitted).

Thus, the AMT reduces John's recovery even further and, under a regime where John must include his entire recovery in his gross income, John pays an inordinate amount of income tax based on the inclusion of amounts received by his attorney, but not by him.

The loss to hypothetical John was not likely intended by Congress when it enacted the AMT⁸⁰ and certainly not when it authorized the fee-shifting provisions in the civil rights laws that allow plaintiffs to recover attorney fees in such civil rights claims.⁸¹ Congress enacted the AMT to "ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits."⁸² However, "discrimination plaintiffs are often penalized through operation of the AMT even though their 'substantial economic income' is the result of a one-time settlement or judgment, and only occurs because of the effects of obtaining a remedy for discrimination."⁸³

The rationale behind the AMT is simply inapplicable to plaintiffs seeking redress for wrongful discrimination committed by employers, lenders, or others because such plaintiffs are already forced to pay tax on their portion of recovery in a settlement or judgment. Under current law that does not allow nonphysical injury plaintiffs to exclude damages received for being wronged, a nonphysical injury plaintiff *does* incur a significant tax liability and *is not* permitted to avoid it by *exclusion*. Moreover, under current law, the plaintiff is unable to fully *use a deduction* given the constraints of Code section 67 and the AMT. Such results appear to be unintended by Congress because as enacted, the result depletes the awards to civil rights plaintiffs. Thus, the result should be avoided by making the attorney fees in such cases fully deductible or excludable from a nonphysical personal injury plaintiff's gross income.

2. *Promoting Accuracy and Fairness to Nonphysical Injury Plaintiffs.*—Full deductibility or exclusion would promote accuracy and fairness for the plaintiff in nonphysical personal injury cases.⁸⁴ Though the U.S. Tax Court in *Kenseth* declined to address tax policy considerations, leaving such authority to Congress, the court's majority, which disallowed exclusion of plaintiff's attorney fees, agreed that current legislation may result in "anomalous or inequitable results

80. STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 432 (Comm. Print 1987).

81. See discussion *infra* Part II.A.4.

82. See STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., *supra* note 80.

83. Brief of Amici Curiae Nat'l Employment Lawyers Ass'n et al., *Sinyard v. Comm'r*, 76 T.C.M. (CCH) 654 (1998); see also *Kenseth v. Comm'r*, 114 T.C. 399, 432 (2000) (Beghe, J., dissenting) (discussing that given the possibility that under the AMT a plaintiff could pay more in tax than he receives, Congress certainly did not expect or intend "that the interplay of the newly enacted itemized deduction and AMT provisions could result in effective rates of tax substantially exceeding 50 percent up to more than 100 percent of a net recovery"), *aff'd*, 259 F.3d 881 (7th Cir. 2001).

84. Sager & Cohen, *supra* note 32, at 1104.

with respect to particular taxpayers.”⁸⁵ Current tax law does render inequitable results with respect to nonphysical injury plaintiff-taxpayers who receive settlements or judgments and are forced to pay income tax on legal fees incurred to pursue their claims. “A full deduction or exclusion would provide a more accurate measure of the plaintiff’s income.”⁸⁶ Increasing the accuracy with which the plaintiff’s taxable income is determined achieves a basic goal of the tax law—taxpayers should pay no more or less than imposed by the Code.

3. *Promoting Consistency and Predictability of Tax Consequences.*—With respect to the tax treatment of attorney fees awarded in nonphysical injury settlements and judgments, greater consistency and predictability is needed on two levels: the tax treatment of such income should be consistent among the federal circuits, and the tax treatment of such income should be consistent despite differences in state attorney lien statutes.

First, full deductibility or exclusion of such attorney fees is needed to promote consistency and predictability among the federal circuits. Currently, plaintiffs and their attorneys are forced to wade through the muddled case law, where the facts in the reported cases are confusing and the analysis often takes anarchic turns.⁸⁷ The federal circuit split results in a landscape where nonphysical personal injury plaintiffs and their lawyers must attempt to predetermine tax consequences of settlements or judgments based not only on the law of the state wherein the transaction occurs,⁸⁸ but also on the federal circuit in which a potential appeal would lie.⁸⁹ Thus, plaintiffs and defendants in different jurisdictions are likely to anticipate different results and therefore act accordingly in planning and litigating these cases.

Second, the federal circuits that have allowed nonphysical injury plaintiffs to exclude attorney fee portions of settlements or judgments have done so in part based on the “vagaries of state law.”⁹⁰ It is not unusual for a federal tax treatment of certain transactions to be determined by state law. Examples include, but are not limited to the following: federal tax treatment of corporate mergers,⁹¹ federal tax treatment of the limited liability company (“LLC”),⁹² and

85. *Kenseth*, 114 T.C. at 415.

86. *Sager & Cohen*, *supra* note 32, at 1104.

87. *See* Robert W. Wood, *Attorney’s Fees: A Few More Observations*, 88 TAX NOTES 701 (2000) (stating that “[e]ven the holdings [of the circuit court cases] are confusing. . . . [T]he facts are literally all over the map . . . [and] not very good”).

88. Plaintiff must not only determine what attorney lien statutes exist in the state, but must also predict how those statutes will likely be interpreted by the courts.

89. Plaintiff must ask, are we in the plaintiff-taxpayer friendly Fifth, Sixth or Eleventh Circuit? Or, are we in the First, Ninth, or Federal Circuit, where the old assignment-of-income doctrine will likely bar our ability to exclude legal fees from the plaintiff-taxpayer’s gross income?

90. *Geier*, *supra* note 72, at 542.

91. The tax-free treatment of corporate reorganizations under Code section 368 depends, in part, on whether the reorganization complies with state laws regarding mergers (i.e., “statutory merger” requirements). At least one author argues that eligibility for such tax-free reorganizations should no longer depend upon state law. *See* Steven A. Bank, *Article: Federalizing the Tax-Free*

application of various federal gift and estate tax provisions.⁹³ However, the reliance of the courts on varying state laws with regard to federal tax treatment of attorney fees in nonphysical injury settlements and judgments has created an unpredictable and harsh tax result for a class of persons largely consisting of plaintiffs who are acting on behalf of all persons as “private attorneys general”⁹⁴ to enforce a host of anti-discrimination statutes.

The current inconsistency among the courts distorts outcomes in litigation because taxpayers, if effectively advised by their attorneys, will make decisions based in part on tax consequences. Although it may be proper for tax policy to provide incentives (or disincentives) for taxpayers to conduct transactions in a certain manner, tax policy should not conflict with other public policy goals.

For example, under the current tax regime, one problem with the quagmire surrounding settlements and judgments in civil rights violation suits is that plaintiffs may be discouraged from pursuing their cases. The fee-shifting provisions of the civil rights laws were intended to encourage private enforcement of civil rights.⁹⁵ However, even if an employment discrimination plaintiff, who is concerned with the tax consequences of his settlement, attempts to avoid adverse tax results by careful drafting of his settlement agreement,⁹⁶ he may face opposing counsel who refuses to allow an agreement that refers to the plaintiff’s portion as reimbursed employee expenses and attorney fees or who

Merger: Toward an End to the Anachronistic Reliance on State Corporation Laws, 77 N.C.L. REV. 1307 (1999).

92. The LLC is a “hybrid entity” that provides insulation from liability to the same extent as a corporation. See William P. Strong, 700-2nd I.1., Tax (BNA) (2001) (citing Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1 (1995)). For a list of states that have enacted LLC statutes, see Samuel P. Starr & Robert J. Crnkovich, *Limited Liability Companies*, 725-1st Tax. Mgmt. (BNA) IV.B. (2000); see also Bruce P. Ely & Christopher R. Grissom, *The LLC Scoreboard*, 81 TAX NOTES 1005 (Nov. 1998). LLC formation and operation depends upon state law authorization. All fifty states and the District of Columbia have some form of authorizing statute in place. See Katherine E. Ramsey Roose, *Like-Kind Exchanges and Real Estate Transfer Taxes: Making Hay from the Single-Member Limited Liability Company*, 18 VA. TAX REV. 665 (1999). In December 1996, the Service and the Treasury Department issued regulations that define how LLCs and other entities will be treated. Under these “Check-the-Box” Regulations, an LLC will be treated as a partnership for federal income tax purposes, unless it elects to be treated as a corporation. See Treas. Reg. §§ 301.7701-1-3.

93. Code section 2518 provides that federal and gift estate tax treatment of disclaimer of gifts and bequests depends on local law. See Mary Moers Wenig, *Disclaimers*, 848-1st Tax Mgmt. (BNA) IV-I (2000). Other federal estate and gift tax consequences that rely on varying state laws include: whether there is a right of survivorship, whether joint tenancy can be revoked by the person who created it, and the marital status of tenants. See Robert T. Danforth, *Taxation of Jointly Owned Property*, 823-1st Tax Mgmt. (BNA) I-C (2000).

94. See *infra* Part II.A.4.

95. See discussion *infra* Part II.A.4; see also *Quaratino v. Tiffany & Co.*, 166 F.3d 422 (2d Cir. 1999). See generally Sager & Cohen, *supra* note 32.

96. See Sager & Cohen, *supra* note 32, at 1101.

may require a premium for the result.⁹⁷ The possibility opposing counsel may act in such a manner is the result of the unsound tax policy created by the courts. The unequal treatment of civil rights plaintiffs and physical injury plaintiffs could, however, be resolved by a simple amendment to the Code that authorizes civil rights (and other nonphysical personal injury) plaintiffs to exclude or fully deduct attorney fees awarded in settlements or judgments.

4. *Preserving the Fee-Shifting Provisions of Anti-Discrimination Statutes.*— Full deductibility or exclusion of attorney fee awards would preserve the fee-shifting provisions of the federal anti-discrimination laws.⁹⁸ Congress has enacted a number of civil rights statutes aimed at eliminating discrimination.⁹⁹ The purpose of civil rights legislation has been to “provide real remedies to victims of discrimination,”¹⁰⁰ to entitle successful plaintiffs to have attorney fees paid by the losing defendant,¹⁰¹ and to encourage plaintiffs to further the end of discrimination via their attorneys acting as “private attorneys general.”¹⁰² Though beyond the scope of this Note, a compelling argument exists that civil rights laws are being undermined because *any* damages arising from nonphysical personal injuries are no longer excludable from a plaintiff’s gross income.¹⁰³

97. *Id.*

98. *Id.*

99. *See, e.g.*, Civil Rights Act of 1991 § 302, 2 U.S.C. § 1202 (1994 & Supp. V 1999); Congressional Accountability Act of 1995 §§ 201-07, 2 U.S.C. §§ 1311-17 (Supp. V 1999); The Fair Labor Standards Act of 1938, 29 U.S.C. §§ 201-19 (1994 & Supp. V 1999); The Employee Polygraph Protection Act of 1988, 29 U.S.C. §§ 2001-09; (1994 & Supp. V 1999); Age Discrimination in Employment Act of 1967 §§ 4, 15, 29 U.S.C. §§ 623, 633a (1994 & Supp. V 1999); Rehabilitation Act of 1973 §§ 501, 504, 29 U.S.C. §§ 791, 794 (1994 & Supp. V 1999); Employee Retirement Income Security Act of 1974 § 510, 29 U.S.C. § 1140 (1994); The Worker Adjustment and Retraining Notification Act, 29 U.S.C. §§ 2101-09 (1994 & Supp. V 1999); Family and Medical Leave Act of 1993 § 105, 29 U.S.C. § 2615 (1994); Civil Rights Act of 1964 §§ 703, 704, 717, 42 U.S.C. 2000e-2, 2000e-3, 2000e-16 (1994 & Supp. V 1999); Fair Housing Act §§ 804, 805, 806, 808, 818, 42 U.S.C. §§ 3604, 3605, 3606, 3608, 3617 (1994 & Supp. V 1999); Americans with Disabilities Act of 1990 §§ 102, 202, 302, 503, 42 U.S.C. §§ 12112, 12132, 12182, 12203 (1994 & Supp. V 1999); Violence Against Women Act of 1994 § 40302, 42 U.S.C. § 13981 (1994 & Supp. V 1999). The above statutes are some of those listed in Senate Bill 2887, Civil Rights Tax Fairness Act of 2000, that seeks to amend the Code to allow civil rights plaintiffs to exclude all damage amounts received on account of “unlawful discrimination” from their gross income. *See* S. 2887, 106th Cong. § 2 (2000).

100. 146 CONG. REC. S7160-03, *S7162-64 (statement by Sen. Grassley).

101. *Id.* (citing a letter from Victoria Herring, Attorney, to Charles Grassley, Senator, U.S. Senate and Tom Harkin, Senator, U.S. Senate (Nov. 30, 1999)).

102. *Id.*; *see also* Brief of Amici Curiae Nat’l Employment Lawyers Ass’n, et al. at 5, *Sinyard v. Comm’r*, 76 T.C.M. (CCH) 654 (1998) (citing *Newman v. Piggie Park Enterprises*, 390 U.S. 400, 402 (1968) for the proposition that fee-shifting provisions of civil rights laws encourage the victim of discrimination to act “as a ‘private attorney general’ vindicating a policy that Congress considered of the highest priority.”).

103. It seems unjustifiable to prevent plaintiffs from excluding such recovery from their gross

Nevertheless, at the very least, the Code should be amended to allow victims of civil rights violations to exclude (or fully deduct) the attorney fees portion of the award to avoid the consequences of the miscellaneous itemized deduction and the AMT combination that may render their award de minimus once attorney fees and taxes have been paid.¹⁰⁴

5. *A Plug for the Floodgates of Litigation.*—The solution advocated in this Note would put an end to the incessant litigation that arises from the current conflict. Exclusion or full deductibility of attorney fees awarded in nonphysical injury claims would encourage settlement. The current tax treatment of attorney fees fosters an environment wherein fewer claims are settled because plaintiffs have a “net” recovery in mind.¹⁰⁵ The attorney for a nonphysical injury plaintiff will of course seek this net recovery for her client. However, according to some courts’ interpretation of the Code, the tax treatment of the attorney fee portion of a client’s settlement forces the plaintiff to ask for more than would otherwise be offered in settlement negotiation. Thus, nonphysical injury plaintiffs and defendants are unable to settle claims as effectively because the tax consequences deplete a substantial portion of a civil rights plaintiff’s recovery.¹⁰⁶

“Because of the tax bite, businesses have to pay more or individuals have to take less to get settlements, or there are no settlements. A lot of cases are on the docket longer, and there are more trials.”¹⁰⁷ A plaintiff’s net recovery, once reduced by the tax consequences of the miscellaneous itemized deduction and the AMT leave “attorneys for both sides attempting to reach a solution that has become nearly impossible.”¹⁰⁸ Moreover, public policy favors the pre-trial

income. In so doing, Congress implies that unlawful discrimination is a less harmful or egregious personal injury than physical injury caused by negligence or some other tort. Congress’ 1996 decision to amend the Code that created the current prohibition is contrary to its thirty-year policy of providing remedies to victims of past and present discrimination. In summary, exclusion of damages arising from unlawful discrimination reinforces the intent of decades of civil rights legislation and allows fair and appropriate remedies for discrimination victims. *See* 146 CONG. REC. S7160-03 (statement of Sen. Grassley). *See generally* Sager & Cohen, *supra* note 32.

104. *See* Sager & Cohen, *supra* note 32, at 1104, where they argue that the tax law should be amended to permit civil rights plaintiffs either to deduct fully or exclude the portion of a civil rights recovery expended for attorney’s fees. The tax law should not be construed or constructed to overstate and overtax the income of civil rights plaintiffs and thereby subvert the national policy of ending unlawful discrimination.

See also Brief of Amici Curiae Nat’l Employment Lawyers Ass’n, et al. at 5, *Sinyard v. Comm’r*, 76 T.C.M. (CCH) 654 (1998).

105. Brief of Amici Curiae Nat’l Employment Lawyers Ass’n, et al. at 5, *Sinyard v. Comm’r*, 76 T.C.M. (CCH) 654 (1998).

106. Coyle, *supra* note 33, at A1.

107. *Id.* (quoting employment lawyer Frederick M. Gittes, a partner at Spater, Gittes, Schulte & Kolman in Columbus, Ohio).

108. Brief of Amici Curiae Nat’l Employment Lawyers Ass’n et al., *Sinyard v. Comm’r*, 76 T.C.M. (CCH) 654 (1998).

settlement of disputes.¹⁰⁹ This goal is frustrated by the current predicament imposed on nonphysical plaintiffs and defendants by the tax law. Amendment of the Code to allow full deduction or exclusion of the attorney fee portion of nonphysical injury awards would alleviate already heavy burdens imposed on the courts and reduce dockets by increasing incentive for parties to settle.

B. Suggested Resolutions

The foregoing discussion establishes that there is a conflict in the current federal tax law that leads to harsh and unjust results in income tax liability for nonphysical injury plaintiffs. Moreover, the conflict should be resolved for a number of important reasons. Assuming that the remedy to the federal circuit court split is to allow nonphysical personal injury plaintiffs to fully deduct or exclude the attorney fee portions of their recoveries, one must address the means by which the law should be corrected. More specifically, one must question whether the courts or Congress should resolve the controversy.

1. *A Resolution by the Courts.*—As previously discussed, the Fifth, Sixth, and Eleventh Circuits have fashioned a fair resolution—that the attorney fee portion of the plaintiff's damages should not be included in the plaintiff's gross income.¹¹⁰ However, these courts arrived at their result by means of state law—a somewhat tenuous ground because of the varying state attorney lien laws. The analysis used in those cases does not translate into a workable solution that can be applied in every case because attorney liens statutes differ immensely from state to state.¹¹¹

At least one commentator notes that in addition to the uneven application of state law, the distinctions between whether the plaintiff had control over or rights to attorney fee awards “should be meaningless.”¹¹² Essentially, under the assignment-of-income doctrine, control is the issue. For example, in *Cotnam*, the operation of the Alabama attorney lien statute led the court to conclude that Cotnam never had control over amounts subsequently paid to her attorneys. Rather, the attorneys were the sole owners of that right to income during the entire lawsuit. However, “[h]aving to pigeonhole the analysis into the ill-fitting assignment-of-income doctrine invites the creation of just such distinctions.”¹¹³ Cases applying the assignment of income doctrine demonstrate

how trying to resolve the problem favorably for the sympathetic class . . . can wreak havoc when application of that same doctrine in a case like *Baylin* would allow a taxpayer to effectively deduct a nondeductible capital expenditure. If, for example, a civil rights litigant succeeds in excluding the portion of the attorneys' fees paid to his attorneys, . . . no

109. *Id.* (citing 42 U.S.C. § 1981, 2000e-5(b) provisions regarding pre-litigation dispute resolution).

110. *See supra* note 36.

111. *See supra* note 66.

112. Geier, *supra* note 72, at 52.

113. *Id.*

grounds [exist] on which to differentiate the plaintiff in *Baylin*, who . . . should be denied deduction of the attorneys' fees (in favor of capitalization) and should not be able to avoid that result through the back door. Collapsing the "income" and "deduction" into a single-step "exclusion" can lead to results that would be wrong if we gave each step tax significance. Curing the problem on the deduction side of the ledger would ensure that only those attorneys' fees that are properly deductible (because they are "expenses" rather than "capital expenditures") would escape taxation.¹¹⁴

Thus, the courts' application of the assignment-of-income doctrine to exclude attorney fees awarded to nonphysical injury plaintiffs is inadequate to resolve the problem entirely. The inadequacy exists because the courts' analysis is based on varying state law and may be misplaced with regard to some plaintiffs who, although they have suffered nonphysical injury (e.g., condemnation of land), are actually expending nondeductible capital expenses to redeem value of lost capital gain.

The problems with *Cotnam* and its progeny do not stop there. Another commentator has noted that the courts' analysis in *Cotnam*,¹¹⁵ *Estate of Clarks*,¹¹⁶ and *Davis*¹¹⁷ "is incomplete because [they] failed to consider the implications of [Code section] 83."¹¹⁸ Code section 83 provides that property exchanged for services is disregarded for federal income tax purposes until the "substantial risk of forfeiture" lapses.¹¹⁹ The argument against *Cotnam* and its forebears is that once those courts determined that contingent fee arrangements operated to transfer a portion of a plaintiff's claim to his attorney via state attorney lien statutes, Code section 83 should have applied to the transfer. The substantial risk of forfeiture is created by the possibility that the attorney may be discharged or voluntarily withdraw from the case before settlement or judgment. However, the transfer does not take place until settlement or judgment, at which time the plaintiff transfers the attorney fee portion of his award to his attorney who includes that amount in his or her gross income. The plaintiff may deduct the attorney fees under Code sections 83 and 162.¹²⁰ This view asserts that the

114. *Id.* (footnotes omitted).

115. 263 F.2d 119 (5th Cir. 1959).

116. 202 F.3d 854 (6th Cir. 2000).

117. 210 F.3d 1346 (11th Cir. 2000).

118. Gregg D. Polsky, *Taxing Contingent Attorneys' Fees: Many Courts Are Getting It Wrong*, 89 TAX NOTES 917 (2000); see *supra* notes 36-37 and accompanying text (arguing that the courts in those cases reasoned that nonphysical injury plaintiffs could exclude from their gross income attorney fees awarded in settlements or judgments because the attorney lien statute in the relevant states gave attorneys rights to their fees and thus, the assignment-of-income doctrine could not be applied to force plaintiffs to include attorney fees in their gross income).

119. I.R.C. § 83 (1994).

120. In the case of transfer of property in connection with the performance of services, Code section 162 allows the individual for whom the services were performed, a deduction in the amount

attorney fee award should not be excluded from the plaintiff's income. Rather, the entire settlement or judgment amount is included in plaintiff's gross income, subject to deductions allowed by Code sections 83 and 162.¹²¹

Therefore, if the federal circuits are either "getting it wrong" or cannot reach a consensus because of the vagaries of state law, a resolution from the nation's highest Court would be helpful. However, a decision from the Supreme Court would not be the most desirable solution because the issue would likely be resolved based upon the court-made doctrines that have aided in creating the problem.¹²² Regardless, such a decision may be long in coming.¹²³

A second view that involves a court-made resolution was suggested by U.S. Tax Court Judge Beghe in his *Kenseth* dissent.¹²⁴ Judge Beghe argues that the courts can and should resolve the conflict. He argues that because court-made law¹²⁵ has contributed to the problem, courts have the authority to ameliorate the conflict. In light of *Cotnam* and its progeny, Judge Beghe distinguishes two separate grounds upon which the courts could resolve the issue of the excludability of attorney fees in nonphysical injury settlements and judgments. One is the "narrow ground," namely that state attorney lien statutes are interpreted to decide the outcome of the federal income tax treatment of income for non-physical injury plaintiffs.¹²⁶ The other is the "broader ground," namely that the contingent fee plaintiff lacks substantial control over the attorney fee income to include it in his gross income.¹²⁷ The latter view avoids the anomaly created by the application of varying state laws to decide such a fundamental federal income tax consequence. Since the broader ground avoids state law application, it would at least provide a resolution that could be applied in every case. Judge Beghe points out that the narrower ground makes a determination

equal to the amount included in the gross income of the person who performed such services. *Id.* § 83(h). Code section 162 defines a deduction for ordinary and necessary expenses used in trade or business. Of course, this is a "below the line" deduction subject to the two percent floor and thus, the plaintiff does not get to fully deduct the amount paid to his attorney. *Id.* § 162 (1994 & Supp. V 1999).

121. "The result would be the same even under the Sixth Circuit's partnership theory." Polsky, *supra* note 118, at 55.

122. See Geier, *supra* note 72, at 76.

123. See Robert W. Wood, *Even Tax Court Itself Divided on Attorneys' Fees Issue!*, 88 TAX NOTES 573 (2000).

124. *Kenseth v. Comm'r*, 114 T.C. 399, 421 (2000), *aff'd*, 259 F.3d 881 (7th Cir. 2001) (Beghe, J., dissenting).

125. Application of the assignment-of-income doctrine forces nonphysical personal injury plaintiffs to pay income tax on the portion of their awards paid for legal fees. Since the doctrine is not mandated by the Code and was created by the courts, tax controversies can be properly settled without its application. Furthermore, Judge Beghe argues that the assignment-of-income doctrine is outdated and applies to a limited amount of cases. Thus, the assignment-of-income doctrine should not extend to cases involving personal injury litigation. *Id.*

126. *Id.* at 433-38.

127. *Id.* at 438-42.

based on “attenuated subtleties” and “refinements” of state law that should be disregarded.¹²⁸ Whereas, the broader ground, where one asks whether the plaintiff in contingent fees cases ever “controlled” the income, provides a more appropriate means to achieve the same result.

However, the broader ground only applies to contingent fee arrangements because it is based on the plaintiff’s control over the award received. In a contingent fee arrangement (versus a flat fee or by the hour fee arrangement), the plaintiff relinquishes control of the funds from the beginning of the litigation. Although the vast majority of nonphysical personal injury plaintiffs are likely to use the contingent fee arrangement to pay for legal services, the few plaintiffs that pay via a flat fee or by the hour “slip through the cracks” and are unable, under Judge Beghe’s approach, to exclude attorney fees recovered when they are awarded a judgment or reach a settlement. Moreover, as previously discussed, the distinction between *how* the plaintiff pays for his attorney should be irrelevant.¹²⁹

Despite the courts’ apparent ability or authority to resolve the issue entirely, the courts may not represent the best means for resolution because it may be difficult for the courts to articulate a rule of broad applicability for all nonphysical personal injury cases. Congress, however, as the creator and amender of the Code, does have the ability to prescribe a direct solution to the arbitrary tax impact of the Code on nonphysical personal injury plaintiffs awarded attorney fees in settlements and judgments.

2. *A Resolution from Congress – Amending the Code.*—There are at least three ways in which the federal circuit conflict could be resolved by Congress’ amending of the Code. First, if Congress decides to act on the basis that the conflict is a “deduction” issue and not a “gross income” issue, the circuit split could be resolved by amending Code section 67¹³⁰ to add “attorney fees paid under Code sections 162¹³¹ or 212¹³²” to the list of exceptions not subject to the two percent floor for miscellaneous itemized deductions.¹³³ Alternatively, the split could be resolved by adding “attorney fees paid under Code sections 162 or 212” to the list of “above the line” deductions listed in Code section 62.¹³⁴

Second, the federal circuit conflict could be resolved, at least for civil rights plaintiffs, if Congress were to pass, and the President were to sign, Senate Bill 2887.¹³⁵ This proposed bill may largely reconcile the current conflict because the

128. *Id.* at 428, 432.

129. *See supra* note 124.

130. I.R.C. § 67 (1994).

131. *See id.* § 162 (1994 & Supp. V 1999) (defining “below the line” deduction for trade and business expenses).

132. *See id.* § 212 (defining “below the line” deduction for production of income expenses).

133. Geier, *supra* note 72.

134. *Id.*

135. *See* S. 2887, 106th Cong. § 2 (2000). The last action taken on Senate Bill 2887 as of this writing was that it was referred to the Senate Finance Committee. Its companion bill, House Bill 1997 is also in committee.

most frequent context in which this issue has arisen is the civil rights arena, particularly, employment discrimination.¹³⁶ Moreover, this proposed bill would allow civil rights victims to exclude their entire recovery, twice their gross income, a practice which would be consistent with our nation's policy against unlawful discrimination.

Third, the circuit conflict could be resolved by amending Code section 104 to exclude from gross income attorney fees that are awarded as part of a judgment or settlement for nonphysical injury. Such an amendment would satisfy a variety of needs. First, it would eliminate confusion and potential abuse that would be incurred by amending the Code sections concerning deductions. Second, as a matter of principle, the amount paid to attorneys should not be included in the gross income of a plaintiff who had no control over such income and never received the income. Additionally, such an amendment would reinforce the intent of civil rights statutes by at least allowing such plaintiffs to exclude attorney fees. Finally, the amendment would put an end to the ongoing litigation that arises out of these tax controversies. Furthermore, the burden to prove an exclusion remains with the taxpayer.¹³⁷

III. THE BEST RESOLUTION TO THE FEDERAL CIRCUIT COURT SPLIT

The federal circuit court conflict can be best resolved by a Congressional amendment to Code section 104. The bill would simply amend Code section 104 to exclude "amounts received (whether by suit or agreement) by a claimant on account of nonphysical personal injury that are designated for and actually paid as attorney fees for services that related to the suit or agreement."¹³⁸

136. *Coady v. Comm'r*, 213 F.3d 1187 (9th Cir. 2000) (wrongful termination), *cert. denied*, 121 S. Ct. 1604 (2001); *Alexander v. Comm'r*, 72 F.3d 938 (1st Cir. 1995) (breach of contract and age discrimination); *Kenseth v. Comm'r*, 114 T.C. 26 (2000) (age discrimination), *aff'd*, 259 F.3d 881 (7th Cir. 2001); *Hukkanen v. Comm'r*, 79 T.C.M. (CCH) 2122 (2000) (sex discrimination); *Sinyard v. Comm'r*, 76 T.C.M. (CCH) 654 (1998). (wrongful discharge). *Cf. Davis v. Comm'r*, 210 F.3d 1346 (11th Cir. 2000) (fraud, conspiracy and breach of contract); *Estate of Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000) (physical injury case in which issue was whether interest on attorney fees was excludable); *Baylin v. Comm'r*, 43 F.3d 1451 (Fed. Cir. 1995) (protest of condemnation); *Cotnam v. Comm'r*, 263 F.2d 119 (5th Cir. 1959) (breach of contract).

137. *Townsend v. United States*, 143 F. Supp. 150 (S.D. Ill. 1956).

138. The following is a draft bill that, if enacted, would end the entire controversy created by the federal circuit court conflict:

A Bill to amend the Internal Revenue Code of 1986 to exclude from gross income amounts received on account of claims based on nonphysical personal injury that are designated attorney fees.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the 'Tax Fairness to Plaintiffs Act of 2001.'

SECTION 2. EXCLUSION FROM GROSS INCOME FOR AMOUNTS RECEIVED

Several members of Congress and a number of commentators agree that the current tax law has created an unintended and egregious tax consequence for nonphysical injury plaintiffs. That consequence exists because of the courts' contradicting positions regarding the excludability of attorney fee portions of damage awards from plaintiffs' income. The problem is undeniable and obvious, as demonstrated by the first example discussed in this Note. However, there are disagreements over how to resolve the current controversy.

Unless the U.S. Supreme Court were to grant certiorari to a prototypical case and apply the reasoning of the Fifth, Sixth and Eleventh Circuits, the problem will not be resolved correctly by the courts. However, even if the Court did grant certiorari and apply the reasoning of those courts, the analysis by those courts is arguably questionable.

The solution, therefore, lies with Congress. In 1996, Congress created the problem when it enacted the Small Business Jobs Protection Act, which included an amendment that followed opinions by the Supreme Court suggesting damages from nonphysical injuries should not be excludable from gross income for federal income tax purposes. The amendment proposed by this Note would allow Congress to correct its harmful and unintended tax consequence to nonphysical personal injury plaintiffs.

The following explains the reasons for each of the operative words in the proposed Code amendment.

First, "claimant" has the same meaning as it does for other purposes within Code section 104. "Claimant" refers to individuals who have brought a cause of action against another individual. Second, the term "nonphysical" is a necessary term because the entire problem discussed in this Note stems from the distinction Congress made in 1996 by amending Code section 104 to only allow an exclusion for "physical" personal injury. Thus, the term "nonphysical" injury refers to those causes of action that are not physical in nature (e.g., civil rights claims, breach of contract, and fraud). Third, the term "personal" is used to indicate that the exclusion is provided for those nonphysical injuries to a person, not a person's property. This distinction should put to rest any concern with those plaintiffs seeking recovery of injury to property (e.g., the nondeductible capital expenditures cases like *Baylin*).

Lastly, the term "injury" refers to harm caused to the claimant. Harms such as breach of contract, fraud, or discrimination are just as harmful to individuals as physical harms. In addition, there is a strong public policy against discrimination. For these reasons, the tax implications of physical and

ON ACCOUNT OF NONPHYSICAL PERSONAL INJURY

- (a) IN GENERAL. – Section 104 of the Internal Revenue Code of 1986 (relating to compensation for injuries or sickness, an item specifically excluded from gross income) is amended by inserting the following clause set forth in (b) after section 104(a)(5):
- (b) EXCLUSION. – "(6) amounts received (whether by suit or agreement) by a claimant on account of nonphysical personal injury that are designated for and actually paid as attorney fees for services related to the suit or agreement."

nonphysical injury settlements and judgments should be the same. Moreover, all laws, including the tax code, should not undermine these policies that have done so much to improve the fabric of our nation and mend past discrimination while preventing and discouraging future discrimination in any form.

CONCLUSION

There are two points to be made regardless of whether, how, or to what extent this controversy is resolved. First, parties, and especially lawyers, on both sides of nonphysical personal injury litigation need to be aware of the current federal circuit court conflict and the impact it can have on settlements and judgments. The tax ramifications are real and, for better or worse, can and will be used to impact negotiations. Understanding the tax consequences associated with such settlements and judgments improves the ability of lawyers on both sides to handle settlement negotiations and, in turn, to provide better representation to their clients. Second, plaintiffs' lawyers handling nonphysical personal injury cases have a special obligation to inform their clients about the tax consequences involved. Plaintiffs' attorneys cannot ignore the Code's impact on settlements or judgments. Moreover, an attorney has the professional responsibility to help her client understand how the Code will affect his tax liability and his "net" recovery in settlement or judgment.

The present discussion exploring the best manner to alleviate the disparaging federal circuit court conflict over the deduction of attorney fees from a nonphysical personal injury plaintiff's gross income is, by its very nature, academic. Only action by the courts or Congress will redeem the faulty and unsound tax policy created by Code section 104 and the courts' interpretations of this portion of the Code. However, Congress, rather than the courts, should be the "final arbiter" of this conflict. It should amend Code section 104(a) so to exclude "amounts received (whether by suit or agreement) by a claimant on account of nonphysical personal injury that are designated for and actually paid as attorney fees for services related to the suit or agreement."

