

Inclusion of Attorney Fees in Taxpayer Gross Income under *Commissioner v. Banks*: Can You Afford to Ignore "Bracket Creep?"

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A. The Problem.

You file a defamation and interference with contract case in behalf of a woman against her former employer for giving slanderous information to subsequent prospective employers. You spend a year on discovery and come up with enough evidence of malice to overcome the former employer's defense of qualified immunity. The case then proceeds to mediation with no great expectations on your part. However, at the end of the day, there's \$175,000 on the table, and you think that's enough to forego your chances at trial. Before you call the mediator back in to tell him you accept, your client turns to you and says, "This is taxable, right? After your 40 percent, my share is down to \$105,000. How much of that money do I actually get to keep?" You quickly respond, "I'm not a tax lawyer. You'll have to discuss that with your CPA. All I know is that you won't get to keep all of it."

You settle the case, give the client a check for \$105,000 and yourself a check for \$70,000. A year later, she's back in your office with her tax bill: \$45,500. If that bill is right, then your client has netted out only \$59,500, about a third of the total recovery. "If you had told me this was going to happen, I never would have accepted that \$175,000 settlement."

B. What Went Wrong?

Let me introduce myself: I am the cold, hard truth, also known as the Alternative Minimum Tax (AMT) and *Commissioner of Internal Revenue v. Banks*, 125 S.Ct. 826 (2005). Back in the 70's, when \$175,000 was a lot of money, Congress enacted AMT to require anybody making that much money to pay 26 percent of it in taxes, with only a few specified deductions. *Banks* requires inclusion in the taxpayer's gross income of non-personal injury lawsuit recoveries, including attorney's fees. Although she paid you \$70,000, and although you paid taxes on that, she still had to pay taxes of 26 percent on the whole \$175,000. That's how her tax bill came to \$45,500, and how she ended up with \$10,500 less than you got, and she's mad. Can you blame her?

C. Partial Solution: The Civil Rights Tax Fairness Act.

As part of the American Jobs Creation Act of 2004, 118 Stat. 1418, Congress amended the Internal Revenue Code, 26 U.S.C., by adding Section 62(a)(19) excluding from a taxpayer's gross income "attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination."

The Act also contains a kind of punch list in Section 16(e) attempting to list all federal laws protecting any employment rights. 26 U.S.C. § 62(e)(1) through (17). Subsection (18) is a catchall covering any federal, state, local law, or common law providing for enforcement of civil rights or regulating any aspect of the employment relationship including terms and conditions of employment, discharge and discrimination, and retaliation or reprisal.

D. Problem Number One.

The Supreme Court noted in *Banks* that the saving statute is not retroactive. Therefore, it applies only to recoveries occurring on or after October 22, 2004. Wood, "Supreme Court Attorney Fees Decision Leaves Much Unresolved," *Tax Notes*, February 14, 2005, p. 793-794. The IRS is now free to go after taxpayers for deficiencies if they fail to pay taxes on the attorney's fee portions of their awards. This includes a lot of people here in Texas, one of the "good Circuits," which formerly held attorney's fees not includable in gross income. *Cotnam v. Commissioner*, 263 F.2d 119, 125-126 (5th Cir. 1959); *Srivastava v. Commissioner*, 220 F.3d 353, 363-365 (5th Cir. 2000).

E. Problem Number Two.

A few claims, some of them employment related, will be difficult to pigeonhole into the IRS definition of employment discrimination: defamation, false imprisonment, intentional or negligent infliction of emotional distress, and insurance bad faith. Wood, *supra*, p. 795. Unfortunately, these "employment torts" are among the most lucrative causes of action, since they are not subject to any of the damage caps customarily found in employment discrimination statutes.

F. Possible Solutions.

1. Effective Date of the Civil Rights Tax Relief Act.

The Act applies to judgments and settlements "occurring" after October 22, 2004. Wood, *supra*, p. 795. What does it mean for a judgment to "occur?" If it means to become final, then judgments on appeal as of October 23, 2004, might not be considered to have "occurred." The safest way for a plaintiff to bring the case within the Act while the appeal is pending, however, is to settle it, because then the settlement occurs after the effective date of the Act.

2. Loopholes in the Banks Opinion.

The taxpayers and their amici proposed three alternative theories for the first time in the Supreme Court: (a) treatment of a contingent fee agreement as a Subchapter K partnership under 26 U.S.C. §§ 702, 704, and 761; (b) treat the cause of action as property and litigation recovery as proceeds from disposition thereof, so the attorney fees could be subtracted as a capital expense under §§ 1001, 1012, and 1016 of the Code; and (c) treat the attorney fees as deductible reimbursed employee business expenses under § 62(a)(2)(A).

The Supreme Court expressly declined to consider those issues. Also, during oral argument, several of the justices, especially O'Connor, raised concerns about constitutional questions arising from confiscatory taxation of money not actually received by the taxpayer. Wood, *supra*, p. 793. All of these might be fruitful areas for future appeals.

The Court also expressed concerns about recoveries under fee-shifting statutes, in language suggesting that it might revisit this issue with a proper set of facts:

"In the federal system statutory fees are typically awarded by the court under the lodestar approach, and the plaintiff usually has little control over the amount awarded. Sometimes, as when the plaintiff seeks only injunctive relief, or when the statute caps plaintiffs' recoveries, or when for other reasons damages are substantially less than attorney's fees, court awarded attorney's fees can exceed plaintiff's monetary recovery. Treating the fee award as income to the plaintiff in such cases, it is argued, can lead to the perverse result that the plaintiff loses money by winning the suit. Furthermore, it is urged that treating statutory fee awards as income to plaintiffs would undermine the effectiveness of fee-shifting statutes in deputizing plaintiffs and their lawyers to act as private attorneys general."

125 S.Ct. at 834 [citations omitted].

However, the Court found it unnecessary to address this issue, because the plaintiff had settled his claim for a gross amount, with no court-ordered fee award or any indication that the contingent fee was paid in lieu of statutory fees. *Id.*

The subject of fee shifting is significant under Texas law, which has 265 fee-shifting statutes. *O'Connor's Civil Practice & Remedies Code Plus*, (Jones McClure Publishing 2004-2005), pp. 148-163. In any fee-shifting case, the settlement should specify the amount of attorney's fees, require separate payment directly to the attorney, and state that the fees are in lieu of those provided by the applicable fee-shifting statute.

3. Flexibility of the IRS Definition of Unlawful Discrimination.

Subsection (e)(18) includes any statutory or common law claim "for the enforcement of civil rights," or "regulating any aspect of the employment relationship." You can argue that freedom from defamation, false imprisonment, and infliction of emotional distress are all "civil rights," and the common law prohibiting them regulates various aspects of the employment relationship.

4. Tell it to the Jury.

Section 18.091 of the Civil Practice & Remedies Code now provides, somewhat inconsistently, that the jury hear evidence of net loss after taxes and that the court instruct whether the recover is taxable. If you put on an expert (usually one of your friends will oblige) to testify about the *Banks* decision, you can then argue that the jury needs to give the plaintiff more money to make him whole.

G. Further Reading.

Robert W. Wood, *Taxation of Damage Awards and Settlement Payments*, Third Edition (2005), published by Tax Institute, 639 Front Street, 2nd Floor, San Francisco, CA 94111, fax 415-834-1888, email info@taxinstitute.com. [Author receives no consideration for this promotion.]