DEDUCTIBILITY OF ATTORNEYS' FEES: HALF A LOAF?[1]

by Robert W. Wood

It is now well-known that most lawsuit proceeds received by way of settlement or judgment represent taxable income. Logic suggests that all expenses to achieve this income (such as lawyers' fees and costs) would be deductible against that income. Of course, logic and taxes are bedfellows all too infrequently. They certainly are estranged here.

Indeed, a majority of circuit courts have said that a plaintiff cannot simply offset the legal fees against a recovery. Instead, the plaintiff must generally include in income the gross recovery, including contingent lawyers' fees — even if the lawyers' fees are paid directly (and solely) to the contingent fee lawyer. Then, the plaintiff can deduct the lawyers' fees, but usually only as a miscellaneous itemized deduction. As a miscellaneous itemized deduction, the lawyers' fees will be deductible only to the extent the aggregate of such deductions exceeds 2% of the plaintiff's adjusted gross income. Even after taking this haircut, there are overall limits on the total amount of itemized deductions that an individual is allowed.

Finally, and usually most significantly, the alternative minimum tax allows no deduction at all for miscellaneous itemized deductions. That means that a recovery for discrimination (or some other unlawful conduct) oftentimes incurs the wrath of a significant tax bite, a tax on the lawyers' fees even through the plaintiff's lawyer will also pay tax on the same dollars. In some cases, the plaintiff ends up owing more in tax than he or she recovers. How is this possible?

It is possible depending on the size of a settlement or judgment, and because of the amount of attorneys' fees that may be paid. Even where the attorneys' fees only represent 33% or 40% (a modest contingent fee by today's standards), the limitations on deductions (and particularly the AMT) can be horrible in application. Where the attorneys' fees climb beyond 50%, the drama gets even more pronounced.

For example, an often cited New York Times article told the story of a Chicago police officer who won a sex discrimination suit, only to find that her recovery resulted in her having to pay $99,000 in extra taxes (so she actually lost money on the suit). Admittedly, this rather extraordinary circumstance may not occur too frequently. In this particular case, the plaintiff only received $300,000 in a trial, but was awarded $950,000 in attorneys' fees and legal costs. This fee award ended up incurring a huge tax liability, and the fees all went to her attorney. (The attorney, of course, also had to pay tax.)

But the tax system treats that amount as the plaintiff's income, to be allowed only as a deduction (and again, only as a miscellaneous itemized one). While a taxpayer actually owing money out-of-pocket to pay taxes on a settlement or judgment may be unusual, taxpayers who end up with only ten or fifteen percent of their recovery after taxes are not uncommon. One question with this kind of unjust and messy circumstance is when the law will change. It now appears that the law may change, though I am not convinced that it will be fully and finally correct.

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The Senate version of the Jobs and Growth Tax Relief Reconciliation Act of 2003, contained a provision that would have helped (although not entirely eliminated), these problems. (The House bill had no provision, and the bill as passed followed the House.) Cast as a new type of above-the-line deduction, the Senate bill would have applied only to certain kinds of lawsuits. The bill would have added Section 223, providing an above-the-line deduction for the portion of amounts received by individuals on account of claims of unlawful discrimination which is attributable to attorneys' fees and costs.

The Senate bill defined "unlawful discrimination" by reference to a long laundry list of laws providing for employment claims. Specifically enumerated are: (1) the Civil Rights Act of 1991; (2) the Congressional Accountability Act of 1995; (3) the Fair Labor Standards Act of 1938; (4) the Age Discrimination in Employment Act of 1967; (5) the Rehabilitation Act of 1973; (6) the Employee Retirement Income Security Act of 1974; (7) the Education Amendments of 1972; (8) the Employee Polygraph Protection Act of 1988; (9) the Worker Adjustment and Retraining Notification Act; (10) the Family and Medical Leave Act of 1993; (11) Chapter 43 of Title 38 (relating to employment rights of uniformed service personnel); (12) §§1981, 1983 and 1985 cases; (13) the Civil Rights Act of 1964; (14) the Fair Housing Act; (15) the Americans With Disabilities Act of 1990; (16) Violence Against Women Act; (17) the False Claims Act; or (18) any provision of federal law prohibiting the discharge of an employee, discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking actions permitted under federal law.

It is item 18 (the last one) in the list that may be most worth noting, since it covers recoveries pursuant to any provision of state or local law (or common law claims permitted under federal, state or local law), providing for the enforcement of civil rights or regulating any aspect of the employment relationship, including prohibiting the discharge of an employee, discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking actions permitted by law. This is a catchall surely, but is it really a catchall, or should its moniker be more accurately a catchsome?

Like many lists, this list is notable for what it does not include. It does not include a variety of types of causes of action that occur outside the employment context and for which attorneys' fee relief has apparently (if this language sticks) been denied. These omitted causes of action would include defamation, false imprisonment, negligent or intentional infliction of emotional distress, wrongful adoption, invasion of privacy, etc. Another common cause of action these days relates to investment losses. If you sue your broker and recover for his churning activity and bad investment advice, you may recover an amount in damages, but may not be able to effectively deduct your attorneys' fees.

Here, perhaps the recovery will be capital, so legal fees might constitute an offsetting capital loss. But if the recovery is ordinary income (as the IRS is want to argue), the legal fees may be caught by the alternative minimum tax. Suppose you are defamed in your local newspaper (perhaps you are called a child molester, ruining your personal and business life). Because of the unlawful activity of the newspaper, you suffer severe losses. When you recover damages, you will be subject to the whipsaw of the tax treatment of attorneys' fees. Why should you be treated less favorable than someone who recovers in one of the enumerated types of employment actions?

The answer may lie in detailed and thoroughly debated policy considerations. If such policy decisions are the subject of such a debate, then so be it. Unfortunately, I am not convinced that such detailed and thorough policymaking is going on.

Other Employment Cases

Even if one answers my questions about defamation (and other nonemployment cases of action), I have more fundamental objections to this language. Clearly, fixing the attorneys' fee problem in any significant group of cases is better than nothing. Still, consider the other employment actions that this will not address.

The bill refers to a laundry list of discrimination claims, with a kind of catchall (or catchsome!) category at the end. Nevertheless, employment lawyers tell me that many employment cases they bring are not true discrimination cases at all, cases that they believe will not fall within the group of claims enumerated in the bill. A plaintiff may sue his or her employer for wage claims, benefit claims, overtime claims, etc., in an action not brought under one of the enumerated statutes. That employee/plaintiff may end up with a serious attorneys' fee tax problem, but find no relief in the bill. Is this fair?

Consider ERISA claims. ERISA, which applies to pension and welfare benefit cases, preempts state law. Of course, the bill enumerates ERISA cases as one of the cases to which the attorneys' fee fix applies. Yet, the bill refers to ERISA cases under Section 510 of ERISA. That section deals with discrimination claims. That section, employment lawyers tell me, is nearly impossible to use under current case law and, in any case, accounts for only a very tiny fraction of successful ERISA claims.

The more typical ERISA claim is one for benefits (pension or long-term disability, for example). It doesn't appear that these claims are included within the enumerated "good claims" in the Senate bill. Thus, attorneys' fees in such cases would continue to incur the wrath of the "bad" (meaning decided for the government) circuit court decisions that claim that the client has income even where the lawyer gets the fees directly.

Overtime pay is another example of the problem. Overtime pay claims are generally not regarded as discrimination claims. At the same time, the bill seems to suggest that any unlawful act which is pursued under the Fair Labor Standards Act should give rise to relief (the above-the-line deduction for attorneys' fees in such a case). The term "discrimination" will likely be narrowly interpreted by the IRS. That would suggest that only true discrimination claims under the FLSA (such as retaliation claims and Equal Pay Act claims) would qualify.

More fundamentally, even if a deduction applies to fees incurred in any Fair Labor Standards Act Claim (including overtime and minimum wage cases), there is no reference in the Senate bill to deducting fees incurred in overtime/wage cases brought under state laws. As in so many areas of the employment law, state laws on overtime/wage cases are far more widely used today than the federal statute.

Of course, one can argue that the catchall at the end of the Senate bill provision would bring many cases under its rubric. This meant-to-be-catchall might be helpful in some cases (and perhaps even in state law overtime cases). Nonetheless, I continue to hear concern that this entire provision will be read as being limited to discrimination-type cases, thus excluding from its scope overtime, minimum wage, or benefit cases.

Different Strokes

The attorneys' fee quandary has been much-debated, and there were different approaches possible. The Internal Revenue Service and the courts have struggled with this issue, and some within the Internal Revenue Service are even sympathetic to the plight of plaintiffs who get tagged

with attorneys' fees they never see. When you consider that attorneys' fees may be 40% or 50% but sometimes are much higher (I have seen contingent attorneys' fees as high as 73%), the problem is manifest.

Still, the Internal Revenue Service doesn't believe it has the authority to fix this problem. And, at least some courts have struggled with this problem, as witness the violent split in the circuits. With a winnowing number of courts yet to face these issues, though, and the way in which the majority of circuit court cases have gone in favor of the government and against taxpayers, a legislative solution is needed.

I have always believed that a netting approach would be preferable, so that the amount of gross income is only the net amount received. Unfortunately, the Internal Revenue Service has theoretical objections to this (at least from what I've heard), and exclusions have generally not fared well in the legislative process. The Civil Rights Tax Relief Act of 2003 (H.R. 1155) had proposed such an exclusion, but the Senate bill (the Jobs and Growth Reconciliation Tax Act of 2003), opted for a deduction above the line rather than exclusion. As noted, the House had no provision, and no relief was passed.

Of course, had the Senate bill passed, it's deduction would have had the effect of obviating the miscellaneous itemized deduction rules (2% plus phaseout), as well as the AMT. Equally obviously, there are many classes of claims that produce income that are not brought within the civil rights and whistleblower rubric of the new provision. To this extent, in its own way, the bill discriminates against certain types of litigants.

A last minute amendment to the Senate bill, introduced by Senator Hatch, dealt with punitive damage awards and is worth noting. The Hatch amendment indicated that even though punitive damages are now always taxable to the recipient (and that was made clear back in 1996), a plaintiff will not be taxable on any punitive damages that must be paid to a state under a so-called "split-award statute." Many states require that in a civil action where punitive damages are paid to a private party, the state automatically gets a 50% cut. In such a state, this clarification makes clear that even though the punitives received by the plaintiff will be taxable to the plaintiff, those going to the state will not. It should not be otherwise.

Perhaps more pertinent to this topic of attorneys' fees is the second portion of the Hatch amendment, which said that in such a case, any attorneys' fees or other costs that are incurred by the taxpayer in connection of obtaining an award of punitive damages would also not be taxable.

Last Word

Unfortunately, there was no relief for the attorneys' fees issue in the bill as passed. Despite its flaws, this bill represented an enormous step in the right direction. Indeed, I would have been happy if the alternative minimum tax position alone (leaving aside the 2% and phaseout problems) had been fixed, but fixed for all income-producing litigation, not just for employment discrimination claims and whistleblower claims. I believe an approach that differentiates some claims from others may prompt taxpayers (and who can blame them?) to attempt to pigeonhole their claims within the list of "good" attorneys' fees. Good attorneys' fees are those paid or incurred to pursue employment discrimination and/or whistleblower claims.

In the real world, the vast majority of lawsuits have multiple causes of action and a mixture of messy factual details. What will happen if someone sues for six different causes of action based on a set of facts, and only one of these causes of action is for employment discrimination? Will the IRS try to allocate the fees? Will it be like the situation so often occurring in the context of divorce (where

attorneys commonly allocate their fees between regular divorce legal fees and tax legal fees, the latter being deductible)?

I'd like to think that these issues won't arise, but I'm afraid they will. The National Taxpayer Advocate, Nina Olson, went a long way toward highlighting the egregious nature of this problem in her Fiscal Year 2002 Annual Report. When will Congress fix this ridiculous problem?