ARTICLES

THE FEDERAL INCOME TAXATION OF CONTINGENT ATTORNEYS' FEES: PATCHWORK BY CONGRESS AND SUPREME COURT CREATES UNCERTAINTY

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I. INTRODUCTION

This article reviews the changing landscape of the federal income tax treatment of attorneys' fees. The tax treatment of contingent legal fees has been rife with controversy for more than a decade, with the last few years seeing several particularly momentous developments. The first major development was Congress's enactment of the American Jobs Creation Act of 2004[1] (Jobs Act). Although legislators had been considering versions of a bill to affect the tax treatment of attorneys' fees for years,[2] Con-

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1. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418, 1547 (2004) (codified as amended at I.R.C. § 62 (West 2005)).

2. *See* Civil Rights Tax Fairness Act of 1999, H.R. 1997, 106th Cong.; Civil Rights Tax Fairness Act of 2000, H.R. 4570, 106th Cong.; Civil Rights Tax Relief Act of 2001, H.R. 840, 107th Cong.; Civil Rights Tax Relief Act of 2003, S. 557, 108th Cong.

gress finally acted upon such a bill only as the United States Supreme Court was also set to consider the issue.[3]

Suggesting that Congress acted only to save face might be an exaggeration. Nevertheless, it took many years for Congress to provide *any* relief on the tax treatment of attorneys' fees.[4] The provision that was finally passed as part of the Jobs Act had been proposed and re-proposed since 1999, when it was first introduced as the Civil Rights Tax Fairness Act of 1999.[5] However, the issue cried out long before that for attention.[6]

The second significant development began with the Court's grant of certiorari in two attorneys' fees cases in 2004, *Commissioner v. Banks*[7] and *Commissioner v. Banaitis*.[8] The two cases were consolidated before the Court for briefing and argument.[9] When the Court issued its unanimous opinion on January 24, 2005,[10] the Court not only missed a chance to correct an appalling tax problem, but it also created substantial uncertainty about precisely what kind of tax planning will be permitted to avoid the general tax rule the Court announced.

The Jobs Act and the *Banks* decision both address the issue of how the Internal Revenue Code (the Code) should treat contingent attorneys' fees and costs paid by successful plaintiffs.[11] Of course, the lawyer must pay federal income tax on his or her legal fees received. The question is how the client will be taxed. The issue is of surprising prevalence, as it arises whenever lawsuit proceeds in a settlement or judgment represent taxable income. Notwithstanding section 104 of the Code and its personal physical injury

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3. On March 29, 2004, the Supreme Court granted certiorari in Comm'r v. Banks, 345 F.3d 373 (6th Cir. 2003), *cert. granted*, 541 U.S. 958 (2004), and in Comm'r v. Banaitis, 340 F.3d 1074 (9th Cir. 2003), *cert. granted*, 542 U.S. 958 (2004).

4. Taxpayers have had to include attorneys' fees in income in some circuits as far back as O'Brien v. Comm'r, 319 F.2d 532 (3d Cir. 1963), *cert. denied*, 375 U.S. 930 (1963). As noted in *supra* note 2, Congress began debating the issue in 1999.

5. *See* sources cited *supra* note 2.

6. News Release, Internal Revenue Service, National Taxpayer Advocate Releases Annual Report, IR 1999-08 (Jan. 12, 1999), *available at* http://www.irs.gov/newsroom/lists/0,,id=98040,00.html.

7. 345 F.3d 373 (6th Cir. 2003), *cert. granted*, 541 U.S. 958 (2004).

8. 340 F.3d 1074 (9th Cir. 2003), *cert. granted*, 542 U.S. 958 (2004).

9. Comm'r v. Banks, 543 U.S. 426, 426 (2005) (the consolidated cases will hereinafter be referred to as *Banks*).

10. *Id.*

11. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418, 1546-47 (2004) (codified as amended at I.R.C. § 62 (West 2005)); *Banks*, 543 U.S. at 429. *See also* Robert W. Wood, *Taxation of Settlements and Judgments*, 102 TAX NOTES 1120, 1120 (2004) (discussing developments in the contingent attorney fee debate).

exclusion,[12] most lawsuit proceeds received via settlement or judgment represent taxable income.

Logic suggests that all expenses incurred to achieve this income, including lawyers' fees and costs, would be deductible against that income. However, prior to the Court's decision in *Banks*, a majority of circuit courts held that a plaintiff could not net legal fees against his or her recovery.[13] In these circuits, the plaintiff had to generally include the gross recovery in income, even if the legal fees were paid directly to the contingent-fee lawyer.[14] In contrast, a minority of circuits allowed plaintiffs to report gross income measured only by their net recovery.[15] This practice was usually based on the theory that a plaintiff's attorney has an underlying interest in his percentage portion of the case, and would in any case be taxed on his attorneys' fees. In *Banks*, the Court agreed with the majority of the circuit courts, albeit only as a general rule.[16]

The difference between the net and gross approach to reporting attorneys' fees can be significant. Under net reporting, a successful plaintiff reports gross income only in the net amount he eventually keeps. Under gross reporting, the plaintiff reports the entire settlement or judgment in gross income, and then takes a deduction for the attorneys' fees and costs paid to counsel. Although the plaintiff can deduct his attorneys' fees, the deduction is generally a miscellaneous itemized deduction, which can be claimed only to the extent it exceeds 2% of the plaintiff's adjusted gross income.[17]

Overall limits also apply to itemized deductions.[18] Most draconian of all, the alternative minimum tax (AMT) allows no deduction for miscellaneous itemized deductions.[19] The Jobs Act elimi-

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12. I.R.C. § 104 (West 1994) (amended 1996).

13. *See* Alexander v. Comm'r, 72 F.3d 938 (1st Cir. 1995); Raymond v. United States, 355 F.3d 107 (2d Cir. 2004); O'Brien v. Comm'r, 319 F.2d 532 (3rd Cir. 1963); Young v. Comm'r, 240 F.3d 369 (4th Cir. 2001); Kenseth v. Comm'r, 259 F.3d 881 (7th Cir. 2001); Benci-Woodward v. Comm'r, 219 F.3d 941 (9th Cir. 2000); Coady v. Comm'r, 213 F.3d 1187 (9th Cir. 2000); Sinyard v. Comm'r, 268 F.3d 756 (9th Cir. 2001); Campbell v. Comm'r, 274 F.3d 1312 (10th Cir. 2001); Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995).

14. *See* cases cited *supra* note 13.

15. *See* Estate of Clarks v. United States, 202 F.3d 854 (6th Cir. 2000); Davis v. Comm'r, 210 F.3d 1346 (11th Cir. 2000); Srivastava v. Comm'r, 220 F.3d 353 (5th Cir. 2000); Comm'r v. Banaitis, 340 F.3d 1074 (9th Cir. 2003), *cert. granted*, 542 U.S. 958 (2004); Comm'r v. Banks, 345 F.3d 373 (6th Cir. 2003), *cert. granted*, 541 U.S. 958 (2004).

16. *Banks*, 543 U.S. at 429-30.

17. I.R.C. § 67 (2000).

18. *Id.* § 68. This limitation is generally referred to as "phaseout."

19. *Id.* § 56(b)(A)(i).

nates these historical concerns in some cases. In other instances, these problems will continue to plague taxpayers.

For example, suppose a plaintiff receives a gross award of $100, owing 40% to his lawyer. Historically, a majority of circuit courts held the plaintiff has $100 of gross income, and must claim a deduction for the $40 paid to his attorney (even if his attorney is paid directly out of the proceeds of the case, with the money never passing through the plaintiff's hands).[20] In the minority of circuits, the plaintiff only has $60 of gross income.[21] The tax difference between these seemingly equivalent economic results can be dramatic.[22]

The minority circuit taxpayer has gross income and taxable income of $60. The majority circuit taxpayer has gross income of $100 and a miscellaneous itemized deduction of $40, of which the first 2% of adjusted gross income (or $2) would not be deductible.[23] On top of this 2% limit, this plaintiff may face phaseouts of deductions.[24] Finally, attorneys' fees will not be deductible for AMT purposes.[25]

The latter point can actually turn a prevailing party in litigation into a financial loser. An often cited *New York Times* article highlights the plight of a Chicago law enforcement officer who won a sex discrimination suit, only to find that her recovery resulted in her *paying* $99,000 more in taxes than she recovered in the suit.[26]

Such situations shriek of inequity and bear no relationship to fundamentals of a fair tax system. The problems associated with the tax treatment of attorneys' fees has led to endless academic debates, numerous legislative assaults from various taxpayer groups,[27] a strident position announced by the U.S. Taxpayer Advocate,[28] and ultimately, to passage of the attorneys' fee provision

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20. *See* cases cited *supra* note 13.

21. *See* cases cited *supra* note 15.

22. *See* Robert W. Wood, *The Plight of the Plaintiff: The Tax Treatment of Legal Fees*, 81 TAX NOTES 907, 907 (1998).

23. I.R.C. § 67 (2000).

24. *Id.* § 68.

25. *Id.* § 56(b)(A)(i).

26. Adam Liptak, *Tax Bill Exceeds Award to Officer in Sex Bias Suit*, N.Y. TIMES, Aug. 11, 2002, at 18 (discussing Spina v. Forest Preserve Dist. of Cook County, 207 F. Supp. 2d 764 (N.D. Ill. 2002)) (emphasis added).

27. *See* NAT'L TAXPAYER ADVOC.: FY 2002 ANN. REP. TO CONGRESS, Dec. 31, 2002, at 161-71, *available at* http://www.irs.gov/pub/irs-utl/nta_2002_annual_report.pdf; *see also* Taxpayers Against Fraud, www.taf.org (last visited Mar. 6, 2006).

28. *Id.*; *see also* News Release, Internal Revenue Service, IRS National Taxpayer Advocate Releases Annual Report to Congress, IR 2003-2 (Jan. 6, 2003), *available at* http://www.irs.gov/newsroom/article/0,,id=105403,00.html.

of the Jobs Act.[29] Regrettably, the Jobs Act focuses solely on employment claims and cases arising from the Federal False Claims Act. Even though attorneys' fees tax problems arise in many non-employment cases, employment cases traditionally have served as the poster child of inequity.

Although a taxpayer going out-of-pocket to pay taxes on a settlement or judgment may be unusual, successful plaintiffs often face a disproportionate tax burden on their recoveries compared to the tax burden borne by other income. The magnitude of the problem varies with the following factors: (1) the size of the recovery; (2) the percentage of contingent fees; (3) the amount of costs and the way in which costs are applied under the fee agreement; (4) the plaintiff's other income; and (5) the plaintiff's other deductions. Given contingent attorneys' fees and costs may be 40% or 50% of a recovery, and sometimes much higher,[30] the problem is manifest.

Prior to the Court's decision in *Banks*, the tax treatment of attorneys' fees generated a decade of bitterly fought litigation, leaving a deep rift in the circuit courts around the United States.[31] The lack of uniformity led to forum shopping and frequent gerrymandering of attorneys' fees arrangements.[32] Although the Jobs Act eliminates the attorneys' fee problem in some cases, its scope is limited, with many cases escaping its relief.

Moreover, the general rule announced by the Court in *Banks* makes clear that broader relief is needed. In the meantime, the self-expressed limitations of the *Banks* opinion should give some taxpayers hope that they may be able to distinguish their case

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29. For a discussion of the above-the-line attorneys' fee deduction created by the Jobs Act, see Robert W. Wood, *Jobs Act Attorney Fee Provision: Is it Enough?*, 105 TAX NOTES 961, 961 (2004).

30. I have seen contingent attorneys' fees and costs as high as 73%.

31. The cases cited in *supra* note 13 followed the majority rule. The cases cited in *supra* note 15 followed the minority rule. For additional discussion of pre-*Banks* tax treatment of attorneys' fees see Robert W. Wood & Dominic L. Daher, *IRS's MSSP on Lawsuit Awards, Settlements: Useful as a Gelding at a Stud Farm*, BNA DAILY TAX REPORT, Dec. 23, 2003, at J-1; Robert W. Wood, *Second Circuit Perpetuates Attorneys' Fee SNAFU*, BNA DAILY TAX REPORT, May 19, 2004, at J-1; Robert W. Wood & Dominic L. Daher, *Attorneys' Fee Debacle Keeps Going, Going, and Going as Mutinous Sixth Circuit Refuses Reliance on Lien Law Analysis*, BNA DAILY TAX REPORT, Jan. 20, 2004, at J-1; Robert W. Wood & Dominic L. Daher, *Another Bite at the Apple? Ninth Circuit Takes Another Look at the Attorneys' Fee Fiasco and Changes Its Tune*, TAX PRACTICE AND PROCEDURE, Apr.-May 2004, at 59; Robert W. Wood & Dominic L. Daher, *Contingent Attorney's Fees in Class Action Cases – From Bad to Worse for Taxpayer-Plaintiffs*, 99 J. TAX'N 228 (2003).

32. *See* Robert W. Wood, *More Confusion on Tax Treatment of Attorneys' Fees: Whose Law Applies?*, BNA EMPLOYMENT DISCRIMINATION REPORT, May 21, 2002, at 701.

from the general rule announced in *Banks*. Yet, so far, the limited post-*Banks* case law suggests that taxpayers may have a rough time with these arguments.

II. The Jobs Act

The Jobs Act, signed by President Bush on October 22, 2004, allows an above-the-line deduction for amounts attributable to attorneys' fees and costs received by individuals based on claims brought under the False Claims Act,[33] section 1862(b)(3)(A) of the Social Security Act,[34] or unlawful discrimination claims.[35] The law identifies the types of qualifying "unlawful discrimination" by referencing a long list of laws that provide for employment claims. Specifically enumerated, these laws are as follows:

1. Civil Rights Act of 1991;[36]
2. Congressional Accountability Act of 1995;[37]
3. National Labor Relations Act;[38]
4. Fair Labor Standards Act of 1938;[39]
5. Age Discrimination in Employment Act of 1967;[40]
6. Rehabilitation Act of 1973;[41]
7. Employee Retirement Income Security Act of 1974;[42]
8. Education Amendments of 1972;[43]
9. Employee Polygraph Protection Act of 1988;[44]
10. Worker Adjustment and Retraining Notification Act;[45]
11. Family and Medical Leave Act of 1993;[46]
12. 38 U.S.C. §§ 4301-34 (2000) (relating to employment rights of uniformed service personnel);
13. Civil Rights Act of 1991;[47]
14. Civil Rights Act of 1964;[48]

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33. 31 U.S.C. §§ 3721-33 (2000).

34. 42 U.S.C. § 1395y(b)(3)(A) (2000).

35. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 703, 118 Stat. 1418, 1546-47 (2004) (codified as amended at I.R.C. § 62 (West 2005)).

36. Civil Rights Act of 1991 § 302, 2 U.S.C. § 1202 (2000) (current version at 42 U.S.C. § 2000e-16b (2000)).

37. Congressional Accountability Act of 1995 §§ 201-07, 2 U.S.C. §§ 1311–17 (2000).

38. 29 U.S.C. §§ 151-69 (2000).

39. *Id.* §§ 201-19.

40. Age Discrimination in Employment Act of 1967 §§ 4, 15, 29 U.S.C. §§ 623, 633a (2000).

41. Rehabilitation Act of 1973 §§ 501, 504, 29 U.S.C. §§ 791, 794 (2000).

42. Employee Retirement Income Security Act of 1974 § 510, 29 U.S.C. § 1140 (2000).

43. Education Amendments of 1972 tit. 9, 20 U.S.C. §§ 1681-88 (2000).

44. 29 U.S.C. §§ 2001-9 (2000).

45. *Id.* §§ 2102-9.

46. Family and Medical Leave Act of 1993 § 105, 29 U.S.C. § 2615 (2000).

47. Civil Rights Act of 1991 §§ 1977, 1979, 1980, 42 U.S.C. §§ 1981, 1983, 1985 (2000).

48. Civil Rights Act of 1964 §§ 703, 704, 717, 42 U.S.C. §§ 2000e-2, e-3, e-16 (2000).

15. Fair Housing Act;[49]
16. Americans With Disabilities Act of 1990;[50]
17. 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 other actions permitted under federal law (known as whistleblower protection provisions);[51] or
18. any provision of federal, state or local law, or common law claims permitted under federal, state or local law, that provides for the enforcement of civil rights, or regulates any aspect of the employment relationship, including claims for wages, compensation, or benefits, or 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 other actions permitted by law.[52]

The list is noteworthy in that it covers two basic groups: (1) Federal False Claims Act claims and (2) employment claims.

A. False Claims Act

False Claims Act cases are generally brought to expose fraud and to recover monies for the federal government. Under the False Claims Act, a whistleblower who uncovers fraud serves in the capacity of a private attorney general, and on the successful prosecution of the case is entitled to a relator's share.[53] The government may or may not choose to intervene in the case. Litigation is often protracted, and attorneys' fees and costs tend to be very high. The latter fact exacerbates the already difficult attorneys' fee deductibility problem.

Many states have their own versions of the False Claims Act to recover monies for their state.[54] Although the Jobs Act applies to Federal False Claims Act cases, claims brought under state counterpart legislation are not entitled to an above-the-line deduction for attorneys' fees under the Jobs Act.[55] Congress has granted relief for the attorney fee problem in the employment litigation context and for Federal False Claims Act cases, but relators

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49. Fair Housing Act §§ 804, 805, 806, 808, 818, 42 U.S.C. §§ 3604, 3605, 3606, 3608, 3617 (2000).

50. Americans With Disabilities Act of 1990 §§ 102, 202, 302, 503, 42 U.S.C. §§ 12112, 12132, 12182, 12203 (2000).

51. I.R.C. § 62(e)(17) (West 2005).

52. *Id.* § 62(e)(18).

53. 31 U.S.C. § 3730(d)(1) (2000).

54. *See, e.g.*, False Claims Act, CAL. GOV'T CODE §§ 12650-12655 (West 2005).

55. The Jobs Act's exhaustive list does not include claims brought under state false claims acts.

in cases brought under state counterparts to the False Claims Act get no relief. This omission suggests that there is a premium on form, instead of substance, and results in different tax treatment of similar claims.

B. Employment Nexus

The Jobs Act's list of sixteen federal statutes that entitle plaintiffs to an above-the-line deduction for their attorneys' fees are all related to employment.[56] Also included on the list of those entitled to protection are whistleblower provisions which cover provisions of federal law (thus omitting state whistleblower protections) that prohibit the discharge of (or discrimination or reprisal against) an employee for being a whistleblower.[57] There is a catchall category, but it also applies only to employment cases.[58] Most whistleblowers are employees or former employees who have access to information. A Federal False Claims Act case, or state counterpart, in which the relator is seeking a recovery for the government (with a share to the relator) might *also* involve a claim under a whistleblower protection statute, but that would generally be a separate action.

In this age of increasing legal specialization, a whistleblower may use one law firm to bring a False Claims Act action and another law firm to bring an employment action. For example, such a situation would arise where the employee/whistleblower is fired and discriminated against on the job. Suppose a whistleblower receives (1) a $300,000 recovery in the employment action that is protected from double taxation of attorneys' fees under the Jobs Act, and (2) a $3 million relator's share under a state counterpart to the False Claims Act. The latter is not covered by the Jobs Act, and thus is presumptively subject to the general rule expressed by the Court in *Banks*.

C. Scope of the "Catchall"

The final "catchall" at the bottom of the list of provisions, which allows for specific above-the-line deductions, expressly enti-

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56. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 703, 118 Stat. 1418, 1546 (2004) (codified as amended at I.R.C. § 62 (West 2005)); *see* sources cited *supra* notes 36-50.

57. I.R.C. § 62(e)(17) (West 2005).

58. *Id.* § 62(e)(18).

tles attorney fee relief in Federal False Claims Act cases.[59] State false claims cases are not mentioned and presumably not entitled to relief. Indeed, after the litany of specific statutes that are all employment related, the catchall basket appears to embrace *employment* cases only, and would seem not to bring other things within it. Although it does scoop up state and local laws, and even common law claims made under federal, state or local law, it is hard to imagine the catchall applying to non-employment claims.

D. Other Causes of Action

Various other claims also do not appear to be within the catchall, such as defamation claims. If a taxpayer is defamed and successfully brings an action through a contingent-fee lawyer, the general rule of *Banks* will presumptively apply, and the taxpayer will suffer the same kind of attorney fee problems which taxpayers have dealt with for years. The Jobs Act plainly suggests that defamation claims are less deserving of protection against tax inequity than employment claims. Defamation, a tort under the common law, is not entitled to an above-the-line deduction for attorneys' fees unless it occurs in the context of employment.[60] The Jobs Act thus supplies one tax rule if a taxpayer is defamed outside of his employment, and quite another tax rule if he is defamed, for example, by his employer.

It is arguable that a defamation claim, whether based inside or outside the employment relationship, is never an employment claim. However, it seems likely that a defamation claim against an employer would arise only in the context of other employment-based claims, such as some type of discrimination, harassment or wrongful termination. It remains to be seen whether the Internal Revenue Service (IRS) will attempt to bifurcate recoveries into employment and non-employment claims, seeking to limit the above-the-line deduction to only those attorneys' fees related to the employment claims. Thus far, the IRS has given no guidance on this point.

How this issue will be resolved may be very fact-based. A case that seems predominantly employment-based may be decided one way, while a case brought predominantly as a tort case, but with *ancillary* employment claims, might be resolved in another way. If this does occur, it may put a premium on planning around

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59. *Id.*

60. *See* Wood, *supra* note 29, at 962.

such a result. Although there have always been good reasons to include specific tax allocation language in settlement agreements, there may be yet another reason to be specific. Unlike the Code's pre-1996 version of section 104,[61] which favored tort recoveries over employment recoveries, this new tax incentive-based planning would favor allocations to employment claims (with a corollary allocation to related attorneys' fees) rather than tort claims. Such dramatically contrary incentives turn logic, or at least traditional practice, on its head and are likely to catch some taxpayers and advisors unaware.

Similarly, if a false imprisonment case occurs in the context of employment, an above-the-line deduction for attorneys' fees could apply. Conversely, if the false imprisonment occurs outside of that context, presumably no above-the-line deduction would be available. Thus, if an employer locks an employee in his office, perhaps the employee can deduct his attorneys' fees above the line. Conversely, if the police lock him up in error, he cannot claim an above-the-line deduction for his attorneys' fees and therefore may pay more taxes on his eventual recovery.

Despite the lack of guidance from the IRS or Treasury Department, there is still interplay between attorneys' fees issues and section 104, which excludes personal physical injuries and sickness damages.[62] If a taxpayer actually suffers physical injuries while being falsely imprisoned, he may be able to obviate some or all of the attorney fee problem by claiming a section 104 exclusion. However, section 104 is also controversial with the IRS. The IRS has given very little guidance on the scope of section 104 as amended in 1996.[63] We still do not know precisely how serious something must be before it is considered a physical injury, although it appears the IRS wants to see bruises or other outward evidence before it places a halo of excludability on the injured plaintiff.[64]

The Jobs Act above-the-line deduction plainly does not apply to causes of action for negligent or intentional infliction of emotional distress.[65] Although emotional distress claims are often brought in the employment context, they are also often brought

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61. I.R.C. § 104 (West 1994) (amended 1996).

62. *Id.*

63. *See* Robert W. Wood, *Post-1996 Act Section 104 Cases: Where Are We Eight Years Later?*, 105 TAX NOTES 68, 68 (2004).

64. I.R.S. Priv. Ltr. Rul. 200041022 (Oct. 13, 2000).

65. *See* Wood, *supra* note 29, at 962.

outside of this sphere. As with defamation, emotional distress claims will apparently receive one tax treatment if they occur in the employment context, and decidedly less favorable treatment if they do not. Of course, it could be argued that ancillary emotional distress claims made in the context of an employment action would not be entitled to relief. The IRS could seek to allocate attorneys' fees between various claims. If the IRS attempts to allocate attorneys' fees between the claims, the administrative problems are likely to be enormous.

Invasion of privacy claims seem likely to suffer from the same dichotomy. Causes of action for interference with contractual relations and/or breach of contract would also appear to be treated differently inside, versus outside, the employment context. Claims for investment losses may also be affected. If a broker has made bad investment decisions on your behalf and you recover from him, you may have trouble deducting your attorneys' fees. Conversely, if your employer makes the bad investment decisions for you, and the investment claim is made in the context of your employment litigation, presumably you can deduct the attorneys' fees above-the-line.

E. Noncovered Employment Cases

Despite the apparent completeness of the catchall list in regard to employment cases, some employment lawyers bring employment claims that are not true discrimination cases. In fact, lawyers may be concerned that some of their cases will not fall within the group of enumerated claims, even given the long list and its catchall.

For example, this could be true with some Employee Retirement Income Security Act (ERISA) claims. ERISA applies to pension and welfare benefit cases, and preempts state law.[66] The Jobs Act enumerates ERISA cases as one of the categories entitled to an above-the-line deduction, yet it refers only to cases under section 510 of ERISA.[67] That section deals with discrimination claims and accounts for only a small fraction of successful ERISA claims. Some employment lawyers assert that a section 510 claim is nearly impossible to pursue effectively. A more typical ERISA claim is for benefits, such as pension or long-term disability benefits. This reality makes one wonder whether these other ERISA

66. 29 U.S.C. § 1144(a) (2005).
67. I.R.C. § 62(e)(7).

claims are entitled to the above-the-line deduction under the catchall basket.

Furthermore, overtime pay claims are generally not regarded as discrimination claims. At the same time, the Jobs Act suggests that any unlawful act that is pursued under the Fair Labor Standards Act (FLSA) should give rise to an above-the-line deduction for attorneys' fees.[68] Yet, if the IRS interprets the term "discrimination" narrowly, perhaps only true discrimination claims under FLSA, such as retaliation claims and Equal Pay Act claims, would qualify. It is arguable that the catchall provision would bring many cases under its protection, including overtime, minimum wage, and benefit cases. However, this assumption is far from certain.

F. Punitive Damages

Since the enactment of the Small Business Job Protection Act of 1996 (1996 Act), punitive damages are clearly taxable.[69] This clarification came after decades of confusion about the tax treatment of punitive damages. The IRS has done nothing to address that ambiguity, and there remains no definition of "punitive damages" in the Code or Regulations.[70] Furthermore, many states now require that in a civil action in which punitive damages are paid to a private party, the state is entitled to a share.[71]

For example, suppose a taxpayer receives a punitive damage award for willful defamation in California. Assume the taxpayer recovers $1 in actual damages and $1 million in punitive damages. Under California law, 75% of that punitive damage award (or $750,000) goes to the State of California.[72] The taxpayer would receive the remaining 25%. There are several possible

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68. *Id.* § 62(e)(4).

69. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1(a), 110 Stat. 1755 (1996) (codified as amended at I.R.C. § 26 (West 2005)); *see, e.g.*, O'Gilvie v. United States, 519 U.S. 79 (1996).

70. *See* Robert W. Wood, *Will Courts Import Punitive Characterization*, TAX NOTES 1200, 1200 (1997); Robert W. Wood, *Proposed Nondeductibility for Punitive Damages: Will It Work?*, 100 TAX NOTES 99, 99 (2003).

71. *See, e.g.*, CAL. CIV. CODE § 3294.5 (2005). Note, however, that this provision will automatically be repealed on July 1, 2006. Other states which have enacted similar punitive damage taking statutes include Alaska, Illinois, Indiana, Missouri, and Oregon. *See* ALASKA STAT. § 09.17.020(j) (2005); 735 ILL. COMP. STAT. 5/2-1207 (2005); IND. CODE § 34-51-3-6(b)(2) (2005); MO. REV. STAT. § 537.675 (2005); OR. REV. STAT. § 31.735 (2005).

72. CAL. CIV. CODE § 3294.5(b)(1) (2005).

ways in which this distribution could be taxed, particularly when contingent attorneys' fees are involved.

In 2003, when the Senate version of what became the Jobs Act was being considered, Senator Orrin Hatch, R-Utah, tried to address the increasing popularity of laws allowing for punitive damages to be split. Senator Hatch introduced an amendment to the Senate bill to address punitive damage awards.[73] The amendment correctly indicated that even though punitive damages are always taxable to the recipient, punitive damages that must be paid to a state under a split-award statute would be excluded from taxable income.[74]

The second portion of the Hatch amendment said that in such a case, any attorneys' fees or other costs incurred by the taxpayer in connection with obtaining an award of punitive damages would also not be taxable.[75] Unfortunately, the Hatch amendment was not included in the Jobs Act. It is unclear whether the amendment, having been proposed and not adopted, suggests anything about how this provision of the tax law will be interpreted when the IRS or the courts are faced with this punitive damage awards question.

G. Prospective Relief

The effective date of the Jobs Act is controversial, as its attorneys' fee provision is prospective only. The amendments apply only to fees and costs paid after the date of enactment (October 22, 2004), with respect to any judgment or settlement occurring *after* that date.[76] Thus, the fees and costs must be paid *after* October 22, 2004, and they must be paid thereafter on a settlement or judgment that occurs *after* that date.[77]

Although the Jobs Act plainly states that it applies only prospectively, a Senate floor debate suggests that the Senate (or at least Senators Baucus and Grassley) believed that the Jobs Act provision merely reaffirmed then existing law (from the taxpayer-favored circuits) on the tax treatment of attorneys' fees.[78] The

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73. S. Amend. 627 to S. 1054, 108th Cong. (2003).

74. *Id.*

75. *Id.*

76. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 703(b), 118 Stat. 1418, 1546 (2004) (codified as amended at I.R.C. § 62(e) (West 2005)).

77. *Id.*; *see also*, Wood, *supra* note 29, at 963.

78. 150 CONG. REC. S11, 036 (daily ed. Oct. 10, 2004) (statement of Sens. Baucus & Grassley).

floor debate leading up to passage of the Jobs Act included the following:

> Mr. Baucus:
>
> . . . .
>
> As I understand it, the case law with respect to the tax treatment of attorney's fees paid by those that receive settlements or judgments in connection with a claim of unlawful discrimination, a False Claims Act, 'Qui Tam,' proceeding or similar actions is unclear and that its application was questionable as interpreted by the IRS. Further, it was never the intent of Congress that the attorneys' fees portions of such recoveries should be included in taxable income whether for regular income or alternative minimum tax purposes.
>
> It is the understanding of the chairman that it was the conferees' intention for Section 703 [which provides an above-the-line deduction for attorneys' fees] to clarify the proper interpretation of the prior law, and any settlements prior to the date of enactment should be treated in a manner consistent with such intent?
>
> Mr. Grassley: The Senator is correct. The conferees are acting to make it clear that attorneys' fees and costs in these cases are not taxable income, especially where the plaintiff, or in the case of a Qui Tam proceeding, the relator, never actually receives the portion of the award paid to the attorneys. Despite differing opinions by certain jurisdictions and the IRS, it is my opinion that this is the correct interpretation of the law prior to enactment of Section 703 as it will be going forward. In adopting this provision, Congress is codifying the fair and equitable policy that the tax treatment of settlements or awards made after or prior to the effective date of this provision should be the same. The courts and IRS should not treat attorneys' fees and other costs as taxable income.
>
> As I stated in my May 12, 2004 press release summarizing this and other provisions passed by the Senate as part of S. 1637[:]
>
> "Tax relief gets the headlines, but part of tax relief is tax fairness. It's clearly a fairness issue to make sure people don't have to pay income taxes on income that was never theirs in the first place. That's common sense."
>
> Section 703 will help in well known cases, such as that of Cynthia Spina, an Illinois police officer that secured a settlement in a sexual discrimination case that left her owing $10,000 or more. There are literally dozens of others like her in similar situations and it is my strong belief that the courts and the IRS should apply the guidelines of Section 703 not only after the date of enactment but also to settlements put in place prior to that time.[79]

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79. *Id.* (citing Press Release, Chuck Grassley, Grassley Praises Senate Passage of IRS Whistleblower Help, Civil Rights Tax Reform, Charitable Giving Reform, Ban on Deduction of Government Fines, "Son of Boss" Item (May 12, 2004), http://grassley.senate.gov/releases/2004/p04r05-12a.htm).

Of course, it can be argued that this floor debate is not persuasive in light of an express effective date in the Jobs Act itself. Moreover, the Court's *Banks* decision, in which the Court stated that the Jobs Act was prospective only (without mentioning the floor debate)[80] is another point against the relevancy of this discussion.[81] Nevertheless, it seems likely that this point will be raised by taxpayers in litigation where the effective date of the Jobs Act is important. It will be interesting to see if, when, and how this debate will be raised in the future.

On a more fundamental level, the Jobs Act provision itself raises legitimate questions as to how one determines what settlements or judgments are covered. Settlements are straightforward. Both the execution of the settlement agreement and the payment of the money must occur after October 22, 2004, to qualify for the above-the-line deduction.[82] Judgments, however, are not so simple. Some judgments predating the enactment of the Jobs Act may be on appeal and are only currently being resolved. Consider the following example:

> Taxpayer A brings suit for employment discrimination and recovers a verdict of $800,000 in 2003. Judgment is entered, but the defendant appeals. The Court of Appeals affirms in January of 2006. On February 15, 2006, the date for a petition for rehearing to the state Court expires, and the defendant prepares to pay the judgment.

In this situation, when the defendant pays the judgment, is the plaintiff entitled to an above-the-line deduction provided by the Jobs Act? The Jobs Act's amendment to section 62 (allowing an above-the-line deduction for attorneys' fees) specifically states that the new law applies to "fees and costs paid after the date of the enactment of this Act with respect to any judgment or settlement occurring after such date."[83] The triggering event here is when the judgment can be said to "occur."

H. When Does a Judgment Occur?

No ready answer exists in the statute or its legislative history to the question of when a judgment "occurs." Presumably, this seemingly simple "occur" language refers to something more basic

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80. Comm'r v. Banks, 543 U.S. 426, 433 (2005).

81. In the oral arguments for *Banks*, Justice Scalia commented, wondering who wrote the colloquy between Senators Baucus and Grassley. Transcript of Oral Argument at 30, Comm'r v. Banks, 543 U.S. 426 (2005) (No. 03-907), *available at* http://www.supremecourtus.gov/oral_argument_transcripts/03-892.pdf.

82. American Jobs Creation Act § 703.

83. *Id.* § 62.

than the time at which a judgment is entered, or the time at which a judgment becomes final. The entry of judgment has a legal meaning and can be ascertained with accuracy. The same can be said for the time at which a judgment becomes final.

Similar effective date provisions in other tax law changes have been more clear-cut. For example, when the 1996 Act added the physical modifier to section 104, it did so for all amounts received after the date of enactment (August 20, 1996), except for amounts received under a written binding agreement, court decree or mediation award in effect on, or issued on or before, September 13, 1995.[84]

The time at which a judgment "occurs," on the other hand, is not precise, though some clarification on this topic exists. For example, in the context of the priority of a federal tax lien, a judgment "occurs" when it is first rendered by the court.[85] In *United States v. Dishman Independent Oil, Inc.*,[86] the court of appeals reviewed the procedural history of the litigation, finding that the judgment occurred when the bankruptcy court first entered its final decision, notwithstanding an appeal to the federal district court and ultimately to the court of appeals. The court of appeals stated:

> Dishman was granted judgment by the bankruptcy court on April 27, 1992. The IRS tax lien seeks to collect $2,851,910.09, which is owed to the United States by the debtors for unpaid taxes from the third quarter of 1987 through the third quarter of 1988. On May 29, 1992, the IRS was permitted to intervene in the proceeding to seek a determination by the court that its federal tax lien was valid and prior to any interest held by Dishman in the debtors' property. The IRS eventually filed a motion for summary judgment which the bankruptcy court denied. Dishman then filed its own motion for summary judgment against the IRS. The bankruptcy court granted Dishman's motion for summary judgment, after finding that Dishman's attachment lien was perfected by the judgment entered in its favor on April 27, 1992, and was therefore prior to the federal tax lien against the debtors. The district court affirmed the bankruptcy court's order granting Dishman's motion for summary judgment.[87]

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84. H.R. REP. No. 104-737, at 301 (1996) (Conf. Rep.).

85. *See In re* Crocker Nat'l Bank v. Trical Mfg. Co., 523 F.2d 1037, 1039 (9th Cir. 1975); United States v. Morrison, 247 F.2d 285, 289 (5th Cir. 1957).

86. 46 F.3d 523, 525 (6th Cir. 1995).

87. *Id.* (citation omitted).

The IRS appealed the case to the Sixth Circuit, where the court recognized the taxpayer's judgment occurred on April 27, 1992, notwithstanding the appeals.[88] The court stated:

> We believe this issue is controlled by the holding of *United States v. Acri*, which supports the IRS's position. In *Acri*, the Supreme Court unequivocally held that a federal tax lien filed after an attachment lien was executed had priority over the attachment lien because judgment on the attachment lien *did not occur* until after the filing of the tax lien. In *Acri*, the Court was not persuaded by the recognition of the attachment lien as perfected under Ohio law. Rather, for "federal tax purposes" the lien was "inchoate . . . because, at the time the attachment issued, the fact and the amount of the lien were contingent upon the outcome of the suit for damages."[89]

These lien authorities may not be expressly directed at the question of when a judgment occurs for purposes of section 62. Nevertheless, these authorities do appear to support the view that a judgment "occurs" when it is first rendered. They also suggest that the IRS would probably interpret the term "occur" in a general way, rather than by reference to some technical lapsing of appeal period, or to a judgment otherwise becoming final. There may well be other areas of the body of federal tax law where this kind of spadework should also be done.

The rudimentary formulation of the Jobs Act's effective date, with its simplistic concept of the occurrence of a judgment as a trigger for the effective date of this important provision, may preclude the application of an above-the-line deduction in many cases. However, it should often be possible to enter into a settlement agreement to make the timing of the judgment irrelevant. If a judgment would otherwise not be covered by the above-the-line deduction because it occurred prior to October 23, 2004, a settlement of the dispute between plaintiff and defendant after October 22, 2004, should import the above-the-line deduction. A binding settlement agreement dated after October 22, 2004, would serve as the vehicle for the payment, not the judgment. As long as there is some procedural possibility for keeping the case alive – a writ, an appeal, a proceeding to attempt to set aside the judgment – a settlement should be effective.

Indeed, the plaintiff who needs a settlement for tax purposes may be willing to give up some of the consideration that would be paid via the judgment. Alternatively, the plaintiff may be willing to make other concessions such as agreeing to confidentiality obli-

88. *Id.* at 527.

89. *Id.* (citing 348 U.S. 211, 214 (1955)) (emphasis added) (citation omitted).

gations or other non-monetary items. Given the procedural wrangling and delays that are often encountered in enforcing a judgment, a consensual resolution would seem appropriate. A settlement should not be regarded as a sham if any material term in the settlement differs from those set forth in the judgment.

There may conceivably be cases in which the defendant insists on paying the judgment and not settling a case. There may also occasionally be defendants who are willing to settle, but who insist on extracting a hefty price for their cooperation, perhaps seeking to split what they perceive as the pertinent tax benefits. However, in the vast majority of cases, a settlement should be possible. Hopefully such settlements will secure the plaintiff's above-the-line deduction.

I. Allocating Among Claims

The fact that the Jobs Act differentiates some claims from others may prompt taxpayers to attempt to categorize their claims within the list of "good" attorney fees, which are those paid or incurred to pursue Federal False Claims Act cases and employment discrimination claims. The vast majority of lawsuits have multiple causes of action and a mixture of factual details. For example, a plaintiff might bring a lawsuit with one claim for employment discrimination and other claims including defamation arising out of employment. Will the IRS try to allocate the attorneys' 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?

III. *BANKS*

Although the Jobs Act has brought tremendous statutory change to this area, the Court brought about judicial change almost simultaneously. The Court's decision in *Banks* attempted to resolve the bitter split raging in the circuit courts.[90] *Banks* reviewed holdings where attorneys' liens were held to have been strong enough that the attorneys themselves owned the fees, and the gross income was not considered to pass through the clients' hands.[91] In the lower courts, the respondents in *Banks* had been

90. 543 U.S. 426, 429-30 (2005).

91. *Id.* at 429.

allowed to report only their net income, after attorneys' fees.[92] Although the Court had five times refused to hear a case on attorneys' fees where the taxpayer had lost,[93] in *Banks* it was the IRS who had lost in the lower courts and ultimately asked the Court to intervene.[94]

Oral argument in *Banks* was scheduled for November 1, 2004, a little over a week after the enactment of the Jobs Act.[95] Approximately one week before the oral argument was scheduled, the taxpayers in *Banks* asked the Court not to decide the case, arguing in a supplemental brief that the Jobs Act had mooted their case.[96] Underlying this request was the assumption that taxpayers would be better off at least knowing that the law in some circuits was favorable on the attorneys' fee point, rather than having the door shut entirely. It was a prescient filing by the taxpayers, one that the Court did not heed.

The Court rendered its decision on January 24, 2005.[97] The actual holding is succinct, though much of the Court's opinion is not. The holding bears quoting, particularly since there is much speculation about what this opinion does and does not do. The Court held that, "as a general rule, when a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee."[98]

On first glance, more than a few taxpayers will be comforted by the fact that the Court announced this concept "as a general rule," thus implicitly endorsing the notion that there will be exceptions. The opinion was written by Justice Kennedy,[99] and all members of the Court agreed except Chief Justice Rehnquist, who did not take part in the decision.[100] The lack of dissent, and dis-

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92. *Id.* at 431-32 (citing Banks v. Comm'r, 345 F.3d 373 (6th Cir. 2003), *cert. granted*, 541 U.S. 958 (2004); Banaitis v. Comm'r, 340 F.3d 1074 (9th Cir. 2003), *cert. granted*, 542 U.S. 958 (2004)).

93. *See* Coady v. Comm'r, 213 F.3d 1187 (9th Cir. 2000), *cert. denied*, 532 U.S. 972 (2001); Benci-Woodward v. Comm'r, 219 F.3d 941 (9th Cir. 2000), *cert. denied*, 531 U.S. 1112 (2001); Sinyard v. Comm'r, 268 F.3d 756 (9th Cir. 2001), *cert. denied*, 536 U.S. 904 (2002); Campbell v. Comm'r, 274 F.3d 1312 (10th Cir. 2001), *cert. denied*, 535 U.S. 1056 (2002); O'Brien v. Comm'r, 319 F.2d 532 (3rd Cir. 1963), *cert. denied*, 375 U.S. 931 (1964).

94. *Banks*, 543 U.S. at 426.

95. *Id.*; American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 703, 118 Stat. 1418, 1547 (2004) (codified as amended at I.R.C. § 62 (West 2005)).

96. Joint Supplemental Brief for Respondents, *Banks*, 543 U.S. 426 (2005) (Nos. 03-892, 03-907).

97. *Banks*, 543 U.S. at 426.

98. *Id.* at 430.

99. *Id.* at 428.

100. *Id.* at 426, 439.

cernable lack of compassion for taxpayers in the opinion, seems surprising. It is particularly odd because some Justices in oral argument expressed concern about the possibility of confiscatory taxation. Justice O'Connor made more than a passing point about this during oral argument, saying the tax on attorneys' fees might even raise Constitutional questions.[101] Justice Breyer made a similar suggestion.[102]

After stating the holding "as a general rule," the Court recited the facts, explained the problem of deducting legal fees as a miscellaneous itemized expense, and then noted that Congress had prospectively addressed the problem for many cases (and in particular, for cases arising in the employment context).[103] The Court noted, though, that the Jobs Act is not retroactive, so the taxpayers in *Banks* still needed a decision.[104] As noted above, it could be argued that the Senate floor colloquy between Senators Grassley and Baucus is support for the argument that the Jobs Act is retroactive and merely enunciates current law.[105] It is not clear whether the Court's explicit notation that the Jobs Act is not retroactive was meant to squelch this argument. Of course, the Jobs Act itself notes that its application is prospective only.[106]

In large part, the Court adopted the assignment of income cases, referring to such hoary cases as *Helvering v. Horst*[107] and *Lucas v. Earl*.[108] With strident language, the Court addressed the theory that the attorney-client relationship can be viewed as a kind of business partnership or joint venture for tax purposes.[109] Giving it short shrift, the Court rejected this partnership suggestion, dismissing it with one sentence.[110] The Court then talked about the lawyer as an agent, and cited liberally from the Restatement of Agency.[111]

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101. Transcript of Oral Argument at 28, *Banks*, 543 U.S. 426 (2005) (No. 03-907), *available at* http://www.supremecourtus.gov/oral_argument_transcripts/03-892.pdf.

102. *Id.* at 24.

103. *Banks*, 543 U.S. at 430-33.

104. *Id.* at 433.

105. *See supra* text accompanying notes 78-79.

106. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 703, 118 Stat. 1418, 1546-48 (2004) (codified as amended at I.R.C. § 62 (West 2005)).

107. 311 U.S. 112 (1940).

108. 281 U.S. 111 (1930).

109. *Banks*, 543 U.S. at 436 (citing RESTATEMENT (SECOND) OF AGENCY § 1, Comment *a* (1957)).

110. *Id.* (stating "[w]e further reject the suggestion to treat the attorney-client relationship as a sort of business partnership or joint venture for tax purposes").

111. *Id.* at 436-37 (citing RESTATEMENT (SECOND) OF AGENCY § 13, 39, 387 (1957)).

Citing favorably from Judge Posner's stinging opinion in *Kenseth v. Commissioner*,[112] the Court dispensed with the notion that state law might confer special benefits on attorneys which could influence ownership and, therefore, taxation. Instead, the Court concluded that lawyers are mere agents, and again cited liberally from the Restatement of Agency.[113] The Court seemed to hold up the possibility that state law might make a difference, stating "[t]his rule applies whether or not the attorney-client contract or state law confers any special rights or protections on the attorney, so long as these protections do not alter the fundamental principal-agent character of the relationship."[114] Although the Court noted that state law varies on the strength of attorneys' security interests in a contingent fee, the Court said no state laws of which the Court was aware actually "convert the attorney from an agent to a partner."[115]

This finding suggests that the Court does not, and perhaps can not, comment on all state laws. The recent enactment of a Washington attorneys' lien law, which appears to be far stronger than any of the state laws considered by the Court, could be relevant and was not examined by the Court.[116]

The Court noted that the taxpayers proposed various theories that would exclude attorneys' fees from gross income, or permit deductibility.[117] The Court referred to these as "novel propositions," stating the arguments were not advanced in the earlier stages of the litigation, and therefore were not examined by the courts of appeal.[118] Therefore, the Court "decline[d] comment on these supplementary theories," which were as follows:

- the contingent fee agreement established a Subchapter K partnership;
- litigation recoveries were proceeds from the disposition of property, so that the attorneys' fees must be subtracted as a capital expense from the proceeds; and

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112. *Id.* at 436-37 (citing Kenseth v. Comm'r, 259 F.3d 881, 883 (7th Cir. 2001) which states "the contingent-fee lawyer [is not] a joint owner of his client's claim in the legal sense any more than the commission salesman is a joint owner of his employer's accounts receivable").

113. *Id.* at 436.

114. *Id.*

115. *Banks*, 543 U.S. at 436.

116. *See* WASH. REV. CODE § 60.40.010 (2005). For discussion of the Washington law, see Robert W. Wood, *Washington's Attorneys' Lien Law*, THE TAX ADVISER, Dec. 2004, at 729.

117. *Banks*, 543 U.S. at 437.

118. *Id.* at 438.

- the fees are deductible reimbursed employee business expenses.[119]

Noting that it would not consider any of these arguments (and this is apparently a nonexclusive list of what the Court would not consider), the Court also said it did not reach the fact pattern where a relator pursues a claim on behalf of the United States under the Federal False Claims Act.[120] Although False Claims Act cases are covered prospectively by the Jobs Act, prior False Claims Act cases are not impacted by the *Banks* opinion.[121]

Finally, as if these carveouts were not enough, the Court addressed statutory fee shifting provisions, as well as injunctive relief.[122] The Court noted that Mr. Banks argued that assignment of income principles would be inconsistent with the purpose of statutory fee shifting provisions.[123] Statutory fees may be available to a plaintiff's lawyer under either state or federal law, the idea being that fee shifting, which enables a defendant to bear the plaintiff's attorney's fees, is important to encourage proper compliance with the law. Taxpayers have often argued that the assignment of income analysis frequently applied by the IRS and the courts ought to have no bearing in a fee shifting case, since a fee shifting statute makes the argument for lawyer ownership of the fees considerably stronger.[124]

Indeed, it seems hard to argue in such a case that the client is "paying" the plaintiff's lawyers anything, since the court is awarding damages. Taxpayers have sometimes taken comfort from cases such as *Flannery v. Prentice*,[125] a California decision involving whether a statutory fee award is really the property of the client or the lawyer. Taxation, after all, ought to be about who is entitled to the income. The question in *Flannery* was whether the attorneys or client were entitled to fees awarded under the California Fair Employment and Housing Act.[126] Although not a tax case, the *Flannery* court rejected *Sinyard v. Commissioner*[127] and

119. *Id.* at 437-38 (citations omitted).

120. *Id.* at 438.

121. *Id.*

122. *Id.* at 438-39.

123. *Banks*, 543 U.S. at 438.

124. *See id.* at 437-38; Allum v. Comm'r, 90 T.C.M. (CCH) 74 (2005), 2005 WL 1692488, at *9 (T.C. July 20, 2005).

125. 28 P.3d 860 (Cal. 2001).

126. *Id.* at 862 (citing CAL. GOV'T CODE § 12965 (West 2001)).

127. Sinyard v. Comm'r, 268 F.3d 756 (9th Cir. 2001) (holding that attorneys' fees are taxable to the taxpayer). When *Flannery* was decided, *Sinyard* was the controlling case in the Ninth Circuit regarding attorneys' fees.

found that, absent proof of an enforceable agreement to the contrary, the attorneys' fees belonged "to the attorneys who labored to earn them."[128]

Quite significantly, in *Banks*, the Court glossed over the fee shifting issue. The Court noted:

> After Banks settled his case, the fee paid to his attorney was calculated solely on the basis of the private contingent-fee contract. There was no court-ordered fee award [to Banks' attorney], nor was there any indication in Banks' contract with his attorney, or in the settlement agreement with the defendant, that the contingent fee paid to Banks' attorney was in lieu of statutory fees that Banks might otherwise have been entitled to recover.[129]

All of these explanations are quite important. The Court suggested that the result in *Banks* might well have been different if there had been a court-ordered fee award.[130] The Court also suggested that the result might have been different if there were any indication in Banks's contract with his lawyer that the contingent fees were in lieu of statutory fees. Finally, the Court suggested that the result might have been different if there were a statement in the settlement agreement to this effect.[131]

Any of these suggested differences may have changed the outcome of *Banks*. However, it may have been necessary for all of these facts to be present (a court ordered fee award, plus a provision in the contingent fee agreement obviating a percentage fee when there is a court awarded fee, plus a statement in the settlement agreement that the plaintiff's lawyer is receiving a statutory fee) for *Banks* to have come out differently.

Unfortunately for taxpayers, despite the Court's positive language in *Banks*, at least one case in the Tax Court has already given short shrift to the argument that a statutory-fee-based claim would make a difference. In *Vincent v. Commissioner*,[132] decided after *Banks*, the Tax Court ruled that an award of attorneys' fees pursuant to a California fee shifting statute was not excludable from the taxpayer's gross income. The court noted that Ninth Circuit law governs any appeal of the *Vincent* Tax Court case, and citing *Sinyard*, notwithstanding a statutory fee claim.[133]

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128. *Flannery*, 28 P.3d at 862.

129. *Banks*, 543 U.S. at 439.

130. *Id.*

131. *Id.*

132. 89 T.C.M. (CCH) 1119, ___ (2005), 2005 WL 1022953, at *6 (T.C. May 3, 2005).

133. *Id.* at *7 (citing Sinyard v. Comm'r, 268 F.3d 756, 759 (9th Cir. 2001)).

Perhaps more significantly, the Tax Court stated in a footnote that:

> Petitioner's reliance on *Flannery v. Prentice* is misplaced. We are not bound by State law classifications as to the ownership of income. Any contingent attorney's fees paid by petitioner on account of her (taxable) civil settlement would properly be income under *Commissioner v. Banks, supra*, and she may not escape this outcome by arguing that, because her attorney's fees and costs were awarded by a civil court pursuant to a statutory fee shifting provision, the income is properly attributable to her attorney. We are not presented with, and do not decide, whether petitioner would have been taxed on the attorney's fees paid to her attorney, had she been represented by a nonprofit legal foundation.[134]

The last point the Court did not address in *Banks* is the situation prevailing where there is injunctive relief. Although related to the fee shifting point, it is distinct. Banks argued that in some cases, such as where the plaintiff seeks only injunctive relief, where the statute caps the dollar amount of a plaintiff's recovery, or where for other reasons damages are substantially less than attorneys' fees, court-awarded attorneys' fees can actually exceed a plaintiff's monetary recovery.[135] Banks also argued that treating the fee award as income to the plaintiff in such cases can lead to the perverse result where the plaintiff loses money by winning the suit.[136] The Court held that it need not address such claims.[137]

IV. Questions Remaining Following *Banks*

A. Class Actions

The tax treatment of attorneys' fees in class actions has long been confusing. The authorities have often drawn distinctions between opt-in and opt-out classes, with opt-in plaintiffs being more likely to be treated as receiving attorneys' fees for tax purposes. Tax authorities have even drawn distinctions between those class members who sign, versus those who do not sign, a fee agreement with class counsel. Such distinctions often do not seem to make sense.[138] Because of the nature of class actions, attorneys' fees

134. *Id.* at *7 n.11 (citations omitted).
135. *Banks*, 543 U.S. at 438.
136. *Id.*
137. *Id.* at 438-39.
138. Robert W. Wood & Dominic L. Daher, *Class Action Attorney Fees: Even Bigger Tax Problems!*, 101 Tax Notes 507, 507 (2003).

and costs can be especially high, with *Spina*-like results.[139] Unfortunately, the *Banks* case, with its side-stepping of the statutory fee issue, does not help to clarify this confusion.

B. Insurance Industry

Banks has had a curious effect on the insurance industry. The mere fact that it is an adverse decision on the attorneys' fees issue may prompt some plaintiffs to structure fees they otherwise would not. There is a growing trend of structured settlements outside the personal injury field.[140] A nonqualified structure, with its deferral of tax consequences, can ameliorate the AMT problems caused by attorneys' fees.

For some plaintiffs, *Banks* means that contingent attorneys' fees will continue to cause tax problems. For example, claims for defamation, false imprisonment, intentional or negligent infliction of emotional distress, and insurance bad faith will still give rise to attorneys' fee AMT problems. Any case with punitive damages, even true personal physical injury cases, can raise this problem, too.

Even employment claims that resulted in verdicts prior to October 23, 2004, may still be caught by this problem when they are resolved on appeal, since the effective date of the Jobs Act provision covers judgments "occurring" after October 22, 2004.[141] Successful litigants whose cases are on appeal will have a strong incentive to "settle" the case, since settlements, unlike having the verdict affirmed on appeal, should bring the case within the Jobs Act provision.

Structures of attorneys' fees themselves may become more popular after *Banks*. Some insurance companies have accomplished attorneys' fee structures with a section 130 qualified assignment.[142] Such companies have taken the view that in a true personal physical injury case, the lawyers' portion of the recovery

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139. *See* Liptak, *supra* note 26 (discussing Spina v. Forest Preserve Dist. of Cook County, 207 F. Supp. 2d 764 (N.D. Ill. 2002)).

140. Robert W. Wood, *Structured Settlements in Non-Physical-Injury Cases: Tax Risks?*, 104 TAX NOTES 511, 511 (2004).

141. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 703, 118 Stat. 1418, 1548 (2004) (codified as amended at I.R.C. § 62 (West 2005)); *Banks*, 543 U.S. at 433 ("The Act is not retroactive . . . it does not pertain here").

142. *See* Robert Wood, *Structuring Attorneys' Fees: What's All the Fuss?*, 60 Washington State Bar News 2 (Feb. 2006); I.R.C. § 130 (2000).

can be structured because it too represents section 104 damages, at least to the plaintiff.[143]

At least one insurance company, on the other hand, has shied away from using a qualified assignment company, and used a nonqualified assignment company.[144] *Banks* solidified the view that damages (outside the statutory fee area) belong to the client, first and foremost. This view may make insurance companies more comfortable using qualified assignment companies for structured settlements of attorneys' fees, leading to more structures of attorneys' fees, since the number of providers will grow.

A related point is that structures of attorneys' fees may get a boost from the implications *Banks* has on section 72(u) of the Code.[145] This section taxes the cash build-up in value of a life insurance policy in certain cases.[146] A notable exception is a "qualified funding asset" as defined in section 130(d) of the Code.[147] This provision, therefore, favors qualified structured settlements (within the meaning of sections 104 and 130) as opposed to unqualified (meaning taxable) ones. It has led at least one insurance company to position its assignment company outside the United States for creating nonqualified structures.[148] The *Banks* decision suggested that contingent attorneys' fees "generally" belong to the client first, so that even the attorneys' portion of the award can be structured with a domestic assignment company.[149] The fact that structures of attorneys' fees can be domestic in light of *Banks* suggests that there may be more attorneys' fees structures in the future.

C. Other Misconceptions

It is perhaps a sign of how widely the Court's decision was anticipated that there was much confusion when it was handed down. The *Los Angeles Times* initially reported that *Banks* meant that all personal injury recoveries might be taxable.[150] This misunderstanding was quickly pointed out to the *Los Angeles Times*,

143. *See* Wood, *supra* note 142; I.R.C. § 130 (2000); I.R.C. § 104 (2000).
144. Wood, *supra* note 140, at 511.
145. I.R.C. § 72(u) (2000).
146. *Id.*
147. *Id.* § 130(d).
148. Wood, *supra* note 140, at 511.
149. Banks v. Comm'r, 543 U.S. 426, 430 (2005).
150. David G. Savage, *Lawsuit Winners Lose the Tax Battle*, LOS ANGELES TIMES, Jan. 25, 2005, at A14.

which in turn published a correction.[151] All this created considerably more hubbub than one usually sees with a tax case.

D. Continuing Controversy

Perhaps practitioners were wrong to think that the Court, already materially aided by Congress's enactment of the Jobs Act, would clear up the taxation of contingent attorneys' fees in a tidy way. In fact, the Court's decision was underwhelming, though perhaps its lack of precision and the several areas it declined to consider will allow for some taxpayer planning.

There are some cases that are not resolved by the Jobs Act, and also not resolved by the *Banks* opinion. First, False Claims Act cases are expressly not covered by *Banks*.[152] False Claims Act cases that predate the Jobs Act (or False Claims Act cases that are resolved on appeal and the subject of a verdict relating back to a date prior to October 23, 2004) are governed by old law.[153] Since there is no definitive case dealing with the tax implications of a False Claims Act case, it would appear that the old circuit court split controls.

At the same time, one could argue that a False Claims Act case is fundamentally different from any other attorneys' fee situation. A relator in a False Claims Act case serves as a private attorney general and is in the nature of a bounty hunter.[154] Such an endeavor plainly sounds more like a trade or business than the activity in a typical employment case. Therefore, one might argue that a Schedule C treatment for the qui tam recovery would be the appropriate tax treatment. On a Schedule C, of course, there would be a natural netting of the attorneys' fees without running afoul of the 2% itemized deduction threshold, phaseout or AMT.[155]

Secondly, another big area left open by *Banks* is the statutory fees issue. The Court seemed to invite structures to avoid the *Banks* result by noting that in *Banks*, there was no suggestion that there was a court award of attorneys' fees, and no statement as to the contingent fee award being obviated when there was a statutory award in either the fee agreement or in the settlement

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151. *For the Record*, LOS ANGELES TIMES, Jan. 26, 2005, at A2.

152. *Banks*, 543 U.S. at 429-39.

153. Small Business Job Protection Act of 1996, Pub. L. No. 104-168, § 703(b), 110 Stat. 1755 (1996) (codified as amended at I.R.C. § 26 (West 2005)).

154. 31 U.S.C. § 3730(b) (2000).

155. I.R.C. §§ 55, 67(a) (2000).

agreement.[156] In many cases it would be fairly simple to add one of these elements, and the Court suggested that it might make for a better tax result.

Practitioners might consider adding a statement in a settlement agreement that the lawyer is receiving his or her money directly from the defendant and in lieu of statutory fees that would be awarded in the case had the case gone to trial. Alternatively, or in addition, this could be addressed in the contingent fee agreement between lawyer and client. Contingent fee agreements can be amended, and it may be appropriate to amend or clarify a contingent fee agreement before the case settles. Such an amendment could presumably be made effective as of the date of the original agreement. It is conceivable that such planning may avoid the result reached in *Banks*.

Thirdly, another huge area left open by *Banks* is the situation where there is injunctive relief. A taxpayer who is seeking injunctive relief may end up with enormous attorneys' fees and a relatively small net award.[157] The fact that the Court in *Banks* avoided this fact pattern suggests that perhaps a plaintiff can avoid the *Banks* result in a case of this sort. Allocating attorneys' fees between the injunctive relief and the cash compensation may be one alternative. Mandating the direct payment of the attorneys' fees, providing the appropriate language in the settlement agreement, and making sure that a Form 1099 goes directly (and only) to the lawyers, may also help to obviate the general rule announced in *Banks*.

Fourthly, another open area concerns the theory that the lawyer and client may be in partnership, thus dividing the gross income between the client and attorney. Although the Court devoted one sentence to rejecting the partnership theory at the beginning of the *Banks* opinion, it later said that it was not considering the partnership theory at all.[158] That leads one to wonder whether partnership-like language in a contingent fee agreement may be enough to avoid the general rule announced in *Banks*. Attorneys may consider adding something like the following to a fee agreement: "This agreement will be interpreted as a partnership between lawyer and client to the maximum extent permitted by law."

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156. *Banks*, 543 U.S. at 434.

157. *See* Liptak, *supra* note 26 (discussing Spina v. Forest Preserve Dist. of Cook County, 207 F. Supp. 2d 764 (N.D. Ill. 2002)).

158. *Banks*, 543 U.S. at 437-38.

Unfortunately, there is one Tax Court case post-*Banks* which suggested that meeting the partnership theory may be difficult. In *Allum v. Commissioner*, the plaintiff argued that taxation of attorneys' fees was not dictated by *Banks*, and the Tax Court demanded items of proof.[159] Finding no evidence of any kind of partnership between Mr. Allum and his lawyer, the Tax Court found that *Banks* controlled.[160] The Tax Court seemed to indicate that a high standard will apply to partnership determinations, although in Allum's case there was little to suggest a partnership. In fact, Allum admitted he "hired" his lawyer.[161]

It is unclear, of course, exactly how high a standard will apply. In *Allum*, the taxpayer had done nothing to support the argument that there was a partnership. Given the lack of evidence, it does not seem surprising that the taxpayer's argument based on the partnership theory failed. It remains to be seen whether more significant compliance with partnership-like characteristics might make a difference and might come within the exception to the general rule of *Banks*.

V. CONCLUSION

The federal income tax treatment of attorneys' contingent fees has had a tortured past. Its present has been populated by two enormously significant legal developments, beginning with the Jobs Act in 2004,[162] and culminating in the Court's *Banks* decision in early 2005.[163] Unfortunately, both of these momentous developments have not resolved many of the legal questions that will arise in future tax cases involving taxation of attorneys' fees.

Regrettably, although the Jobs Act eliminates attorneys' fee tax problems from a significant class of cases (employment cases and Federal False Claims Act cases), it plainly did not address the vast population of other litigation claims.[164] Because employment cases posed the most obvious attorneys' fee problems, the mere fact that Congress carved those cases out of the problem (allowing them an above-the-line deduction) may actually have made mat-

159. Allum v. Comm'r, 90 T.C.M. (CCH) 74 (2005), 2005 WL 1692488, at *9 (T.C. July 20, 2005).

160. *Id.* at *10.

161. *Id.* at *4.

162. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 703, 118 Stat. 1418, 1548 (2004) (codified as amended at I.R.C. § 62 (West 2005)).

163. *Banks*, 543 U.S. at 426.

164. American Jobs Creation Act § 703.

ters worse from a broader perspective. It now seems significantly less likely in the current political environment that tax legislation to eliminate the attorneys' fee problem will emerge.

The Court's *Banks* decision purported to set forth a general rule that attorneys' fees will be included in plaintiffs' gross income even if paid directly to their contingent fee attorney.[165] Plainly, though, the Court left open certain avenues by which taxpayers will continue to seek creative methods of avoiding the unfortunate result dictated by *Banks*. Indeed, few would argue that the *Banks* approach is equitable. Several recent post-*Banks* cases suggest that courts may consider both the statutory fee argument and the partnership skeptically, but taxpayers are likely to continue to assert these arguments, providing additional tax cases on this point in the future.

Other planning opportunities may surface. Taxpayers, tax advisers, the IRS, and the courts all need time to digest the Court's ruling and its impact. Bear in mind, too, that all this comes on the heels of the Jobs Act, which itself is hardly a model of clarity.

This article has speculated whether the employment claim focus of the Jobs Act, coupled with the IRS's victory in *Banks*, invites allocation. Thus, in the typical mixed-claim litigation, the IRS may seek to allocate fees between "good" employment claims (that give rise to an above-the-line attorneys' fee deduction) and other "bad" claims. If the IRS bifurcates cases, then the *Banks* rule, with its various exceptions, will become that much more important.

165. *Banks*, 543 U.S. at 429.