Attorneys' Fees Continue to Raise Tax Issues

By Robert W. Wood[1]

The January 24, 2005 Supreme Court's decision in *Commissioner v. Banks* and *Commissioner v. Banaitis*[2] (which were consolidated for briefing and argument) was widely anticipated. These cases on the treatment of attorneys' fees came on the heels of a decade of bitterly fought litigation, leaving a deep rift in the Circuit Courts around the United States. The lack of uniformity and injustice of the rule prevailing in the majority of circuits lead to forum shopping and frequent gerrymandering of attorneys' fees arrangements. All this, in an attempt to avoid the plaintiff being taxed on money he never sees.

The actual holding of the case is brief and succinct, and bears quoting, particularly since there will be much speculation about what this opinion does and does not do. All – and I think it is fair to say that this truly means all – that the Supreme Court ruled is that:

> "We hold 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."[3]

Since the Supreme Court has announced a general rule, it has implicitly endorsed that there will be exceptions. Indeed, the Court expressly notes that it is not considering the following situations:

- The contingent fee agreement establishes a Subchapter K partnership;
- Litigation recoveries are proceeds from the disposition of property, so that the attorneys' fees must be subtracted as a capital expense from the proceeds;
- Attorneys' fees are deductible reimbursed employee business expenses
- Federal False Claims Act cases[4];
- Statutory fee-shifting cases; and
- Injunctive relief.

It certainly appears that the Supreme Court has left open much of the debate. Meanwhile, Congress attempted to address the problem, prospectively at least, in the American Jobs Creation Act of 2004 ("Jobs Act"), which was signed into law on October 22, 2004.[5] Unfortunately, the Jobs Act provision only applies to employment claims and to Federal False Claims Act Claims. Therefore, it does not resolve the attorneys' fee problem (even prospectively) in a large number of cases.[6] Moreover, even in the classes of cases to which the new above-the-line deduction applies, the provision is only prospective in effect – at least by its terms. I qualify this statement because considerable attention has been paid to the effective date of the new above-the-line deduction of the Jobs Act.

Although stated to apply only prospectively, a now well-known Senate floor debate suggests that the Senate (or at least Senators Baucus and Grassley) believe that the Jobs Act provision merely reaffirms existing (good Circuit) law on the tax treatment of attorneys' fees. The 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."[7]

I. PROSPECTIVE EFFECTIVE DATE

One can question the slightly different technical approach to the issue previously provided by the good Circuits (i.e., the attorneys' fees do not represent income to the plaintiff at all) compared with the Jobs Act (i.e., the attorneys' fees represent gross income, but qualify for an above-the-line deduction). In any case, despite the appeal of a retrospective effective date based on Senate floor discussion, the language of the statute itself calls for a prospective effective date. It will be interesting to see if, when, and how this effective date debate will raise its head in the future. Unfortunately, the Supreme Court, in *Banks* and *Banaitis* did little to quell this debate.

However, on a considerably more pedestrian level, mere examination of the Jobs Act provision itself raises legitimate questions as to how one determines what settlements or judgments are covered by the new law. Looking at this issue recently, I was surprised that the answer does not seem to be more clear-cut. I was also surprised that the result, at least based on my reading of this issue, does not seem to be terribly fair.

Settlements seem to be straightforward. Both the execution of the settlement agreement and the payment of the money must occur after October 22, 2004 to qualify for the protection of the new above-the-line deduction. Judgments, however, are not so simple. Relying upon common sense (dangerous with tax law, I recognize), I would have thought that in the case of a judgment, the new law would apply to any judgment that becomes final after the date of enactment (October 22, 2004). After all, a verdict may be appealed, and this may prevent a judgment from becoming final and enforceable for years.

Some judgments predating the enactment of the Jobs Act may be on appeal and may not get resolved until 2005 or 2006. Consider the following example:

> *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 November 2004. On December 15, 2004, the date for petition for rehearing to the state Supreme Court expires and the defendant prepares to pay the judgment. When the defendant pays the judgment, is the plaintiff governed by the old attorneys' fee law (split in the Circuits, etc.), or is the plaintiff entitled to the above-the-line deduction available under the Jobs Act?

The Jobs Act's amendment to I.R.C. § 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*."[8] The triggering event here is when the judgment can be said to "occur."

II. WHEN DOES A JUDGMENT OCCUR?

I do not find a ready answer in the statute or its legislative history to the question when a judgment is considered to "occur." Presumably, this generic layman-like language refers to something different 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.

Granted, there have been some similar effective date provisions in related areas in the past. However, many of these have been more clear-cut. For example, when the 1996 Act added the physical modifier to I.R.C. § 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.

The time at which a judgment "occurs," on the other hand, is not too precise. This language of the statute prompted me to look to other areas of the tax law. In the context of the priority of a federal tax lien, a judgment "occurs" when the judgment is first rendered by the court.[9] In *United States v. Dishman Indep. Oil Co., Inc.*, 46 F.3d 523 (6th Cir. 1995), the court 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, in reciting the facts of the case, 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.
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> 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. *In re Dishman Indep. Oil Corp.*, Nos. 91-00057, Adv. No. 91-0078, 1993 WL 110032 (Bankr. E.D. Ky. Jan. 8, 1993).

> The district court affirmed the bankruptcy court's order granting Dishman's motion for summary judgment."[10]

The taxpayer appealed the case to the Sixth Circuit, and that court recognized that the taxpayer's judgment occurred on April 27, 1992, notwithstanding the appeals. The court stated:

> "We believe this issue is controlled by the holding of *United States v. Acri,* 348 U.S. 211 (1955), 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. *Id.* at 214. In *Acri,* the Court was not persuaded by the recognition of the attachment lien as perfected under Ohio law. Id. at 213. 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. *Id*. at 214.[11]

I recognize that these lien authorities are not necessarily controlling for fixing when a judgment occurs for purposes of I.R.C. § 62. Nevertheless, these authorities do appear to give the IRS authority to conclude that a judgment occurs when it is first rendered. They also suggest that the IRS would interpret this "occurring" term in a general way, rather than by reference to some technical lapsing of appeal periods, or to a judgment somehow 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 statute's effective date, with its almost simplistic concept of the occurrence of a judgment as a trigger for the effective date of this important provision, would seem to preclude the new law applying to many cases.

III. SETTLEMENTS ARE BETTER

I have not yet faced a case where a thorough and painstaking answer to this judgment "occurring" question has to be given. Fortunately, in many cases, it should be possible to enter into a settlement agreement to make the timing of the judgment irrelevant. Thus, if a judgment would otherwise not be covered by the new above-the-line deduction because the judgment occurred prior to October 23, 2004, a settlement of the dispute between plaintiff and defendant after October 22, 2004 would seem to work. 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, even if there is no appeal or other action still possible, a settlement may still be effective in invoking the new law. The plaintiff who needs the 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, perhaps agreeing to confidentiality obligations, or other non-monetary items. Given the procedural wranglings (and just plain 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 in the judgment.

There may conceivably be cases in which the defendant insists on paying the judgment and not settling a case. Conceivably, 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 tax benefits. However, in the vast majority of cases, a settlement should be possible, which hopefully will secure the plaintiff's above-the-line deduction.

Of course, there will be continuing tension about the *Banks* case and its scope since plaintiffs certainly won't want gross income on attorneys' fees if they do not qualify for the above-the-line deduction.

ENDNOTES

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2. 543 U.S. _____; 2005 U.S. Lexis 1370 (2005).

3. *Id.*

4. Federal False Claims Act cases are covered by the American Jobs Creation Act of 2004.

5. P.L. 108-357, 10/22/2004.

6. See Wood, Robert, *Jobs Act Attorney Fee Provision: Is It Enough?*, TAX NOTES, Vol. 105, No. 8, (Nov. 15, 2004), p.961.

7. Congressional Record S11036, October 10, 2004.

8. P.L. 108-357, Section 703(c), 10/22/2004.

9. *See, In Re Crocker Nat'l Bank v. Trical Mfg Co.,* 37 AFTR 2d 76-592 (9th Cir. 1975); *United States v. Morrison,* 247 F.2d 285 (5th Cir. 1957).

10. *United States v. Dishman Indep. Oil Co., Inc*., 46 F.3d 523, 525 (6th Cir. 1995).

11. *Id.* at 527 (emphasis added).